

**A better design of the market for vocational
education and training in Australia?**

A discussion

by

**Michael Cooney
Policy Director, Per Capita**

October 2008

A better design of the market for vocational education and training in Australia?

Summary

The case for reforming the way we do vocational education and training in Australia is strong.

Training is important to wider social and economic policy questions – but it is not done well enough at the moment and this needs to change.

The Victorian and Federal Governments are making big changes, which represent real potential progress.

The demand-side proposals hold real promise. The best argument will deal with the supply-side consequences, especially for existing public providers.

The challenges for governance, workforce, infrastructure are real and the policy needs to evolve rapidly and effectively to take a sophisticated account of these challenges without compromising the benefits of a demand-side approach.

The key is integration of these different objectives into a well designed solution – not balancing these different objectives with competing solutions.

Introduction

Per Capita is an independent, progressive think tank, dedicated to developing a new vision for Australia, with fresh ideas backed by hard evidence.

This Per Capita paper, *A better design of the market for vocational education and training in Australia?*, is designed to provoke discussion of proposed Victorian and Commonwealth Government reforms to vocational training and education. This is an important area of public policy, and one where considerable changes are being proposed. So we hope to encourage a better-informed conversation about these changes, in turn leading to better decision-making by all those responsible.

The paper is to be presented to a seminar hosted by RMIT, where the reforms will be discussed by panels including labour market experts, industry representatives, training providers, and other interested parties. These participants, and many in our audience, intimately understand the detail of how training is delivered in Australia. On the other hand we are, as it were, expert generalists.

So Per Capita's approach in this paper is not to re-state the structure of the existing system, or the details of the new changes, in any exhaustive way. While we introduce those elements, we hope to move rapidly on to offer new contributions to the discussion, in two ways.

One is by discussing how the proposed reforms fit in with the emerging policy framework known as "market design", which is increasingly recognised as a distinctive aspect of the way Australian governments think about delivering public goods. This kind of thinking can illustrate some important strengths of the reform proposals.

The other is by highlighting some salient issues, problems and questions arising from the proposed reforms, in the light of the market design framework. Rather than an exhaustive survey of all the possible problems and solutions in these very broad ranging changes, we seek to bring out a few which are both important to the intended outcomes of the reforms, and relevant to wider market design concepts.

To that end, the paper is structured in five parts.

First, we set the frame with a brief discussion of why training matters. We look briefly at how training has fit into Australia's recent economic history. And we reduce the question to its human core: what advice should you give a young person about training?

Second, we explore the concept of “market design” as it is being applied to a range of public policy questions in Australia. And we apply the market design framework to training in particular, considering what this type of analysis can tell us about problems in training markets, and about possible solutions.

Third, we touch on the key elements of what the Federal and Victorian Governments are proposing, in their redesign of the market for training. And we explore in brief the key themes of the new agenda.

Fourth, we specifically consider the implications of these “demand-driven” reforms for the “supply-side” of the training market – especially the questions that arise about how to generate future investment in training infrastructure and the training workforce while ensuring public training institutions can effectively compete.

And fifth and last, we ask, what else? We raise a number of leading questions for the reform agenda – wider questions about the longer-term policy questions and the issues on the supply-side. The test of a good conversation about this area may well be that it raises more questions than it answers.

Our conclusion?

In short, that the present demand-driven proposals hold enormous promise – but that they must rapidly evolve to a full market design model, becoming more sophisticated and more detailed, and especially taking more account of the complexity of the supply side, if they are to succeed.

Part one: why training matters

Training is important in Australia's specific circumstances today ...

Australia has a pressing need to increase its human capital: the stock of skills and knowledge embodied in Australia's people. This need to increase our human capital is both economic and social. Improving our vocational training is, in turn, critical to increasing our human capital.

In our economy, even as global markets encounter unprecedented instability, shortages of skilled labour, and increasingly of unskilled labour too, threaten upward pressure on wages and prices, with wider negative effects in turn. While lifting workforce participation and increasing skilled migration can provide some relief, these shortages cannot be filled without forming new skills for existing workers and for those entering the workforce. This is especially true as increased participation and immigration put short-term pressure on infrastructure. Ultimately, opportunities for growth are at stake, with the potential economic costs and benefits to all of us are very real.

