

Vocational Education and Training Workforce
Productivity Commission. Draft Research Report
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A response by

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1. Introduction *

The central objective of the Commission's Draft Report is to evaluate and suggest improvements to the performance of the publicly funded VET system in Australia against the criteria of productivity, efficiency, effectiveness and quality (PC 2010: D1). The report made many findings and recommendations to achieve this objective. This response to the Report focuses first, on the theoretical and practical problems confronting the Commission in evaluating the performance of the publicly funded VET system against these criteria. Secondly, it critically assesses the Commission's argument that the performance of the publicly funded VET system can be improved by competitive tendering of this delivery and extending the use of Community Service Obligations (CSOs) to ensure competitive neutrality and meet 'broader government objectives'.¹ Third, it critically assesses the recommendation that the public system should adopt 'contemporary human resource practices', essentially emulating a variety of practices that are claimed to represent good practice in the private sector. Finally, it highlights a number of contradictions between the Commission's findings or recommendations and evidence presented in the report.

* The author's spouse is a casual employee of NSW TAFE. In this response the terms 'Report' refers to the PC Draft Report and 'Commission' refers to the PC.

¹ 'The recent moves towards competitive tendering, private-public competition and User Choice reflect a desire for increased choice and efficiency in the provision of VET via competitive forces' (PC 2010: 4.14)

2. Rationale for the Study

The Commission was directed by the federal government to undertake the study in response to a COAG request for an examination of the Australian VET system. Independently, throughout the Report the Commission also identifies a range of factors that appear to form an additional rationale for undertaking the evaluation of the VET sector. The first are structural problems in the labour market which, it argues, can be addressed in part or in whole, by its proposed changes to the publicly funded VET system. However, the Commission fails to establish how its support for competitive tendering of publicly funded VET and a more deregulated industrial relations system for TAFE, solves these structural problems. The second rationale for the Report is that the Commission identifies a number of deficiencies in the performance of publicly funded VET which are used to discount quite high levels of satisfaction with public and private VET providers. These deficiencies are used to support the Commission's key recommendations for change. These claimed deficiencies are shown to be logically inconsistent or have no empirical base.

2.1 Structural problems in the labour market

The Report identifies a number of structural problems in the labour market. The first is an inadequate participation rate of the population in the workforce. This is creating economy wide skill shortages due to sustained economic growth. Demographic changes will also reduce the rate of increase of labour supply. Second, there is a necessity for 'skill deepening', or increase in the share of the workforce with post school qualifications and with VET qualifications that are on average at higher level than current levels (PC 2010: 6.7-6.8). To meet these labour needs it will be necessary to draw into the labour market and into post-school training segments of the population, such as ATSI, disabled and persons with low school educational attainment. These groups have both a lower population to employment ratio and 'are otherwise... disengaged from education and training' (PC 2010: 6.9).

There is no doubt that skill biased technical change is increasing the overall demand for more qualified workers and, if economic growth persists at current rates, there may be a need to increase workforce participation rates. There is also no questioning that the 'the ability to alleviate or remove a skills bottleneck is likely to deliver great economic benefits in a fairly short time' (PC 2010: 9.2). What is not evident is how, and to what extent, these structural problems will be directly addressed by the principal recommendations in the Report. These recommendations are directed at altering the conditions on the supply side of the VET system by increasing competitive tendering of publicly funded VET and by changing industrial relations in the sector.

The most direct approach to solving the first structural problem is to shift the preference of the working age population from leisure to paid work, by increasing the real wage rate. This is not suggested by the Commission. According to the Australian Bureau of Statistics the barriers to lifting the workforce participation rate have little to

do with education and training but mostly involve improvements to child care; transport to work or working conditions such as arranging family friendly work and facilities in the workplace like access for the disabled.²

As to the second structural problem, a lower than socially optimal participation of the workforce in education and training is due, as the Commission itself describes at length, to a range of market failures (PC 2010: 4.3-4.6). Some of these market failures include, inadequate information for potential students on the benefits of higher educational attainment; poaching of trained workers by ‘free riders’ and credit market imperfections that constrain private agents borrowing to participate in VET. (These market failures in training are discussed in more detail later). None of these market failures is addressed by the Commission’s specific recommendations to alter the supply side of the VET sector. It could be argued that a significant increase in efficiency of the VET sector induced by supply side changes could, if translated into real price reductions of fees for VET students, increase participation in VET. The effect of such a price reduction on participation depends on the magnitude of the price elasticity of demand for VET by students. Based on data provided in the Report this elasticity is likely to be very low.³ This implies that extraordinarily large efficiency gains and price reductions would have to be effected to significantly increase VET participation.⁴

To meet the structural challenges in the labour market the Commission makes a series of findings and recommendations on the required changes to the VET system. These include for example:

- improving the quality of VET teaching by prescribing a minimum pedagogic qualification (PC 20101: 9.6)
- workforce skills deepening requires VET trainers and assessors to hold higher level qualifications (presumably in subject-related fields) compared to existing VET teacher qualification profile (PC 20101: 6.8).
- to lift participation in VET of groups disadvantaged in the labour market VET teachers will ‘need to allocate some resources towards locating and assessing

² The ABS (2009) *Barriers and Incentives to Labour Force Participation* (Cat No. 6239.0) found that in 2008-09 of the 794,000 persons aged 18 years and over who wanted a job or more hours and were available to start work or work more hours within four weeks, just 4.4 percent identified ‘Lacks necessary training/ qualifications/ experience’ as the ‘main reason not looking for work/more hours’ (Table 6).

³The Commission cited research that estimated the price elasticity of demand of VET students with respect to VET fees was just .06. ‘[T]here are suggestions that students’ responses to any increase in fees will be very small, since the fees are relatively low. It is estimated that an increase in VET fees of 10 per cent would result in a decrease in the number of students enrolled by 0.6 per cent’ (PC 2010: 6.3). It is assumed here that the elasticity is symmetrical for the same percentage decrease and increase in VET fees.

⁴ It may be objected that changes to the supply side could result in easier access for students which could stimulate higher participation in VET. On the other hand, currently the great majority of students attend TAFE part time, many during or after work. The use of flexible delivery such as computer based learning is also extensive: ‘the use of ICT in the delivery of education and training is already significant. Recent data show that the internet, email or online instruction was used in delivery of around 40 per cent of VET qualifications (2010 PC: 6.10). There is also a low level of unmet demand for TAFE. In 2009 there were only 28,800 people aged 15–64 who applied to study but were unable to gain a place in TAFE (PC 2010: Table D.1). There were 1.3 million students enrolled in TAFE in 2009 (PC 2010: B4).

these members of the population, and encouraging their participation in VET’ (PC 20101: 6.9)

- the participation of more people with low prior educational attainment will require teachers ‘to possess a greater knowledge of teaching theory and practices’ related to language, literacy and numeracy for such groups (PC 20101: 6.9)
- ‘A broadening student profile suggests that the VET sector of the future will require workers who are suitably equipped to accommodate these students’ personal needs, cultural practices and past learning difficulties. The trend towards a more diverse student profile might also imply that the sector needs to consider employing more members of these groups as part of its own workforce, to improve student outcomes’ (PC 20101: 6.12).
- such groups will also require on completion of their courses ‘more job-seeking assistance as they generally have lower pre-course employment rates than other students
- increased use of flexible delivery through ICT and servicing remote workplaces (PC 20101: 6.10).

These are perfectly sound findings and recommendations that flow logically from the analysis but they sit oddly with the overall thrust of the report which is towards less government direction of the system and more reliance on decentralised public and private RTOs to meet the needs of individual students. The Report does not specify how its recommended changes to supply side conditions will achieve the improvements listed above. Moreover, these *ad hoc* recommendations are not only highly prescriptive in terms of directing the activity of the VET sector, they are also potentially expensive to implement. The Commission explicitly states its recommendations will not result in increased public expenditure:

it is anticipated that the reforms recommended in this study will not involve significant additional costs. The Commission has not suggested more funding of the VET sector, but has recommended that existing resources be used more effectively to lift the productivity of the VET workforce (PC 2010: 9.3).

It is somewhat unclear what the status of these *ad hoc* recommendations is. Are these measures intended simply as information for public and private RTOs to lift their performance, or are they to be used by regulators to evaluate future performance of the VET system and possibly the basis for regulation should the market not adopt these policies?

