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Economies & Diseconomies of Scale – Growing Your Charter Organization Intelligently

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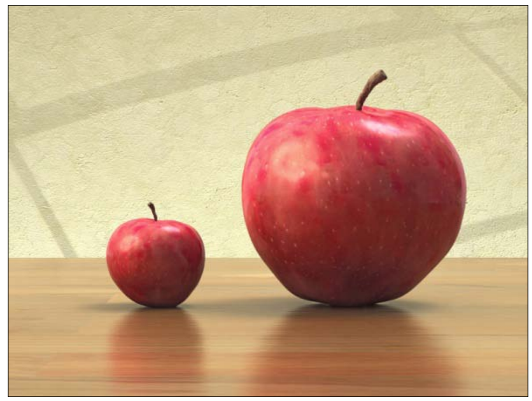
As charter schools successfully navigate the first few years of existence, some explore growth and expansion opportunities. For some charter schools, growth and expansion are part of the original plan, while for others plans for expansion emerge over time. There are many arguments for growth – increased reach and impact, expanded programming, better economic efficiencies and stability, to name a few. In this article, we'd like to focus on the financial side of growing and scaling, and explore both the economies and diseconomies of scale. It is a commonly held belief that growth and scale automatically equate to scalability and sustainability for charter schools. This assumption oversimplifies the challenges of growth and doesn't honor the synergistic convergence of key circumstances, thoughtful decisions, and intended outcomes. Moreover, it ignores the real danger of diseconomies of scale without intervention as organizations grow.



What does charter school growth look like?

Charter growth is often equated with the development of a CMO, however, growth towards financial sustainability can, should, and does take many forms, for example:

- Enrollment and grade growth expansion within a single charter
- Expansion to other sites under the same charter
- Additional charters and replication
- Confederations or alliances between independent charter schools
- Takeovers, turnarounds, absorptions and mergers
- Informal and formal creation of administrative or central office functions to manage multiple charter schools
- Scale-ups and scale-outs

Ultimately, an organization's growth goals should not be informed by the type of growth, but rather, the *growth goals should inform the type of growth*. And if the goal is financial sustainability, it's also important to note that it's all relative and "success" on the financial sustainability front isn't necessarily limited to one particular type or form of growth. There are many successful stories from various organizations with very different objectives, competencies, scales and pace.

What should be consistent across charter school growth and expansion?

What is consistent across the spectrum of charter school organizations successfully exploring growth and expansion is the presence of a formal strategy. Successful organizations have created extensive growth plans that reflect mapped-out processes, timelines, financial assumptions and considerations. If you are considering growth as a means to financial sustainability, you must codify the assumptions and key performance indicators. Your growth strategy should have the flexibility to evolve, and it should be easily aligned with, but not constrained by, other organizational documents like your charter, mission, and broader strategic plan. The plan should incorporate business plan elements, and should clearly speak to cost, time, and resources deemed necessary. Though it can be a difficult and time-consuming exercise, the process of writing a strong and executable plan is essential to putting a successful growth strategy into action.

We also couldn't talk about financial considerations without considering perhaps one of the most fundamental economic drivers – ***demand***. It is essential for you and your team to assess and quantify the true demand for additional educational offerings. Whether that demand is existing or speculative, organic or cultivated, **substantiate it**. Focus on a target range - not a specific number - that will meet your requirements. Focusing on a target range instead of a target number will allow for flexibility in decision making, and you won't run the risk of creating a strategy that is unsustainable due to a small variance in ADA. Moreover, if the existing school or organization is not currently at full capacity, focus on reaching capacity before "doubling down" and embarking on other growth endeavors. Although the desire to add schools to supplement or subsidize existing revenue streams may seem attractive, that calculus often doesn't account for the costs and obligations that come with more schools and growth: ***dis***economies of scale can undercut a charter school leader's plans.