In our society, vocational training and skill formation play a critical role in building social inclusion. Training is a key to successful transition from school to work, from welfare to work, and to ensure workers who lose jobs as a result of economic change are quickly re-employed. Good training outcomes in these areas will in turn help ensure people are genuinely included in the wider society: not only helping people remain employed, but helping them become and remain well served and listened to by Government, personally resilient and well-connected.

... and training has always been important.

Training has always created value, not only for the person being trained and the person doing the training, value which individuals and firms find difficult to capture. This is true for instance of formal, credentialed training that is recognised outside the immediate context of the firm or person providing the training. Formal, credentialed training specifically increases a person's ability to move jobs, and by definition, employers who provide such training cannot capture the full value of that.

The way this problem has been addressed in the Australian economy has changed profoundly, along with the economy, through the post-war era.

Traditionally, many companies tried to capture some of these positive externalities by indenturing part of the trained workforce. Training would be provided conditional on various kinds of return of service obligations placed on the student. At the same time the state, through its ownership

of industrial capital in utilities like telecommunications, electricity generation and transport, provided a massive boost to training and skills formation, which generated benefits right across the old industrial economy.

Change came, reducing the incentives for firms to grow individuals' skills.

Indentured labour arrangements largely became uncompetitive, though they do persist in some quite particular circumstances. A growing need for a labour market with greater short-term flexibility to respond to economic internationalisation – arguably alongside social changes which put greater emphasis on individual choice – forced this upon firms. In the same period, and for sound reasons, the state largely exited direct ownership of industrial capital, and new utility businesses cut investment in long-term skills in favour of shorter-term considerations.

Yet this change created new problems to be addressed. The growing reliance on stand-alone training institutions (such as TAFEs) to be the “supply side” of the training market saw a rationing of investment in skills formation and some loss of flexibility and responsiveness to industry needs.

In particular, this resulted in public funding for skills formation being pipelined through education funding, and considered principally as creating a social good, rather than for instance through support to industry, considered principally as building economic capacity. In Australia’s very economically focussed public and political culture, the result was inevitable – an effective stagnation in funding of skills formation over time.

While a shortage of investment in training is thus part of the problem, this shortage is itself a product of structural faults in the way training is funded. As a consequence, structural change is required, not simply increased spending through existing structures.

Change came again, increasing the incentive for individuals to invest in themselves.

Over the last decade, the great fact of the recent Australian economy has been the resource boom driven by growth in China and India. And one of the great implications of that fact is the boom in demand for skilled labour within Australia.

The skills and knowledge embodied in individual Australians have never been more valuable. The returns to individuals on investing in themselves have never been greater. And even with global financial markets unstable and uncertainty hanging over all economic forecasts, the prospects for those with skills and knowledge will remain higher than the prospects for those without.

The social and economic narrative come together in interesting ways

Interestingly, the growing economic returns on skills and knowledge fit neatly into an Australia where inequality and disadvantage remain, but classical notions of class in society have been swept away. Simply put, inequality and disadvantage are no longer determined by ownership relations with factors of production. And social conflict is no longer fought out between social groups determined by the source of their income.

In the age of human capital, everyone has become an owner of his or her own knowledge and skills. Young skilled workers now have huge potential earnings, just as, in the traditional imagination, white collar graduates did. This has any number of implications for policy and ideas.

For instance, white-collar graduates are able to make the most of income contingent loans to pay for their investment in human capital. They are able to defer tens of thousands of dollars in university fees under the HECS scheme. Yet while total fees for vocational training are almost always far lower than those for higher education, the up-front fees are comparable, and in some cases are actually higher. This is both unfair and bad economics.

All these wider social and economic changes pose hard questions for the way we deliver training in Australia, today and tomorrow.

Hard questions about the returns on investing in human capital

So where has that background brought us? Well, think about it this way.

Put aside the institutions and the policies for a moment and think of the training market in micro: think about one young person planning their life and career, and considering options for their own education and training, knowledge and skills.

What would you, the reader, advise this seventeen year old to do? Pursue a caring profession – say in nursing, or teaching? Join the defence forces? Become a doctor or a lawyer? Get a trade?

Now ask yourself this – what does the *economy* advise them to do? It's not an easy question. But it's the heart of the training policy dilemma.

Yes, there are real incentives to train, and we know that real demand for training exists. Aligning funding with this demand, and allowing providers to meet it where it exists, is the missing link. You can give that kid good advice, and even give them money to act on that advice – but you must have a system that allows them to act on it.

Training facts

Is there a firm link between incentive and return?

TAFE fees are approximately 12 per cent of course costs.