2.2 Student and employer satisfaction with VET

The Report cites annual surveys of student and employer satisfaction with VET conducted by NCVET. The Commission observes that the survey instruments are valid, reliable and ‘robust’ (PC 2010: D.3) The Commission notes that ‘[o]verall, student outcomes and satisfaction with the quality of their training in the publicly-funded VET sector are high (PC 20101: 5.7). For example in 2009 ‘87 per cent of

graduates and 81 per cent of module completers were satisfied or very satisfied with the overall quality of training they undertook' (PC 2010: 5.7). Similarly, in 2009, '57 per cent of employers used the VET system, that is, hired someone with vocational qualifications...Of those who hired a VET graduate, 83 per cent were satisfied with formal vocational qualifications in providing employees with the skills required for their jobs (PC 2010: 5.19).⁵

The Commission seeks to discount high user satisfaction levels by suggesting that 'problems remain in meeting some of the needs of industry and the community, more generally' (PC 2010: 5.19). These deficiencies in performance also justify, in part, the key recommendations. These deficiencies are derived from a number of sources including research by NCVER, reports by industry associations and submissions to the Commission inquiry. The principal deficiencies are first that 'a consistent message from small and large businesses requiring qualifications for jobs was that the system needed to provide more practical skills training and workplace experience' (PC 2010: 5.20). Second, the VET system was not meeting the needs of employers and should be more 'industry led' ((PC 2010: 5.21). Third, there are demands from industry, including the Australian Chamber of Commerce and Industry that the VET system needs higher funding levels 'so that it is responsive to meet demand' (PC 2010: 5.20).

The validity of these claimed deficiencies is questionable. Demand by industry for more 'practical skills training and workplace experience' should not have been uncritically accepted by the Commission. It contradicts, in part, the goal of competency based training, which places equal emphasis on the acquisition and application of knowledge and skill and the ability to apply knowledge and skills to novel problems and situations.⁶ Supplying training that is increasingly oriented to the needs of a particular workplace also contradicts the economic logic of public funding for VET which, in part, rests on the claim that the private market will adequately supply firm specific skills, but there will be underinvestment by employers in general or transferable skills due to the risk that an employer may not be able to fully appropriate this investment in human capital. General skills provide economy wide efficiency gains, especially improved labour market mobility. A wider skill and knowledge base of workers fits them for a wider range of job openings and enables them to adapt more readily to technological change (Toner 2011).

The claim that there is a significant mismatch between the needs of industry and VET delivery and that the system needs to be more 'industry led' would suggest that there are fundamental problems with the architecture and governance of the system. This

⁵ To put these results in perspective private market research companies do extensive surveys of customer satisfaction for private companies. Customer satisfaction of public vet is similar to levels of the major supermarket chains tracked over the last six years (around 85%) and is consistently higher than internet service providers (73%) (<http://www.roymorgan.com/> accessed 4th Feb 2011). A survey of 3000 small business owners found that only 63.8% were satisfied with the four major banks. (<http://www.roymorganonlinestore.com/News/1044---Bendigo-Bank-leads-the-banking-satisfaction.aspx> accessed 4th Feb 2011)

⁶ Competency is defined as 'the consistent application of knowledge and skill to the standard of performance required in the workplace. It embodies the ability to transfer and apply skills and knowledge to new situations and environments' (NQC 2009: 6). Competency standards are set by industry (PC 2010: 5.10).

follows from the Commission's observation that since 'the late 1980s, the VET system, moved from a provider-driven approach, towards an industry-led system' (PC 2010: 5.10). In other words, the system is already meant to be 'industry led'. However, the Commission makes no specific criticism of this architecture or the system of Industry Skills Councils which set the content of training, competency methods and standards (PC 2010: 5.15). It could well be that under-pinning the claim of a mismatch between what industry wants and the VET system delivers is the conflict over firm specific versus general skills. This was dealt with earlier.

The claim of a mismatch is not only imprecise but the Commission presents no evidence that such a mismatch is generalised. In addition, any claim that such a mismatch will be addressed by a further extension of competitive tendering confronts the problem that there have already been substantial 'moves to increase competition and contestability in the provision of VET, which provides employers with greater opportunity to reveal their preferences for some RTOs over others' (PC 2010: 5.14). In 2008 over one dollar in five of public VET funding was open to competitive tender (PC 2010: 4.16). This is likely to have increased substantially since then. If the problem of mismatch is generalised this suggests that competitive tendering has not provided an adequate solution. Finally, the demand of industry for more funding for the VET system is not directly addressed by the Commission.

3. Definitional and measurement problems

Efficient pricing in markets relies on accurate information with respect to both the characteristics of the good or service being transacted and the quantities demanded and supplied. The Report makes it clear that these two minimum conditions do not apply in the market for VET services. The Report explicitly states that there are, as yet, no robust measures of productivity, efficiency, effectiveness and quality. Moreover, there are multiple objectives imposed on the VET system, the output of which cannot be quantified or related directly to input use. The distinction between commercial and non-commercial VET activities, which forms the basis for classifying certain VET activities as subject to Community Service Obligations, has no basis in economic theory. These difficulties undermine the case that contracting out of publicly funded VET services will result in more transparent and efficient pricing and delivery.

3.1 Inability to Define Productivity, Efficiency, Effectiveness and Quality in Education and Training

A foundation principle of programme evaluation generally, and public policy formulation in particular, is the centrality of an objective and methodologically sound evidence base. The Report notes the general absence of data on many aspects of the VET sector and especially the difficulty in establishing valid and reliable methods to measure productivity, efficiency and effectiveness in education and training provision. Given the inadequacy of current measures and absence of acceptable hedonic pricing of inputs and outputs for the VET sector ‘the Commission considers that other measures of VET sector efficiency should be examined’ (PC 2010: D.22). The Commission does not develop these nor suggest any alternative measures.⁷

The Commission also notes similar conceptual and empirical difficulties with ‘quality’:

‘there are no unequivocal indicators of teaching quality in VET. Nonetheless, indirect evidence is available from research on school teachers, suggesting that teacher qualifications explain little of the variance in teacher effectiveness (gauged via measurable student outcomes). There needs, therefore, to be a rigorous quantitative analysis of the full range of trainer and assessor characteristics that can contribute to quality outcomes’ (PC 2010: XLVI).

⁷ The Commission does produce an ‘annual proxy of VET sector efficiency’ based on ‘estimates of real government expenditure per hour of government-funded delivery’. Between 2005 and 2009 efficiency increased by 4.6 per cent per year. However, this measure is regarded by the Commission as an inadequate index of productivity. This highlights the difficulties in establishing valid and reliable quantitative metrics of VET performance.

Given the acknowledged absence of a valid and reliable method to collect data on efficiency, effectiveness, productivity and quality with respect to education and training, it is unsound for the Commission to arrive at findings and policy conclusions that are premised on the availability of such a method and data. The evidence base on which the Commission relies is essentially anecdotal. Without objective evidence there is no sound basis for the findings and recommendations nor any criteria to evaluate the effects of the recommendations should they be implemented. Accordingly, the Commission should have proceeded with much greater caution and humility.

3.2 Complexity of VET Systems Objectives

The Commission identifies a number of objectives or outputs from the VET system:

- provide the skills needed by the economy
- inspire, stimulate and enrich learners from all segments of the community
- contribute to social inclusion and civic participation (PC 2010: 9.1).⁸

There is no question that VET, like other forms of education and training, does perform multiple roles. However, these multiple objectives pose major problems for moves to increase contracting out of VET services. It is difficult to even approximately specify what VET courses and other activities produce these outputs and in what proportion each output is being produced by individual courses and/or activities. For example, the first output, ‘providing skills for the economy’, may appear to be relatively straightforward, but the Commission itself cites research that finds there is, in aggregate, only an indirect connection between the VET qualifications people acquire and the jobs they get. ‘In 2008, only 30 per cent of recent VET graduates reported that they were employed in an occupation group that was related to their training course’ (PC 2010: 5.12). As the Commission itself appears to acknowledge, it is in fact difficult to establish a valid and reliable metric of the extent to which the VET system matches or mismatches labour market needs (PC 2010: 5.12-13). This problem is heightened in the case for the other two VET objectives.