Defining Economy

Economy of scale in an educational context is the decline of per-pupil costs as a charter school grows, typically due to the more efficient use of fixed costs such as facilities or administrative overhead that are spread over a larger student base. This decrease in per-pupil cost is advantageous because of the potential resources or revenues it then frees up – costs go down per student, but the revenue per student stays the same. Economies of scale can sometimes be confused with revenues and costs growing proportional to the base case, where the per-pupil amounts stay the same in both cases. While it is true that a charter school will then see more revenue in terms of total dollars, the difference between revenues and costs is not increasing, which is the intended benefit of a true economy of scale.

A diseconomy of scale, on the other hand, is triggered when charter school growth creates operational demands that add fixed costs and increase the per-pupil cost. While our anecdotal experience with the inefficient bureaucracies of large organizations might suggest that diseconomies are more common in larger charter school organizations, it turns out that diseconomies of scale aren't limited to any particular profile. Unexpected costs may trigger diseconomies more easily in single charters or newer charter organizations when enrollment is lower and the overall margins are smaller. Oftentimes, mid-size charter organizations can see difficulties as they navigate and transition from smaller to larger organizations. And as intuition would suggest, many larger charter organizations have also been observed to have, and have self-reported, their own challenges with scale, particularly as they increase their geographic footprint, centralize, and approach district size.[i]

As charter schools and charter organizations grow, several parts of the budget will naturally see diseconomies unless carefully managed. For example, any school task managed by volunteers may require paid staff as the organization grows. Tasks such as lunch service, recess supervision, or data entry can be handled well by volunteers when a school is small, but once it grows past ~300 students, the management challenges with volunteers many times outweigh the benefits. School leadership often feels the indirect impact of diseconomies of scale, so that while the percentage of budget spending may decrease with charter size, the school leadership's time and energy can be spread too thin.

Benefits of economies of scale can potentially create an environment conducive for diseconomies. Charter schools are often looking for ways to drive per pupil costs down in order to redeploy resources to supplemental program offerings. In that redeployment, those "new" costs are contingent upon that initial revenue/cost differential continuing, but may not necessarily lend themselves to being scaled back. For example, a charter school may decide to open a second school and leverage some of the unobligated resources on an afterschool program. What happens if one of the charter schools, for whatever reason, isn't renewed? Certainly the remaining school will have to change how it spends its resources, but how feasible will it be to shut down an afterschool program, particularly once it's had time to become a valued part of the educational offering?

It is these kinds of considerations that charter school leaders and board members must keep in mind when thinking about growth and expansion. And while this is by no means exhaustive, the following are some of the main areas of consideration when exploring growth and expansion opportunities and their financial impact.

Upfront Resources

Understanding what resources you need upfront is critical, but that depends on determining the true cost of initial expansion efforts, which can be tricky. Most growth strategies often rely on some form of in-kind leveraging of existing resources, but the growth can actually divert said resources, as well as time and energy of existing personnel, and ultimately can have some more removed financial impact elsewhere in the organization. Mitigate this dissociation by quantifying the in-kind benefits that the new school or endeavor will receive. If personnel are spending time on the new endeavor, it's imperative to approximate the time spent and calculate pro-rata costs appropriately. If supplies or materials are likely to be consumed, consider creating a specific budget or line item within the existing school's budget for purchases or services associated with the new growth opportunity. If you are borrowing from one school for another school, associate the costs of borrowing with growth activity; some larger organizations artificially shoulder debt across a portfolio which may make their financial picture appear better than it truly is. Your thought exercise around estimating costs should consist of "if I didn't have an existing charter school to support these growth efforts, what would I have to otherwise pay for?"

Being realistic about the upfront resources available to your new growth endeavor is also critical. Previous go-to startup resources like the PCSGP and Revolving Loan programs have been less dependable in recent years. Programs like the Charter School Growth Fund come with ambitious growth requirements that may not fit into your strategy. The ability of an existing charter school to leverage fund balances and cash reserves for a new school is becoming increasingly difficult with the current deferral climate in California. The private and philanthropic resources that a number of the larger CMOs rely on may be an opportunity, but the ability to tap into these resources may be limited or outside of your organizational profile. For example, Rocketship Education targets $3.75M in startup funding for 8 schools and 4,000 students to support activities prior to scaling; KIPP LA was targeting over $4M recently to support growth expansion.[ii]