(Victorian Government, *Securing our future economic prosperity*, Discussion Paper on Skills Reform, April 2008)

"However current fees for students are unrelated to the level of training or the future financial benefit of undertaking the training."

"Training ... improves their chances of getting a job ... they can earn higher incomes ... up-front investment in study continues to pay off year after year. Estimates suggest that this payoff is high, at around 7 per cent or more of the total they pay in fees and the income they give up while they study."

(Chapman, B and Rodrigues, M, and Ryan, C (2007) "HECS for TAFE: the case for extending income contingent loans to the vocational education and training sector", Commonwealth Treasury Working Paper, 2007-2, April, cited in Victorian Government, *Securing our future economic prosperity*, Discussion Paper on Skills Reform, April 2008)

Is there a firm link between incentive and return?

"Recent research provides estimates of rates of return to students enrolling in vocational courses, that is, the impact on future income from attainment of these qualifications. Researchers found that rates of return are progressively higher for higher level vocational qualifications. For example, a Certificate III or IV qualification provides a healthy 20 per cent return. This is even higher for Diploma or Advanced Diploma qualifications which provide up to 37 per cent return."

(Long, M and Shah C 2008, "Private returns to Vocational Education and Training qualifications", National Centre for Vocational Education Research)

Training facts

Is there a firm link between incentive and return?

"We know, for instance, that having post-school VET qualifications reduces a young person's likelihood of being unemployed by an average of 40 per cent."

(Julia Gillard speech, ACPET 2008 National Conference, 29 August 2008)

"69 per cent of those who had not undertaken any post-school study were in full-time employment, compared with 91 per cent of participants in apprenticeship courses, 81 per cent of participants in traineeships, and 75 per cent of participants in non-apprenticeship VET programs."

(The ACER report on VET Pathways Taken by School Leavers written by David D Curtis, cited in Julia Gillard press release, "VET provides pathways to work", 18 September 2008.)

Are we building enough of new knowledge and skills?

"Forty per cent of students enrolled in Certificate II courses already hold a Certificate II or higher qualification."

(Office of Training and Tertiary Education, Department of Innovation, Industry and Regional Development, internal data, cited in Victorian Government, *Securing our future economic prosperity*, Discussion Paper on Skills Reform, April 2008)

"27 000 students missed out on a TAFE place across Australia last year."

(Australian Bureau of Statistics, *Education and Work*, 2007, cited in Victorian Government, *Securing our future economic prosperity*, Discussion Paper on Skills Reform, April 2008)

Training facts

Are we building enough of new knowledge and skills?

"On the basis of the current level of skill formation, in 2020 Australia will have nearly three times the proportion of low skilled or unskilled workers than the best performing countries."

(Australian Government, *Skilling Australia for the Future*, 2008)

"Continuing the existing level of training outcomes in vocational education and training would result in a shortfall of 240 000 in the VET trained workforce over the ten years to 2016."

(Shah and Burke, Report to National Training Reform Taskforce, November 2006, cited in SAF)

"Businesses continue to report that the lack of access to skilled workers is a significant barrier to their success."

(Allen Consulting Group (2006) *World Class Skills for World Class Industries*, Report to the Australian Industry Group, Sydney)

"State-run TAFEs dominat[e] the market and government funding [is] delivered primarily to these and other public institutions."

(Australian Government, *Skilling Australia for the Future*, 2008)

Part two: what is market design?

As we noted earlier, this paper is intended in part to discuss how the proposed reforms fit in with the emerging policy framework known as “market design”, which is increasingly recognised as a distinctive aspect of the way Australian governments think about delivering public goods.

So what does market design mean?

Market design is about setting the rules of the game to get the right outcomes – in new markets like carbon, water and broadband, and in old markets where existing provision has failed, like infrastructure and housing. With good market design, governments harness market forces by setting incentives and accounting for risk.

(Hetherington and Cooney, *The Investing Society: Memo to a Progressive Prime Minister*, Per Capita, November 2007)

In short, the market design idea allows us to analyse a policy problem according to the structure of buyers and sellers within that policy area, and develop new solutions which take account of these structural, economic features.

It’s not the same thing as expanding private provision or private purchasing, and it’s not the same thing as more contracting between government and private providers, or between individuals and private providers – though those practices may take place within market design oriented reforms. Rather, market design is an analytical framework, which recognises that markets are everywhere, and seeks to better understand them.