In addition, these outputs are arguably not discrete products of the VET system but are best regarded as ‘joint products’. Joint products occur when a single production process produces multiple products concurrently. The ratio of those three outputs will differ across different course types, according to the characteristics of the student participants and according to the interests and abilities of individual teachers. The pricing of joint products is conventionally regarded as especially problematic. Such problems are amplified when output quantities cannot be specified.

⁸ Social inclusion has some important economic benefits. The VET workforce is in a position to contribute to social inclusion of both young people and adults...there can be significant payoffs in terms of positive employment, social and civic outcomes (PC 2010: 1.4). Referring to any state TAFE’s statement of purpose will reveal the complexity of the organisations’ objectives. (See for example TAFE SA 2008).

These objectives are also to some degree in conflict; achieving an increase in skills for the economy in order to improve workforce productivity could be achieved at the expense of increased equity through a lift in the participation of disadvantaged in the labour market. Effective and efficient contracting out requires the public policy maker to employ multi-criteria decision making which, in the absence of objective data, is highly sensitive to assumptions made in the analysis, uncertainties, and weighting factors.

This difficulty in quantifying how various VET courses and activities produce the three objectives of VET, and in what ratio, is important because it means it is not possible to accurately, or even approximately, price these VET activities. In other words, without specifying the quality adjusted quantity of the three outputs that is demanded by a public sector purchaser or supplied by VET providers there is no method to establish efficient pricing.

What is known however is that surveys reveal quite high levels of student and employer satisfaction with the publicly funded and delivered VET system and that there appear to be positive outcomes for students in terms of employment and participation in further education and training. These and other related measures in these surveys are admittedly simple quantitative indicators of VET performance, and are not a satisfactory metric for pricing inputs and outputs. They are however, probably the best performance metrics that can be reasonably expected to be developed with constrained public sector finances.

3.3 Commercial and Non-Commercial VET Activities

The Commission argues that in the delivery of VET services a distinction can be made between ‘commercial’ and ‘non-commercial activities’ (PC 2010: LII). This distinction is not clearly defined but it appears that ‘commercial’ involves the delivery of training leading directly to a module or course completion and non-commercial is the delivery of activities that support participation in, and completion of, modules and courses. These non-commercial activities are equivalent to activities that fulfil ‘broader government objectives’ (PC 2010: 4.20). The Commission notes that these include activities such as improving the quality of VET provision, lifting literacy and numeracy levels in the population, provision of additional assistance for persons disadvantaged in the labour market to improve their participation in VET and introduction of green skills into VET courses. The Commission seems to suggest that commercial and non-commercial activities are directed at improved labour market efficiency and improved labour market equity respectively. Commercial activities are directed at improved labour market efficiency by addressing market failures in the provision of VET training and non-commercial are directed at meeting ‘broader government objectives’.

As noted by the Commission, at the most abstract level, the primary justification for the provision of public funds for VET is to address a variety of market failures which apply to private education providers, individuals and the economy as a whole. These

market failures would otherwise result in a level of investment in education and training that is lower than socially optimal. The factors giving rise to under-investment by private agents include, potential students applying an excessively high discount rate to future earnings arising from participation in VET; having inadequate information regarding other benefits of participation in education; information asymmetries between purchasers and providers of VET that can deter students from participating in VET or result in students being ‘ripped off’; and the absolute cost of participation can exclude some disadvantaged groups from participating (PC 2010: 4.3-4.7).

The suggestion that commercial VET activities are directed at improved labour market efficiency and non commercial activities are directed at equity is an unsound basis for such a distinction. Public funding of ‘non-commercial’ activities or ‘broader government objectives’ rely on an identical economic rationale to the funding of ‘commercial’ activities. The causes of and solution to improved labour market efficiency and labour market equity are both to be found in redressing market failures in the provision of VET. Indeed, the Commission seems to acknowledge that redressing these market failures is justified on both labour market efficiency and equity grounds this is the case (PC 2010: 4.3-4.7).⁹

In addition, as noted above, in many circumstances achieving labour market efficiency and equity are joint products arising from government intervention in VET.

The distinction between publicly funded commercial and non-commercial education and training activities is also *non sequitur* as all publicly funded VET activity is a ‘non-commercial’ activity in the sense that without public funding the activity would, by definition, not occur in a private market. The distinction between commercial and non-commercial activity in the field of publicly funded VET is entirely arbitrary and has no basis in economic theory.¹⁰

3.4 Community Service Obligations

The distinction between commercial and non-commercial VET activity is important as it underpins the Commission’s argument that more use be made of Community Service Obligations (CSOs) to fund delivery of non-commercial activities. CSOs apply ‘where governments require an enterprise to engage in a non-commercial activity in order to meet a social objective’ (PC 2010: XXVII). CSOs are intended to promote increased competition between public and private providers by establishing ‘competitive neutrality’ between public and private by removing any implicit or explicit subsidies to public providers:

⁹ Even the government mandated introduction of ‘green skills’ into courses can be viewed from this economic perspective as it can be justified in addressing a negative externality due to an under provision of such skills.

¹⁰ Pitchford and King (1998: 315) make a similar point to the argument that ‘public firms are not subject to the rigours of a competitive market and this lack of competition leads to inefficiency. This argument misses the point. Many publicly owned firms are precisely in areas of business that would not have a natural competitive market structure even if they were private’

the use of CSO payments by government has the potential to facilitate greater competition between public and private sector organisations. Such CSO payments can be made to either public or private providers, to ‘compensate’ them for delivering broader government objectives (PC 2010: 4.20).

The use of explicit on-budget community service obligation payments for these providers has the potential to improve transparency regarding their viability, and to improve competitive neutrality across providers (PC 2010: 4.1).

3.4.1 Difficulty in defining the scale and scope of CSOs

This difficulty in establishing a clear theoretical and empirical distinction between commercial and non-commercial activities is apparent in the difficulty the Commission has in operationalising the scale and scope of these activities. The Report notes a range of ‘broader government objectives’ including for example:

- ensuring ‘VET sector’s activities are consistent with national objectives in particular areas’. This includes incorporating ‘green skills’ into Training Packages
- ‘Governments can also use funding to explicitly attempt to improve the quality of VET provision’ (PC 2010: 4.9).

There are also a number of specific VET activities the Commission identifies as requiring support, although these are not specifically identified as requiring a CSO, they appear to be examples of activities that could receive such funding:

- ‘Students from non-English speaking backgrounds might need, as well as expect, extra support in learning English or improving their English language skills. These students might also expect the VET sector to be culturally sensitive’ (PC 2010: 5.5)
- ‘Indigenous students stand to benefit most from the VET sector when it is able to provide a culturally supportive learning environment’ (PC 2010: 5.5)
- ‘Students with disability expect that the VET sector will provide a supportive learning environment, free of direct or indirect discrimination, allowing them to be as independent as possible. They might also expect providers to be aware of, and offer, technologies that allow them to become more independent (PC 2010: 5.6)
- Support for student unions or student associations to ‘provide opportunities for VET students to influence the sector’ (PC 2010: 5.7)
- ‘The delivery of LLN [Language Literacy and Numeracy] skills may require VET trainers and assessors to possess a greater knowledge of teaching theory

and practices than is required in the delivery of more vocationally-specific courses' (PC 2010: 6.9)

- Meeting government objectives to lift Language Literacy and Numeracy skills in the population means 'the VET workforce may also need to allocate some resources towards locating and assessing these members of the population, and encouraging their participation in VET' (PC 2010: 6.9)
- 'The trend towards a more diverse student profile might also imply that the sector needs to consider employing more members of these groups as part of its own workforce, to improve student outcomes' (PC 2010: 6.12)
- Disadvantaged students 'on the completion of their courses...might require more job-seeking assistance as they generally have lower pre-course employment rates than other students' (PC 2010: 6.13).

Given the difficulty in establishing a clear theoretical and empirical distinction between CSO and non-CSO activities as a basis for establishing competitive neutrality between public and private providers it is arguable that CSOs extend to an even broader range of VET activities. These could include public subsidies for private RTOs investing in buildings, capital equipment and libraries. Given the logic of competitive neutrality as applied to VET, it is difficult to conceive how CSOs can't apply to these activities. The Commission has explicitly indicated they apply to measures to improve the quality of teaching, which could equally extend to support for private RTOs assisting their teachers attain higher level qualifications and increased professional development.