Ongoing Finances

With limited resources beyond public dollars available to charter schools, creating opportunities for sustainable growth will mean focusing on the cost side of the equation, specifically at the school-level. Building off the earlier discussion of philanthropic support, most of those resources going to the larger organizations aren't going to school-specific costs, but rather to subsidize administrative offices as they reach scale and subsidize their own administrative offices. These larger organizations are not just relying on pupils to close this gap, but are actually driving their costs down. Technology has been critical for curtailing costs for larger organizations, as well as strategic sourcing and procurement, which offer degrees of opportunity for organizations of all scales. Some element of outsourcing is also likely necessary initially, particularly for smaller organizations, but it comes with tradeoffs for the cost savings and should be approached strategically. Group purchasing programs offered by organizations like CCSA may appear to have limited return, but in aggregate, can be significant for your bottom-line.

Driving ongoing costs down not only requires good visibility into your own spending data, but also good benchmarking data to compare your spending relative to peer organizations and contexts. Benchmarking gives you a good point for evaluating your own opportunity for savings as well as on specific areas to focus, and also illuminates probable areas where you can expect costs to rise or fall as you grow. For example, consultant expenses, when comparing standalones and CMOs, are fairly comparable at around 11-12% of total spending[iii], so the opportunity for turning that dial down as you grow would seem to be minimal.

Staffing

Staffing can be the largest opportunity for achieving economies of scale benefits, but requires focused and diligent work to accomplish this goal. Based on 2009-10 financial data, CMO staffing and benefits costs, not including central office staff, averaged around 56% of total spending vs. 64% at standalone schools.[iv] Keep in mind, the percentage of spending on teachers does tend to increase over time. Instructional staff, particularly elective teachers, supplemental roles, and classified staff may be the greatest subset opportunities for scaling. It is essential to develop clear decision points for adding or subtracting staff, and developing a staffing pipeline vs. managing other recruitment costs, can be quite difficult. Additionally, staff-to-student ratios need to come down over time, so as mentioned earlier, systems investments need to be in place to create higher efficiencies, all the while ensuring that you're not burning out your staff.

Facilities

Facilities can be a pain point for any single charter school, but organizational growth can add another layer of complexity and headache. There are many different facility options and resources, and growing charter organizations must rely on a number of options that scaffold and complement each other. Prop 39 facilities seem to be a preferred option cost-wise, as well as a way to address needs as the organization grows to its full scale, but there are unique challenges associated with this method, particularly for smaller organizations. For example, the process can be particularly laborious and time consuming, unless you can generate some efficiency brokering multi-school, multi-year agreements.

Commercial leases can offer attractive initial terms but can escalate over time, pushing per-pupil costs past sustainability, particularly within this relatively flat funding environment, and this option obviously needs to be revisited on a multi-year basis. New construction or renovation may be one of the strategic growth priorities, but often comes with its own potential diseconomies of scale when true construction costs and tenant improvements are not figured into the initial analysis. Many of the larger charter organizations are investing early on in full-time facilities staff to save down the line, but full-time staff may not be within the means of a single charter school exploring a new growth opportunity.

Parting Thoughts

Done thoughtfully and methodically, growth and expansion of your charter school can yield meaningful financial benefits. Much of the information covered here offers a good starting point, but is by no means exhaustive of what should go into a growth strategy. If you're interested in learning more or have specific questions or comments, feel free to email gasper@edtec.com.

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[i] Several white papers and studies have been done on the topic of economies and diseconomies of scale of CMOs. In Lake et al., *National Study of CMO Effectiveness,* 2010 and Lake et al., *Paying for Scale: Results of a Symposium on CMO Finance,* 2011, many of the larger CMOs self-reported that they had still yet to reach scale, well behind initial projections

[ii] Based on promotional materials on growth strategies from both organizations

[iii] *Measuring Up: Using and Understanding Benchmarks for Budgeting,* CCSA Conference 2012

[iv] *Measuring Up: Using and Understanding Benchmarks for Budgeting,* CCSA Conference 2012