Rather than having empty debates about public versus private or market versus state, we see a new role emerging for government as a designer of markets. For instance, Medicare is a market for primary health care, and in many ways a well designed one. The Jobs Network is a market for employment services, one which has served the country well, but is ripe for new reforms. And so on.

It’s important to state clearly that market design is not a one-size fits all conception of the role of Government. Rather, it should be seen as a useful tool, in the right circumstances.

There are two conditions which must be present to warrant government embarking on an exercise in market design. Firstly, the circumstances of existing provision are such that the introduction of competitive forces is likely to improve cost and/or quality. Secondly, private provision alone is likely to generate significant market failure ... concentration of market power, externalities, information asymmetry or underprovision of public

goods. Where both of these conditions are met, governments face a genuine market design problem.

(Hetherington, *Market Design in Health & Wellness and Education & Training*, Per Capita, February 2008)

This thinking is having a growing influence on policy in Australia. Indeed a rash of recent newspaper articles discussing the term and its significance suggest this may grow into the future.

The Australian's Lenore Taylor ("Mix and match the new market design", *The Australian*, October 11) wrote recently:

When the US is considering partial nationalisation of its banking system and the British Government has already done it, at least temporarily, it seems safe to conclude that there's a fair bit of rethinking going on about the role of markets and the role of governments ... a way of thinking that sees markets not as some force of nature that governments seek to tame to greater or lesser extents but as a means to an end.

While in the same newspaper ("Mandarins with a market plan", *The Australian*, 27 September) economics correspondent David Uren had previously put it this way:

The concept of market design ... suggests new scope for government intervention and pops up frequently in the speeches of ministers such as Julia Gillard, Nicola Roxon and Penny Wong.

We believe market design is genuinely emerging as a key theme of the Rudd Government's governing project. In addition to the specific training agenda discussed in this paper, consider two recent public speeches by senior Government figures.

Deputy Prime Minister Julia Gillard's speech to the City of London Corporation (18 July 2008) spoke broadly of the role of market design in connecting diverse policy elements:

We are focusing on the fundamentals of market design. Whether it is an Emissions Trading Scheme – a market in carbon – or a national water market capable of incentivising water savings – or the growth of renewable energy sources – or the role of the labour market in lifting social mobility and workforce participation – or the adaptation of our tertiary education sector to a new global landscape – the same issues emerge. How can we develop markets which interact productively with strong public institutions and empower users to participate successfully in them?

While Health Minister Nicola Roxon, in her Bathurst Light on Hill speech (20 September, 2008), put emphasis on the explanatory power of this

idea in her own portfolio.

By leaving old contests and false contests behind, we can focus on real challenges instead – how can we make health care more accessible? How can we shift from a focus on hospitals to a focus on prevention? How can we use health policy to tackle disadvantage? How can we deliver health care that is better quality? Ultimately, better outcomes are what is important - and I doubt they will come from leaving markets behind or arguing for full public ownership or nationalisation. Instead, we need to ask whether we can design markets more effectively – and how we can strike the right balance between the market and government intervention to deliver the outcomes we need. [*emphasis added*]

And in the same period, speeches and statements by the Prime Minister, Kevin Rudd, the Treasurer, Wayne Swan, and the Minister for Climate Change, Penny Wong, have struck similar notes.

A new agenda?

“We need to establish a properly designed market that will allocate resources in the most intelligent way but without ignoring important quality and equity issues.

“Thanks to the existence of a large pool of high quality private providers Australia already has a market for vocational training provision. The point is to make it work at an optimal level by combining a strong institutional framework with fully empowered and informed consumers and measures to prevent the disadvantaged from being excluded.

“Attempts by previous government to create a training market have not been fully successful because they neglected to design an adequate market structure. Instead they focused almost solely on subsidizing private providers at the expense of universal service provision.”

(Julia Gillard speech, ACPET 2008 National Conference, 29 August 2008)

The point we wish to discuss in more detail is this: can this increasingly influential idea help us to judge the reforms being proposed in training?

The characteristic market design approach is not only to ask “who should deliver training and how” (the supply-side question) but “who should buy training, and why” (the demand-side question).

We can identify at least four different populations of students who could buy training, each with different purposes for their purchase:

- School leavers, to manage school to work transitions
- Existing workers, to upskill and meet demands of their firms
- Workers changing jobs, retraining to meet their own need for new work
- Individuals moving from welfare to work

In each case, individuals receiving training will benefit from their training, but there will be benefits to industry and to the public as a whole.