Given that the PC explicitly says that its findings and recommendations will not require increased government spending on VET it follows that opening up public funds for VET in the form of CSOs to private RTOs can only result in TAFE losing funding for activities such as libraries, student counselling, keeping buildings and equipment up to date etc.

The vagueness of the CSO concept as applied to publicly funded VET undermines the argument that competitive tendering will improve resource allocation. Unless the scale and scope of CSOs can be unambiguously defined on a theoretical and practical basis there is a danger that their application will be arbitrary. Such imprecision can result in either over- or under-investment by public or private providers. Imprecision in the distinction between CSO and non CSO activities results in a situation where there is no clear criteria for deciding whether investments by a private RTO should receive scarce public funds to establish competitive neutrality or whether they should be funded directly by private RTOs to improve their competitiveness. This is not a good basis for public policy.

3.4.2 Non-Excludable Nature of CSOs

There is a significant practical problem in providing CSOs to private RTOs that also supply training to fully privately funded students. The latter are not intended recipients of CSOs. It is either difficult or impossible to exclude such students benefiting from CSOs given to private RTOs. For example, teaching materials for students who require assistance with numeracy, literacy or job finding, such as books, videos, computers and computer software kept in open libraries or modifications to buildings for disabled students can be accessed by all students whether they are publicly subsidised or full fee paying. Funding for CSOs may also overcome indivisibilities in the employment of human or physical capital. For example, a teacher in say job search may be unwilling to work just a few hours per week at a private RTO. These few hours, combined with other hours funded via a CSO for job search activity, may make it worthwhile for the teacher to work at the private RTO.

The provision of these additional services funded by a CSO can thus provide a competitive advantage to a private RTO in the full fee for service private training market.¹¹ This results in a market distortion and misallocation of resources. The scope for exploiting the non-excludable nature of many CSO activities is partly a practical problem and also a function of the ethics of the private RTO owner. Non-excludability is a defining feature of public goods. Such goods are most efficiently provided, in terms of fewer distortions, directly by the public sector.

Not only is the distinction between commercial and non-commercial unjustified in economic theory and on practical grounds (the ‘joint product’ and ‘exclusion’ problems), the Commission has not made the case, first, that these activities are functionally separable and, second, that there are efficiency gains in their separation. Rather, the Commission simply asserts that there are gains arising from such a separation. The Commission needs to make the case that provision of training leading to module and course completions and the provision of services that include for example, student support for literacy and numeracy and improvements in the quality of teacher training, are functionally separable. Functional separation means that the activities as inputs to the production of a VET output can be contracted to discrete economic entities without a decline in the quality or quantity of the output. The difficulties in establishing such a case are presented in the following section.

¹¹ There are many other examples of non-excludable activities that can arise from CSOs. Knowledge spillovers within an RTO from teachers paid through a CSO can improve the performance of teachers engaged solely in privately funded training.

4. Transaction Costs, Risk and Regulatory Burden

The Report fails to give sufficient weight to the risks and costs in subjecting publicly funded VET to competitive tendering. When prices cannot unambiguously signal to a purchaser (be they a potential student, firm or public sector purchaser) the characteristics of the good or service they are seeking from a provider principal-agent problems emerge. This section details these problems and also identifies certain conditions which create an identity of interests between a student and VET provider to jointly minimise effort and teaching costs. Such collusion between an agent and principal leads to a significant reduction in the quality of training provision.

Principal-agent problems and collusion between an agent and principal impose risks and costs on purchasers, providers and the wider economy. The nature of these risks and costs is well-established in the economics literature. These risks and costs can detract from any envisaged efficiency gains in subjecting publicly funded VET to market based transactions. The economics literature makes it clear that under conditions of significant information asymmetry between purchasers and providers, and collusion between principals and agents, market based competition is no guarantee of quality, efficiency, effectiveness or productivity. These are not risks that can be discounted as a theoretical *curiosum* or as having a low probability of occurrence. Nor are they risks that can be efficiently and effectively managed through regulation of private VET providers. This section briefly describes several documented recent examples, using a variety of sources, of principal-agent problems and collusion in the delivery of VET in Australia. Crucially, the evidence points unambiguously to these principal agent problems lying almost exclusively in private RTOs. These examples also reveal major deficiencies in the Australian regulatory system governing quality in VET delivery. It is concluded that expanding the share of publicly funded VET delivered by private RTOs poses a significant risk to quality and probity. Improving the capacity of the regulatory system to cope with these heightened risks will arguably impose compliance and monitoring costs on the VET system that may negate any anticipated efficiency gains.

4.1 Principal-Agent Problems and Risk

The economics literature has subjected the conditions for efficient inter-firm or inter-organisational contracting to extensive analysis. It has also identified the risks and costs to economic welfare where these conditions are not met. Subjecting public VET activity to competitive tender does not meet the minimal conditions for efficient contracting. Consequently, the scale and scope of risks and costs arising from contracting will arguably negate, and possibly exceed, anticipated improvements in efficiency from outsourcing.

4.1.1 Transaction Costs

The original formulation of the concept of transaction costs emphasised the direct costs that can impede inter-firm transactions in an otherwise competitive market.

In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost (Coase 1960: 7).

Depending on the scope and scale of these transaction costs producers can elect for 'vertical integration' and produce the output internally under direct administrative supervision rather than use the market to co-ordinate its supply. Transactions costs, in part, underlie the decision to 'make or buy'.

The original Coasian formulation thus identified specification, search and monitoring costs imposed on the principal in contracting to an agent. Applied to the contracting out of publicly funded VET this model reveals considerable costs. Efficient and effective contracting-out can require considerable resources in tightly specifying the properties and performance characteristics of the good of service and in creating unambiguous indicators of performance. These costs include for example, defining and developing valid and reliable quantitative performance indicators of productivity, efficiency, effectiveness and quality for both inputs and outputs of VET teaching activity. Costs also arise in developing similar indicators for Community Service Obligations, as these are also intended to be subject to competitive tendering. There are also costs in advertising tenders, assessing tenders from competing bidders and negotiating with bidders. There are costs in monitoring and assessing performance indicators. There is also the potential cost of resolving disagreements between the contractor and contractee through direct negotiation between the parties, engaging the services of independent arbitrators or resorting to the legal system.¹²

The above examples of transaction costs were considered primarily from the point of view of the contractee. From the point of view of potential contractors the preparation of unsuccessful tenders¹³ can be a significant sunk cost, as resources are expended for no economic return.

¹² An indicator of the difficulty in establishing these conditions is the considerable uncertainty in determining the probability of success when courts are used to resolve commercial disputes. If contracts did not have significant ambiguities with respect to contractual obligations there would be no point in one contractual party either litigating against another party or a party seeking to defend their position. If contracts were, to use the economics term, 'complete', legal action over commercial contractual matters would not occur as the outcome of such action would be known or predicted with a high degree of certainty by all parties.

¹³ One large scale survey of the effects of contracting out of public VET services found that 'a substantial majority of both TAFE institutes and all registered training organisations indicated that increased transaction costs (for example, administrative and marketing) outweigh reductions in training delivery costs under contestable funding arrangements (Anderson 2005: 27).

There are other potentially significant transaction costs imposed on public and private VET providers in the move towards greater contestability and demand-driven purchasing. The Commission argues that greater competition to attract students will require more marketing and the employment of more managerial and marketing specialists by public RTOs. Moreover, the Commission argues that the employment of these specialists will require a relative reduction in other occupations within the VET sector, presumably including teachers. Increased competition does:

imply a need for greater investment in marketing and advertising to appeal to students, increasing the importance of staff associated with these functions within the workforce. More generally, the move towards a more commercial operating environment might place even greater importance on managerial, entrepreneurial and marketing skills. While the VET sector already comprises professionals with such skills, it may require proportionally more of these workers in the future assessment (PC 2010: 6.14).