All these transactions will in their own way benefit the public, and industry, as well as the individual, to different extents and in different ways over time.

This is why in a well designed system, student, industry, and government all share the cost of buying training: because they all benefit.

Individuals shouldn't pay for all of it: as well as externalities for their employer and the public, "prior endowments" mean that those who need training the most may be least likely to be able to pay for it when they need it, and in some cases (such as welfare to work transitions or reskilling after job losses) individuals need more personal capabilities developed even to get them engaged in seeking and undergoing training.

A well designed system will also ensure that while the individual meets some of the cost of their training, proportionate to their individual gain, this does not become a disincentive for individuals to train. This requires some way of limiting the price for individuals at point of sale.

Traditionally industry and government have contributed to the cost of training through various forms of subsidy to the supply of training. Simply put, government sets up institutions which deliver training, and levies various kinds of charges on industry to support those institutions. A co-contribution – for instance, in the form of "TAFE fees" – is applied to individuals when they enter training.

This kind of structure, really, is what is meant by a supply-driven approach. There are two major weaknesses in this.

The first is that by directing the industry and government contribution through a centralised mechanism or mechanisms to subsidise institutions, there is a natural rationing of investment. Rather than individuals having an entitlement to a subsidy, and that subsidy being delivered to as many or as few individuals who take it up, institutions are established with fixed budgets and costs, and made available to a fixed number of individuals, through various queueing and rationing methods.

But the second is that even where there is sufficient investment, a supply-driven approach focuses on the needs and preferences of providers, institutions, and trainers, rather than on the needs and preferences of the people being trained. There is an almost inevitable loss of the natural patterns of demand in a system which begins with a fixed supply and makes this available to individuals, when compared to a demand-driven system which begins with supporting demand from individuals, and encourages suppliers to respond to that over time.

For example, under the supply-driven system, government will agree to provide a fixed number of places in a training course at a particular institution, and offer those to students. If there are more people who want to do that course, they simply have to go somewhere else.

A demand-driven system would allow the institution to offer as many places as there are qualified students seeking them, without centralised or artificial limitations on how many can be offered.

This would also allow students to choose where they are trained: rather than the “overflow” being directed to less popular or well-regarded institutions, places would follow demand, rewarding success with growth in funding.

It’s obvious that there are limits on the flexibility of suppliers to respond to changing demand under such a system. At the most extreme level, workshops and class rooms cannot be constructed, or torn down, overnight; nor can teachers be hired (or indeed trained) in a week. So there are real questions about how supply can be encouraged to respond effectively to demand under such a system – and we’ll return to those below.

Nevertheless it seems that the logic of market design thinking leads us to conclude that government and industry support for training should increasingly be mediated through direct funding to individuals to buy the training they want, while ensuring adequate supply of training to meet the emerging demand. This can be expected to deliver important new social and economic benefits.

The critical question is: how? And do the proposed reforms do this?

Let us turn to this now.

Part three: what is proposed – “demand-driven reforms”

When the Victorian Government kicked off its reform process, it listed seven key problems in the training system.

- Lack of alignment between those whose training is subsidised by government and those who individually need training
- Lack of alignment between how much a person benefits from training and how much they pay towards their training
- Lack of incentive to move up in level of training
- Focus on managing the supply of training rather than meeting the demand for training
- Training system growing more complex
- Good providers are not rewarded – places are not allocated on performance
- Too slow developing and approving new training “products”

In other words the system has problems, and we can see these as problems of poor market design: inefficient allocation of scarce resources, misaligned returns on investment, institutional barriers to entry, lack of reward for excellence or mechanism for failure, poor incentive for innovation, and sheer complexity.

While Governments have recognised these problems, what are they saying and doing about them? What are the solutions?

Key themes of the new agenda

The Victorian Government’s announced policy was released on Tuesday 26 August, in the paper *Securing Jobs for Your Future, Skills for Victoria*.

(A press release summarising the announcement can be found on the Victorian Premier’s website at [http://www.premier.vic.gov.au/newsroom/\\$316-million-training-guarantee-for-victoria.html](http://www.premier.vic.gov.au/newsroom/$316-million-training-guarantee-for-victoria.html) and the full report is available at <http://www.skills.vic.gov.au/corporate/directions/skillsreform> along with some other supporting material.)