The requirement for public and private VET providers to use taxpayers' dollars to fund an increase in both their advertising budgets and the proportion of non-teaching staff is not evaluated in the Report. At a minimum the Commission should have estimated the scale of the diversion to advertising and non teaching staff against any expected gain in efficiency arising from these expenditures.

4.1.2 Efficient contracting and risk

More recent developments in transaction cost economics have further relaxed a number of the key assumptions required for perfect competition underpinning conventional economic analysis (Williamson 1985, 1989). Conventional analysis assumes that consumers and producers have perfect information, an infinite capacity for optimising decision-making and that prices contain sufficient information to optimise current and future investment and consumption decisions. Perfect information implies there is no capacity for deception or cheating- that contracts are honoured and/or that legal remedies constrain wrong doing by compensating the cheated and punishing the cheater. In reality, producers and consumers have 'bounded rationality'; they may intend to act rationally but they have limited information, limited information processing power and limited decision making capacity. Second, transaction cost economics allows for 'opportunism' in market transactions- some producers or consumers cheat by failing to honour contracts, shirk effort or otherwise do their best to ensure they get the best out of any bargain.¹⁴ Transaction costs economics argues that a key, if not sole, factor determining the extent to which an

¹⁴ The Report provides examples of bounded rationality and opportunism in the provision of publicly funded VET. For example, principals have major information gaps without accepted definitions of productivity, efficiency, effectiveness and quality for VET inputs and outputs. That labour shirking occurs amongst teachers in private and public VET providers is to be inferred from the Commission's recommendation to extend the application of performance based pay. This is necessary to achieve a better 'alignment of incentives and outcomes' (PC 2010: 7.30).

agent actually engages in opportunism are economic incentives confronting the agent. In summary, typically a contractee knows more than a principal about the characteristics of a good or service they offer and the conditions under which it is produced. This leads to information asymmetry between the principal and agent which can result in inefficient contracting even if all parties act in good faith. This inefficiency is likely to be heightened if agents act opportunistically.

The extent of the risk attached to contracting under such circumstances depends on a range of factors. Two of the major factors are dealt with here. The first concerns the importance of the contracted activity to the performance of the principal's organisation. The more important an activity to the 'survival', profitability or quality of an organisation's output the higher the risk in contracting an activity out. Second, some activities are complex in that it is difficult/and or expensive to precisely specifying their features, performance characteristics and the precise inputs required for their production. The scope for opportunism on the part of agents is increased with such activities, imposing higher monitoring, and testing and enforcement costs on principals. Complexity applies to activities not just from technological or design complexity but also the extent to which a product or service is subject to uncertainty over time. Uncertainty can arise if a product or service is subject to rapid technical change, technological redundancy or large fluctuations in demand.

Awareness of these inherent limitations is one factor inducing principals to either produce a good or service themselves or to contract with external suppliers in such a way as to minimise the risks and costs in sourcing from external suppliers. However, transaction cost economics has revealed that attempts to minimise or shift risk between contracting parties itself generates costs and risks. For example, a principal can contract with multiple suppliers over a short term to source a good or service. This reduces possible losses to a principal from agents cheating and makes it possible to identify superior suppliers. But it also imposes higher search, negotiation and co-ordination costs on the principal. Short term contracts are not always possible. If a principal wants to contract for a good or service that requires an agent to make highly specific capital investments, say for a private RTO to make expensive investments in specialist buildings, equipment and teachers to run apprenticeship courses, the agent will demand a contract term sufficient to recoup the investment. The greater the specificity of an investment, or the fewer alternative uses that can be found for an investment in a market, the greater the risk to the agent. The greater the dependence of an agent on one or a few buyers the greater the incentive not to engage in opportunistic conduct. But longer contract terms for agents expose a principal to a number of risks. The more a product or service is subject to a range of uncertainties (as described above) the greater the risk that a principal will contract for the supply of a product that in the future will have a reduced market. There may also be technical change in the methods for producing the contracted good or service which results in a principal being 'stuck' with a high cost agent. Inducing an agent to make capital specific investments in most cases would require a principal to reduce the number of suppliers with whom they contract. (Capital specific investments may not only require

a longer term but also a high volume of output to amortise the cost). Long term contracts thus may reduce the number of potential future suppliers and the level of competition in a market.¹⁵

As noted above the extent to which an agent actually engages in opportunism is determined in part by the economic incentives confronting the agent. (Ethical considerations are also obviously a factor). Transaction cost economics points to differences in the structure of incentives facing public and private sector workers as a factor that needs to be considered in contracting decisions. At its simplest owners of private RTOs gain a pecuniary benefit in improving the financial performance of a firm by increasing revenue and minimising costs. Private sector employees can share in bonus scheme for improving financial performance. By contrast TAFE was established to overcome market failure and promote social equity by delivering services that perform multiple, and sometimes conflicting objectives. Its explicit function is to deliver a quality service subject to externally imposed budget constraints. The achievement of these objectives is difficult or impossible to relate precisely to input use. TAFE SA (2008: 1) for example states its purpose as:

We work with individuals, employers and regional communities to provide the knowledge and skills necessary to create and sustain a strong and vibrant economy.

Given the complexity of the objectives assigned to public VET and the difficulty in precisely aligning inputs to outputs it is more efficient to assign the task of delivering this activity to the organisation which has within it the least incentive and opportunity to diminish service quality.

4.1.3 Risk and contracting public VET activity

Publicly funded VET activities are precisely those that are unsuitable for contracting, first, because of risk arising from failure of delivery and second, the inability to define accurately the features and performance characteristics of the good or service to be contracted or to relate VET inputs to VET outputs.

¹⁵ The following illuminates some of the abstract propositions about the conditions for optimal contracting and risk in a concrete example of 'cost shifting' between agents in VET. Assume firm A is contracted by the public sector to teach a 'commercial' activity such as Certificate IV in Training and Assessment and an unrelated entity firm B is contracted via a CSO to deliver 'non-commercial' student support for the course. Firm A has an incentive to reduce teaching quality and cost by shifting to firm B responsibility for students acquiring the requisite knowledge and skills. Cost and effort shifting is possible in this example because, in practice, the distinction between teaching a specified course content (such as the Certificate IV in TAA) and student support for the course is very difficult to draw. Student support, say with literacy and numeracy, often takes the form of assisting students with work set by the course teacher, such as homework or essays, and requires the support teacher to be familiar with the course content. That is to say, assistance with literacy and numeracy cannot be provided independently of providing assistance to students in mastering course content. The difficulty in establishing the clear boundaries and responsibilities for course teaching and student support creates the conditions for costs shifting between entities and reduced quality. These conditions make it difficult and expensive for a principal to assign responsibilities to particular agents and to monitor agents' performance.

The fundamental objectives of publicly funded VET, as argued by the Commission, are to improve economic efficiency by redressing market impediments in the provision of vocational education and training and lift social equity by encouraging participation of disadvantaged groups in VET. Failure to achieve these objectives imposes large negative externalities on individuals and the wider economy. King and Pitchford (1998), in the spirit of transaction costs economics, have argued that the critical consideration in the decision to corporatise or privatise a public service is the extent to which failure to deliver the service results in significant social cost.

There are large potential costs in VET service delivery failure. Inadequate training lowers labour force productivity. Contracting imposes inefficient search costs on potential users seeking to avoid adverse selection of VET providers. It also creates a negative externality for public and private providers in terms of ‘reputational risk’ to higher quality providers as the perception of low quality may deter potential students and other potential users from participating in VET. Finally, under such conditions low quality providers can undercut higher quality providers, potentially supplying the service below the optimal marginal cost because they are not incurring the expense of delivering a quality service. Under these conditions competition is not a guarantee of either effective pricing or quality. (The following section outlines many instances of these effects occurring in the private VET market).

Inability to precisely define VET inputs and outputs produces a high probability of inadequate provision from a contracted service. Without a rigorous measurement of productivity, efficiency, effectiveness and quality for VET inputs and outputs the minimum condition for efficient and effective contracting is absent. This problem is compounded by multiple and overlapping objectives for the VET system which cannot be directly related to input use or outputs and an imprecise distinction between commercial and non-commercial VET activities.

The absence of minimum conditions to establish a competitive market for publicly funded VET provision means the minimum conditions for effective and efficient contracting are absent. This has profound implications for current moves, endorsed by the Commission, towards competitive tendering of publicly funded VET activity and ‘outcomes based’ funding of this activity. The Commission is critical of current funding mechanisms used in publicly funded VET because they link ‘payment to inputs (hours of teaching delivered) rather than outcomes (number of students passed or firms serviced’ (PC 2010: 7.36). Given the low probability (or impossibility) of developing sophisticated indicators of VET system performance, that is, quality adjusted measures of efficiency, effectiveness and productivity, it is inevitable that less sophisticated measures will be used. These will focus on simple quantitative measures such as module or course completions or number of ‘firms serviced’. Under these conditions TAFE will not be able to compete against private RTOs in this ‘quasi market’. The reasons for this were outlined above. TAFE was established to deliver a quality service within prescribed resource constraints, not deliver lowest cost per module or course completion nor to maximise the dollar return on public funds

invested as, for example, would apply to a fully corporatised Government Business Enterprise. TAFE does not have the governance structure to perform this role nor are incentives for managers and teachers geared to elicit this performance. It was established to overcome market failure and promote social equity by delivering services that perform multiple, and sometimes conflicting objectives, the achievement of which are difficult or impossible to relate precisely to input use. Requiring TAFE to adopt the objectives, forms and practices of private RTOs represents a profound misunderstanding of the economics of publicly funded VET provision.

The imposition of competitive tendering and outcomes based funding effectively changes the rules of the game for TAFE. As the Commission itself observes there is ‘a tension between promoting competition and maintaining the viability of TAFE’ (PC 2010: 4.16).

4.2 Recent Examples of Principal-Agent Problems in Education and Training

There are many recent Australian examples that suggest principal-agent problems are possibly pervasive in private training delivery, including VET. This section briefly mentions five cases that are on the public record. Four of these cases have been the subject of official Inquiries and one is drawn from data published by VET regulators. Two of these Inquiries are referenced in the Report, though their implications for the potential benefits of contracting-out of publicly funded VET were not fully developed.

4.2.1 *Foreign Students and Private RTOs*

The Commission acknowledges that in the provision of education and training to overseas students by Australian private education providers, including VET providers there is ‘increasing concerns about the quality of courses offered, the support provided to students and, in some cases, about the safety of the students’ (PC 2010: 4.14).

These problems were the subject of a recent Baird Inquiry (2010) into the regulatory system for delivery of VET training to overseas students. This regulatory system applies to both public and private providers of VET to overseas students. Importantly, the Inquiry emphasised that the risks for quality were in private RTOs and highlighted the risks for quality in extending the role of private RTOs in domestic VET provision.

‘In reviewing these [regulatory] frameworks I believe international education is a leading indicator for domestic policy makers. For the Australian Government’s aspiration of increasing participation in education to be realised the education sector will need to grow. The international education experience has shown that the private sector has the greatest ability and capacity to be responsive to demand and hence grow quickly. However, where profit is a key outcome from delivering education services, the quality of the service will at some point and for some providers come under pressure. The issues international education is facing right now are likely to be future issues for the whole education sector. It would be naive of us to think otherwise’ (Baird 2010: 5).

4.2.2 Certificate IV in Training and Assessment

The Commission also cites a recently completed audit of RTOs in Western Australia and NSW who delivered the Certificate IV in Training and Assessment (TAA).¹⁶ These audits were conducted on behalf of the national VET regulator (PC 2010: 8.6). The TAA is the minimum mandated teaching qualification for VET teachers. The WA audit found that only 50 per cent of the sample of 24 RTOs delivering the TAA was compliant with the national regulator's specified standards. Non compliance was found *inter alia* in:

inadequate, inaccurate or out of date course information provided to students... lack of systematic collection, analysis and acting on information to improve on training and assessment...inadequate record keeping systems and administrative processes...inadequate validation of assessment strategies/tools or moderation of assessment outcomes (National Strategic Industry Audit 2010: 2).

The inability of a principal to efficiently discriminate between private providers on the basis of quality and price means that competition is no guarantee of quality and indeed, may undermine quality through a 'race to the bottom'. The NSW VET regulator audit of the Cert IV in TAA concluded that:

RTOs offering an educationally sound program incorporating an appropriate number of face-to-face hours and sufficient hours to complete self study and projects and assessments, find it difficult to compete with RTOs offering a short, cheap course in three to five days. Some RTOs perceive their bottom line is not to lose applicants to less conscientious RTOs (NSW VETAB 2008: 18).

4.2.3 Corruption in Private NSW RTOs

Stark examples of market and ethical failure in the private provision of education and training in the domestic market are revealed in separate investigations by a statutory corruption organisation the NSW Independent Commission Against Corruption (ICAC). It investigated VET training provision in the NSW construction industry (ICAC 2004); training and assessment for residential house builders and structural engineers (2005) and the security industry (2009). In each of these reports the ICAC noted the 'high risk' nature of the activities in terms of potential harm to both inadequately trained persons working in these licensed occupations and to the wider

¹⁶ These audits collected data on compliance by RTO type that is TAFE, private RTO, community organisation etc. The WA Department of Education and the National Quality Council were contacted to provide data from these audits on compliance performance cross-classified by provider type. Both organisations refused to supply the data. Informal advice from one of the state regulators indicated that the TAFE colleges included in the sample were compliant.

public. It also noted that corruption had become so extensive as to undermine the integrity of the VET system in the specific fields of training.

To illustrate these problems just one of these investigations, into training for the NSW construction industry, is briefly mentioned here. The ICAC investigated systematic corruption by private RTOs in the late 1990s and early 2000s that offered nationally accredited ‘assessment and certification for machinery operators, the issuing of OHS induction statements, and the training and certification of crane operators working in the vicinity of overhead power lines’ (ICAC 2004: 70). The investigation found:

deliberate and widespread abuse of the competency assessment regulations by six accredited assessors. The Commission found evidence that these assessors had issued some thousands of Notices of Satisfactory Assessment without having properly conducted the specified assessment procedures. In some cases individuals were provided with Notices of Satisfactory Assessment without any testing at all of their actual competence in operating the specified equipment (ICAC 2004: 6).¹⁷

The ICAC identified a number of market conditions giving rise to these adverse outcomes. First, training and assessment activity for these qualifications had previously been undertaken directly by the WorkCover NSW, a NSW government Department. This function was outsourced in 1996. ‘The outsourced nature of the function, with its inherent weakening of centralised controls, increased the need for a rigorous corruption risk management approach’ (ICAC 2004:72). Second, the regulatory system put in place was grossly inadequate to detect systemic corruption (ICAC 2004:72).¹⁸ Third, assessors were either self employed or had a small number of employees. This meant there were either no potential internal whistle blowers to expose mis-conduct or the probability was greatly reduced. Finally, corrupt behaviour on the part of these trainers and assessors made it difficult for ethical providers to compete.

¹⁷ There was evidence that these improper practices extended beyond the operations of the six identified assessors. The six assessors were responsible for issuing a significant percentage (12.6 per cent) of the total number of Notices of Satisfactory Assessment issued in New South Wales between 1996 and 2003 (ICAC 2004: 11).

¹⁸ Five years later in its report into corruption in training and assessment for the security industry the Commission’s assessment of the VET regulatory system was absolutely damning. It found that the ‘licence upgrade process has failed in its objective to weed out incompetent and undesirable RTOs and security officers. The Commission also considers how the evidence of corrupt conduct and poor quality recognition of prior learning (“RPL”) assessments uncovered during this investigation raises real doubts about the legitimacy of all current security licences in NSW and the integrity and competence of all security training providers...The Commission also [noted]...the fragmentary and confused state of the current regulatory system and the lack of means for regulators to identify which current security qualifications are legitimate, which RTOs are corrupt, incompetent or lazy, and which are ethical and legitimate security training providers’ (ICAC 2009: 7). Gallagher and Anderson (2005) cite a report on corruption by the Victorian VET regulator into the private delivery of ICT training. A number of RTOs were ‘splitting’ generous public subsidies for the provision of ICT VET courses between themselves and employers and providing minimal training.

‘All six corrupt assessors admitted that their corrupt activity had a compounding effect and that it had generated a market for improperly issued certificates (ICAC 2004: 72).