The centrepiece of the policy is described as a “Victorian Training Guarantee” – a specific entitlement for individuals to receive specified government funding for training at any time where they seek a new higher level of qualification. For people under 20, the Guarantee extends to any level of training.

The funding is to be delivered through a direct subsidy, while loans will be available for new fees on top of this subsidy. This mix of public and private funding reflects the thinking that the distinct private and public benefits of training are best reflected in a system where there is a mix of payers.

The structure of fees sees costs reduced for some lower level qualifications, including some training preparation courses, while costs increase for higher level qualifications. This should reflect both the cost structures inherent in delivering these types of training, and the relatively higher returns available for higher level training.

Students are offered expanded choice about where to receive their training, through the ability to train at a wider range of providers with more flexibility about where public funding will be offered.

Training plans

Federal steps

"A demand driven approach to training delivery, in contrast to past supply driven approaches."

(Australian Government, *Skilling Australia for the Future*, 2008)

"A demand-driven approach to delivering skills and training provides more incentive for training providers to be flexible and innovative. It encourages training providers to concentrate on the quality of outcomes rather than focussing resources on attracting and enrolling students ...

"Introducing greater competition to the training system, including contestability for government funding, and providing public institutions with the flexibility to compete, will ensure that training providers are better able to respond to industry and employer needs."

(Australian Government, *Skilling Australia for the Future*, 2008)

"The Commonwealth will support Victoria in the establishment of an Income Contingent Loan (ICL) scheme for government subsidised diploma and advanced diploma students ... will meet the administrative costs of the scheme and not charge a loan fee to students."

(Julia Gillard media release, "Commonwealth will support States willing to reform VET", 26 August 2008)

"Our reform agenda will be complemented by increased investment in innovation and infrastructure through the new \$11bn Education Investment Fund ... in the next round of funding, eligibility will be expanded and we expect it to help transform the VET sector and increase its capacity to meet the skill needs of Australians into the next decade ..."

(Julia Gillard speech, Mick Young Oration 2008, 17 September 2008)

Training plans

Victorian steps

"Under the proposed demand-driven model, industry will have access to as many government supported places as they can generate demand for. This means that if industry is able to generate demand for certain courses through business and their employees, the Government would support this training through the provision of government supported places ...

"To ensure the level of training and employment prospects are broadly in balance, a cap on the number of places in some courses would apply."

(Victorian Government, *Securing our future economic prosperity*, Discussion Paper on Skills Reform, April 2008)

"Securing Jobs for Your Future is the largest ever single investment in our VET system. Key features include:

- The establishment of a Victorian Training Guarantee. This Australian-first initiative, gives people the entitlement to access Government-subsided training at any time so long as they keep moving up the qualification scale for skills;
- The creation of up to 172,000 additional training places;
- We will fund the hiring of an extra 900 teachers and 500 non-teaching staff;
- We will support greater student choice – by enabling eligible students to train at either public or community providers, including a much broader range of private providers;
- We will create the opportunity, for the first time, for students to access finance to study in TAFEs and private RTOs;
- We will boost the workforce and IT capacity of the TAFE and Adult Community Education sectors;
- We will give businesses support to make the training system easier to access for their workforces; and we will redesign the system to make VET easier to navigate for students and business."

(Premier John Brumby, "\$316 million training guarantee for Victoria", 26 August 2008)

Part four: there is still a supply-side

So what are the implications of these “demand-driven” reforms for the “supply-side” of the training market?

In other words, if funding is delivered through subsidies to students, rather than through subsidies to institutions, how will training institutions themselves develop and grow over time? What will be the source of investment in training capacity – things like infrastructure and workforce – and will there be enough?

Under a genuinely demand-driven system, key questions arise about how to do this.

Alongside the need to ensure long-term investment in training capacity, existing public institutions need to transform themselves if they are to succeed as trainers in a reformed demand-based system. This transformation demands that they achieve greater flexibility.

Broadly speaking, these “supply-side” issues are identified in general, but not yet addressed in detail, by the Victorian Government’s announcement.

Infrastructure

Good infrastructure will remain a key to good training outcomes, and the design of the training market must provide appropriate incentives for infrastructure development. It’s worth noting that Victoria alone has spent \$399 million on TAFE capital since 1999.

(Victorian Government, *Securing Jobs for your Future – Skills for Victoria*, 2008)

In its own announcements, the Victorian Government has noted this issue and outlines a range of options for raising capital for infrastructure over time:

- Funding for the ongoing maintenance, refurbishment and renewal of TAFE facilities
- PPPs with business and industry
- Access to restricted managed credit for TAFE providers
- Land rationalisation and asset sales
- The use of significant retained earnings within the TAFE system to reinvest in public infrastructure

(Victorian Government, *Securing Jobs for your Future – Skills for Victoria*, 2008)

There is a threshold question here, which is whether future investment in infrastructure is to be funded through the demand-side funding model, or through continued direct investment on the supply-side.

Following the logic of the announced changes would suggest that fees should be allowed to rise to allow institutions to build up extra income, or to borrow in anticipation of future income, in order to build appropriate infrastructure for the long term. That is, Government as “market designer” could set prices high enough that they will allow a surplus over time. Students would meet these higher fees either through income contingent loans, or through increased student-centred subsidies from Government, or a combination of both.

Government would also allow individual providers both the independence to manage their own infrastructure and the capacity to retain surpluses for investment over time as well. This would mean the institutions could invest surpluses already built up, or enter partnerships with businesses and industry where they use existing or new business and industry infrastructure. They could also be allowed to borrow in prospect of future earnings in the market.

However the announcements and discussion papers of both the Commonwealth and Victorian Governments display some hesitation at recommending this, and indeed give some concrete indications of an alternative approach.

The alternative is continued direct investment in training infrastructure. In other words, Government as “owner” of the public institutions could continue to fund infrastructure directly through investment in the institutions which compete in the training market. And the Federal Government is indicating its preference for ongoing centrally allocated direct investment.

Our reform agenda will be complemented by increased investment in innovation and infrastructure through the new \$11bn Education Investment Fund ... in the next round of funding, eligibility will be expanded and we expect it to help transform the VET sector and increase its capacity to meet the skill needs of Australians into the next decade ...

(Julia Gillard speech, Mick Young Oration 2008, 17 September 2008)

This approach may miss significant opportunities. By requiring public providers to compete for student-centred funding without allowing them the independence to take advantage of what for some is a key strength – their prior endowment in infrastructure – it could put the public sector at a significant competitive disadvantage to their private competitors.

Further, while ongoing funding for training services would be competitive and contestable, according to the principles of market design, funding for infrastructure and investment would be rationed through a centralised fund.

It's hard to see how this will be the best way to reward success in the new market. Indeed, the better arguments for this kind of centralised approach to funding infrastructure rely on seeing centralised funding as a check or balance against the operations of the market – whether by limiting failure, or by smoothing out volatility in demand.

Workforce

Workforce capacity – that is, the development and management of training staff – will also loom large in the transition to a new market.

It will be difficult for public institutions to compete effectively if they cannot compete on the cost and structure of their workforce. In turn, this may well mean that individual TAFE colleges need to be allowed to manage their own workforce independently, rather than through the current system of multi-employer agreements covering multiple public institutions.

As with flexibility for infrastructure investment, failure to give public institutions autonomy over their workforce arrangements may put them at a considerable competitive disadvantage in competing with private registered training organisations.

The Victorian plan envisages ongoing public investment in the training workforce. Specifically, this includes:

- A recruitment program to bring part-time VET teachers in from industry, training 250 industry experts to the level of Certificate IV in Training and Assessment, along with a targeted public campaign informing prospective teachers of the benefits.
- And an accredited qualification in Assessment of Informal Learning for 1000 TAFE teaching professionals.

This kind of direct government investment in skills within the training workforce will continue to be appropriate, just as government investment in skills across the economy is justified. Direct government investment in the training workforce should not be superseded entirely by investment by the institutions employing the training workforce.

Balance and integration on the supply side

How should funding for training capacity like infrastructure and workforce be structured? How should public institutions be enabled to compete?

These challenges are very real ones for policy-makers. They're not just hard, they're complicated. And we suggest this is the most important long-term question yet unanswered by the proposed reforms.

We don't pretend or attempt to own the solutions in this discussion paper. Our conclusions are more tentative, and designed to focus discussion of the solutions on the most promising approaches.

So we emphasise that a well designed training market must effectively deliver long-term investment in training infrastructure and workforce. And in general, we suggest that it will be preferable to do this in a way which integrates long-term investment into the design of the market itself, rather than with proposals which "balance" a market approach to the short-term interests of students on the one hand against a centralised approach to the long-term investment on the other.

To put it another way, where possible, effective pricing policy should be preferred to centralised investment.