4.2.4 Adverse Findings by Regulators Against Private RTOs

A condition for RTOs to train and assess National Training Packages and issue qualifications is that the RTOs must be registered to meet standards prescribed under the Australian Qualifications Training Framework. These standards are focussed on the capacity of the RTOs to deliver a minimum standard of quality in their training and assessment. Assessment, accreditation and registration of RTOs is currently the responsibility of state based VET regulators. (Establishing a national VET regulator is in train). To deliver publicly funded VET both private and public RTOs must be registered under the AQTF. One indicator of the scope and scale of the risks involved in contracting VET services are the audits to assess continuing registration of RTOs conducted by VET regulators. Some states make the results of these audits public on their websites.¹⁹ Adverse findings by the regulator can result in the deregistration of the RTO.

Over the course of 2010 in Victoria 66 RTOs ceased operating for a variety of reasons; of this total the registration of 15 RTOs were cancelled due to non-compliance (VRQA 2011). Another RTO was suspended, which means its registration to deliver one or more Training Packages was cancelled. In NSW 22 RTOs were cancelled due to non-compliance over the period 1995 to 2010 (NSW VEETAB 2010).²⁰ All cancelled or suspended RTOs were private RTOs. This data supports the finding of the Baird Review that the overwhelming source of risk in terms of non-compliance with minimum quality standards lies in private provision of VET.

These audit results almost certainly understate the level of non-compliance by private RTOs with minimum quality standards. Under the AQTF not all RTOs are assessed regularly, rather audits are based on a ‘risk management’ principles. RTOs may be audited depending on the level of complaints or the RTO delivers a Training Package that is known to have high levels of non-compliance. (Such as the Certificate IV in TAA cited earlier). There are also different levels of intensity of audits. An initial audit may comprise only an examination of the ‘paper trail’ for training and assessment. (Are student records of attendance and evidence of competencies achieved in order?). More intensive audits, involving site visits and interviews with past and current students are resource intensive and state regulators have limited funding. In addition, given the requirement for VET regulators to operate under rules of ‘natural justice’ the processes leading to deregistration can be lengthy. After an initial adverse finding by a regulator an RTO has an opportunity to rectify a problem

¹⁹ Unfortunately, it is neither required for states to make these result public nor for the presentation of the results to be based on nationally consistent data categories. The latter problem makes comparability of audit results across states difficult.

²⁰ The marked difference in the number of forced deregistrations between NSW and Victoria, with the latter having 22 deregistrations over 5 years and the former 15 in one year suggests there are significant differences in the auditing processes across the states.

and request to be re-assessed. If there is an unresolved dispute between the regulator and the RTO, the RTO can ask for the case to be adjudicated by a state Administrative Appeals Tribunal. If the RTO is dissatisfied with this result the RTO can take the regulator to a Supreme Court. Prior to the final determination of an adverse finding an RTO can simply elect to voluntarily relinquish its registration and cease operating. Of the 66 Victorian RTOs that ceased operating in 2010 40 were listed under 'voluntary cancellation'. There are, of course, many reasons for an RTO voluntarily cancelling their registration, of which seeking to avoid being compelled by the regulator to cease operating is only one. However, it is important note that business failure is recorded separately to 'voluntary cancellation' as a reason for an RTO ceasing to operate. The remaining ten RTOs who ceased operating in Victoria in 2010 did so because they were in 'liquidation' or in 'voluntary administration'.

4.3 Collusion between principals and agents to diminish quality

There is an additional market failure in the provision of VET that is distinct from problems arising due to information asymmetry between principal and agent. There are particular market conditions creating perverse incentives for VET students not to demand quality training and for RTOs not to supply quality training. Under such conditions a principal and agent collude to diminish quality of training provision. In some circumstances employers of people undertaking such VET training are also involved in this collusion. This market failure occurred in two examples previously cited, that is, corruption revealed by ICAC Inquiries and the widespread quality problems in the delivery of VET training to foreign students.²¹ In both of these examples there are similarities but also distinct differences in the conditions giving rise to collusion.

The ICAC identified market conditions leading to students, trainers, assessors and employers to act corruptly. These were discussed earlier and included inadequate regulation and low probability of whistle blowers within these corrupt RTOs informing regulators. The ICAC also identified factors that created demand for the services of corrupt trainers and assessors. Possession of the qualifications was mandated for employment in the construction industry. The qualifications thus had a high market value as they permitted entry to high paying jobs. Crucially, many students and employers of construction labour were apparently indifferent to the quality of training. This indifference was due to high labour 'demand created by the building boom' associated with the Sydney Olympic Games; indeed, pressure was sometimes directly exerted by employers on these assessors to pass their employees to ensure adequate labour supply (ICAC 2004: 72).

The official inquiry into the delivery of VET training to overseas students in Australia and other studies reveal a number of different market conditions which contribute to collusion between principal and agent.

²¹ Collusion between RTOs, students and employers also applied in the Victorian private RTOs delivering ICT training. For brevity this case is not detailed.

First, acquisition of a VET qualification was a mandated requirement to achieve the students' objective, which was to gain Permanent Residency (PR). The VET qualification had no utility or value to the student other than a means to gain PR (Birrell, Healy and Kinnaird 2007). Many of the students were uninterested in working in an occupation related to the VET qualification upon achieving PR (Birrell, et al 2007: 39). VET providers were aware of the incentives motivating participation of the foreign student in VET. Private providers sought to maximise profits by minimising the cost and quality of training provision.

Second, given that attaining a VET qualification was simply a means to a highly valued end, the students were prepared to pay a high price to gain a VET qualification. Prices for the provision of such courses were unregulated. For example, in 2005 fees of close to \$20,000 were charged for 2 year courses in commercial cookery (Birrell et al. 2007: 36). Baird (2010: 23) found that in 2009 'the average annual cost for an Australian international education course is almost \$17 000'. Lack of demand for quality training and the high price charged by colleges to provide training created an incentive for overseas students to seek paid employment and reduce their college attendance. This further reduced the opportunity and incentive for providers to supply quality training.

Third, the rapid rise in demand from overseas students for these VET courses and the high prices charged for these VET courses led to a rapid expansion of private supply of these VET courses. The number of overseas students in private colleges increased from 11,000 in 2000 to 192,300 in 2009 an increase of 16.5 fold. By contrast overseas students in public providers doubled from 19,800 to 39,700 (PC 2010: Table B.21). Such rapid growth created a burden for regulators that could not be met in the context of constrained public expenditure. Given this regulatory burden the risk to the student and provider in colluding to reduce training quality was perceived as low.

Four, there were low financial barriers to entry into the private VET college market due to low sunk costs and low fixed costs. There were also low barriers to exit in that the cost of ceasing operations could be minimal. Colleges could obtain equipment and buildings through short term leases and employ casual teachers (Birrell et al. 2007: 36). Low financial barriers to entry and exit reduce the potential cost of engaging in financially risky behaviour; reduces the potential costs of adverse action by regulators and shortens the investment horizon of the college proprietor.²² 'Many of the failed providers closed their doors within 5 years of operation because they could start a business with relatively small working capital and insufficient assets to protect the students' interests. Current entry requirements are dangerously undemanding' (Baird 2010: 15). These conditions leading to market failure are neatly summarised in the Baird Report:

The opportunity to migrate to Australia is a significant reason for the increase in international student numbers over recent years. It was resoundingly clear from

²² Low barrier to entry and exit are identified in transaction cost economics as a factor conducive to opportunism by principals and agents.

the consultations that migration as a driver of student demand has an impact on the behaviour of a range of stakeholders, including providers, agents, governments and students...This link has resulted in some providers and their agents being interested in 'selling' a migration outcome to respond to the demand from some students to 'buy' a migration outcome...The pathway to general skilled migration has resulted in opportunistic providers entering the market with an eye to short-term profits, with a lack of focus on providing a high quality education and/or training experience (Baird 2010: 14).

In some cases students appear to collude with these people for mutual gain. In such cases this usually results in poor education outcomes' (Baird 2010: 6-7).