Part five: leading questions for the reform agenda

So last, we ask, what else? The test of a good conversation about the proposed changes in training policy may well be that it raises more questions than it answers. It is our hope these questions do some of that work – and that the discussion will continue to grow.

The longer-term policy questions

Is this really a market design approach?

On the one hand, the language of the Federal and Victorian announcements is clear: demand-driven funding, fee deregulation, income contingent loans for fees.

But it's striking that the announcements also retain the freedom for the governments to cap numbers of places for specific courses "to ensure that the level of training and employment prospects are broadly in balance".

It's not clear why caps would be necessary under the new system or how they would operate – whether they would be a genuinely reserve power available *in extremis*, or whether it is envisaged they would regularly operate to direct labour into priority areas for training. Similar points arise from the initial indications of infrastructure funding – and the unanswered questions about future workforce arrangements.

So is this market design – or just a distributed model of public funding?

What have we learnt from recent public policy experience?

The Commonwealth and states now share considerable experience both of demand side market based reforms and of student-centred funding for training in particular.

So what are the lessons – good and bad – from the design of social markets like the Job Network? And what are the lessons – good and bad – from training changes, such as the former Howard Government's New Apprenticeships Scheme and skills vouchers, and the current Rudd Government's "Productivity Places" program?

What is the long-term role for State governments if a national market emerges?

This agenda need not involve a diminution of public responsibility for training. While the nature and structure of State government involvement in particular may change very much, it is clear that there will be an important role for governments under the new system.

Over time, it is possible to envisage the present arrangements consolidating into one where different elements of state Governments will play different roles within the market. Treasuries would work to design the market, through pricing policy, Education departments could own and operate demand-funded training providers, and perhaps both industry and welfare departments would fund the purchase of training by individuals. Equally, in a national market these could be national functions.

As the Commonwealth encourages more states to move toward a market design model for training, these questions will become more important.

Restating the supply-side questions

Will the policy outcomes genuinely expand student choice?

It's possible to deliver limited choice through parcelling out fixed amounts of publicly funded places in specific fields to different institutions, allowing students to choose where they apply to study.

But genuine choice demands genuine competition between institutions: information that allows students to know who is doing well and incentives for those who do well to keep doing it.

This would require that the new market have clear mechanisms for successful providers to grow and for unsuccessful providers to exit the market. This would be needed for there to be real competition, not only between public and private providers but importantly between public and public – real competition within the Victorian public system and, over time, between the several states.

Will investment in training capacity be adequate over time?

Under a more demand-funded model, how would ongoing investment in the training workforce and training infrastructure be guaranteed? In other words, who "owns" the supply-side and who invests in it?

Will public providers be able to generate a unique price-value proposition? Will the supply side be deregulated along with the demand side? Will they be able to design new courses and offerings? If they have to compete on price, will they be free to compete on costs?

Conclusion

The proposed Federal and Victorian Government changes to the way training is delivered are a significant reform and represent real progress in a key social and economic policy area. The system of vocational education and training must improve if Australia is to grow towards greater fairness and greater prosperity. Training is a key driver of social inclusion and other indicators of fairness in our society. And training is a key driver of skill formation and other indicators of prosperity in our economy.

The logic of market design is particularly applicable to training policy. This is an area where a well designed market is especially important. Training is a complex and diverse economic activity, which generates a diverse range of private and public returns on investment, and where a new role for government as a designer of markets has real power.

The proposed reforms have been summarised by their authors as “a demand driven approach to training delivery, in contrast to past supply driven approaches” (Skilling Australia for the future, Australian Government discussion paper 2008). While this approach holds enormous promise, a well-informed and sophisticated market design approach will recognise that there is still a supply side in the market for training, and will take this into account in policy design and implementation.

We have drawn two specific points from this.

First, a well designed training market must effectively deliver long-term investment in training infrastructure and workforce.

Second, it will be preferable to do this in a way which integrates long-term investment into the design of the market itself – rather than with proposals which “balance” a market approach to the short-term interests of students on the one hand against a centralised approach to the long-term investment on the other.

And we have identified a range of other leading questions. In particular, we urge government, industry, training providers and students to engage in a more focussed and demanding consideration of the lessons learned from analogous public policy reforms.

Our ultimate conclusion? The present demand-driven proposals hold enormous promise – but that they must rapidly evolve to a full market design model, becoming more sophisticated and more detailed, and especially taking more account of the complexity of the supply side and the lessons of the recent past, if they are to succeed.

cj