Collusion between agents and principals is also highly likely in delivery of the Certificate IV in TAA. The Commission (2010: 8.11) notes that despite being mandated under the AQTF 'many people actively engaged in the VET sector as trainers and assessors do not have the necessary minimum educational qualification of the Certificate IV in TAE or an equivalent qualification'. This implies that both teachers and employers do not give much weight to the qualification as necessary to deliver useful skills that would improve their job and/or promotion prospects or improve the attractiveness of their firms' to prospective students. Where a person is already employed in a VET teaching position and is required to gain a qualification to maintain this position, this is likely to be viewed as simply a bureaucratic imposition- or 'being forced to jumping through hoops'. Under such conditions there is neither an incentive for a student to demand quality teaching nor for providers to supply it.

Qualifications under the AQTF are meant to be a standardised product, accepted nationally and delivered to the same prescribed quality across all providers. The extraordinary variation across RTOs, in both the price for delivering the Certificate IV in TAA to a student and the duration of study required to complete the qualification, support the claim that there are considerable differences across RTOs in the quality of teaching delivery. A recent audit of RTOs delivering the qualification in Western Australia found that:

Fees were in the range of \$1500 - \$7,800 for the full qualification...the duration of training...varied from 8 consecutive days to up to 2 years involving mixed-mode delivery (National Strategic Industry Audit 2010: 2).

4.4 Risk and Contingent Liability for the Taxpayer

The Commission fails to identify the significant risk of contingent liability associated with the current level and anticipated growth in the share of publicly funded VET delivered by private RTOs. Delivery of large scale workforce training through the public VET system is an essential service. Services are 'essential' when there are large negative economic externalities arising from failure to supply the service. For example, in the case of the collapse of private colleges training overseas students the government identified a need to prevent 'reputational' risk to the broader Australian

education system. The risk attached to failure is amplified when there are few producers of the service. In outsourcing or privatising delivery of essential services, either in whole or in part, government cannot dissociate itself from the need to guarantee continuity of service supply or from bearing other costs arising from the financial failure of the private supplier. The risk of this guarantee is, in effect, a contingent liability for the government, for which some provision may have to be made depending on estimates of both the probability of the liability being realised and size of the liability.

In addition, the more rigorous the government regulatory regime imposed on the private suppliers of the service the greater the expectation that the government will be held responsible for ensuring continuity of supply and/or meeting other costs in the event of failure of supply or insolvency of the private supplier. Government cannot avoid the consequences of regulatory failure over essential services. Government guarantee of supply can take a number of forms, such as additional financial support to insolvent private agents, providing the service using remaining public sector assets or re-nationalising the service.

There are many Australian examples of government not being able to dissociate itself from the risk of guaranteeing continuity of supply or bearing other costs following the collapse of private providers of regulated essential services. These include for example, the collapse of Ansett Airlines, the Pyramid Building Society, ABC Learning,²³ private colleges servicing foreign students²⁴, the re-nationalisation of privatised public transport systems and toll roads and deposit guarantees for Australian banks during the GFC.

The case of ABC Learning is particularly instructive. In the late 1990s there was a change in federal government policy from direct funding of local government and other not-for-profit child care centres to payment of a subsidy to parents of young children who were free to choose any provider. The publicly listed ABC Learning used high levels of private debt financing and access to public subsidies to consolidate the private child care industry through acquisitions and building new centres. By 2005 it operated 20 per cent of the total long day care market (Rush and Downie 2006: 13). Its subsequent financial failure threatened large negative externalities, such as a fall in the labour market participation of many parents due to the removal of the child care service.

Private agents contracted to supply essential services are aware of the implicit guarantee of continuity of the essential service. This implicit guarantee creates a moral hazard or an incentive for the private agents to increase their risk preference (Ferris

²³ ‘The insolvency of ABC Learning is the greatest ever shock the Australian child care market has experienced. A large number of ABC Learning centres could have ceased operating. Given the substantial disruption this would have caused, the Commonwealth Government provided support to the receivers to keep the centres operating for a transitional period’ (DEEWR 2010: 11).

²⁴ ‘Throughout the 1990s the Australian Government stepped in and paid more than \$70 million in refunds to overseas students and associated costs to protect the reputation of Australia as a reliable provider of quality education and training services’ (Baird 2010: 50).

and Graddy 1986). This increases the probability, and possibly scale, of the liabilities for which government may be responsible.

The government could seek to address moral hazard and distance itself from the risk of guaranteeing supply and other costs by imposing a compulsory levy on all private RTOs delivering publicly funded VET. The levy would be used to establish a prudential fund to ensure continuity of service and meet other costs in the event of failure of private RTOs delivering publicly funded training. Such a scheme already exists for private RTOs providing VET training to foreign students (Baird 2010). Similar schemes have also been set up for RTOs delivering training to domestic students, such as the Australian Tuition Assurance Schemes run by the Australian Council of Private Education Providers. However, participation in such schemes does not appear to be compulsory.

A compulsory levy would raise the cost of private RTOs providing training, including that contracted out by the public sector. These costs reduce the anticipated benefit of outsourcing. There are also costs associated with establishing and regularly monitoring the actuarial risks underlying such prudential schemes. The scale of risk and difficulty in assessing their probability has prevented private insurers from accepting these risks.²⁵ The inability of specialists in the private sector whose job it is to the price risk of failure on the part of private RTOs is another factor in the government not being able to insulate itself from risk in outsourcing training delivery to private RTOs.

Finally, introducing such a levy to cover the risk of failure of private RTOs delivering publicly funded VET would be open to the charge that it was incoherent public policy. The cost of the levy would be factored into the market price set by private RTOs to deliver publicly funded training, but the levy would only be required because of the original decision to commence or increase outsourcing of publicly funded VET. Alternatively, the private RTOs could argue that the cost of their participation in prudential levy schemes to deliver publicly funded VET should be subject to a Community Service Obligation. This would ensure competitive neutrality between private and public RTOs given the implicit government guarantee of financial support for public VET providers.²⁶

²⁵ The Baird report (2010: 54) concluded of the current prudential scheme for foreign students in private RTOs: 'in the current environment there is little prospect of a commercial insurer taking an interest in accepting the financial risks associated with the current assurance frameworks. Indeed, for some years the Fund has been unable to find an issuer to underwrite it due to the increasing number of closures and calls on the Fund, the difficulties associated with assessing the risk of future closures and the rapid way in which risk profiles have altered. It is unlikely that a commercial insurer would take the view that they could adequately assess and quantify the associated risks with sufficient confidence to underwrite the risk'.

²⁶ Where public enterprises and private business are in direct competition, competitive neutrality requires that any advantage applying to a public enterprise arising from its public ownership be offset. These advantages include for example, non payment of profits and company taxes, or having access to lower borrowing costs on credit markets. These advantages are offset by numerous means such as requiring public enterprises to pay dividends to the government set at a commercial rate of return in lieu of profits to shareholders; or payment of special dividends to government equal to the company tax rate (Denniss and Toner 1999: 119).

4.5 Regulatory Burden for Quality Assurance in VET and Corruption Prevention

To address these information asymmetries, principal-agent collusion and other risks to quality the Commission suggests a more vigilant and comprehensive external auditing of provider performance and wider dissemination of these results. The Commission recommends for example, more intensive regulation for delivery of the minimum pedagogical qualification for VET teachers, the Certificate IV in Training and Education. The certificate 'should maintain its status as a high risk qualification. Auditing by state and territory regulators of RTOs with this qualification on their scope needs to be more frequent and more intensive' (PC 2010: Draft Recommendation 8.1).

The Commission also endorses the approach of the new national VET regulator, the National Quality Council, which will significantly expand the extent and intensity of regulations imposed on VET providers. This will encompass for example, checks on financial viability, ensuring an appropriate level of qualifications for teachers, adequacy of teaching resources and equipment and separate training from assessment by using agents external to an RTO to undertake student assessment (PC 2010: 4.13; NQC 2010).

In addition, as recommended by the NSW ICAC there must be a separate and complementary set of anti-corruption measures to protect the interests of taxpayers and the overall integrity of the VET system. The three NSW ICAC investigations referenced here made it clear not only the powerful economic incentives for both providers and agents to engage in corruption, but the large scale adverse impact on the quality of the VET system that will arise unless strong anti-corruption measures are put in place.

It is clear from the results of the Baird Review, the NQC study of the Cert IV in TAA, the three ICAC investigations and the incidence of deregistration of RTOs by VET regulators that the locus of principal-agent problems and unethical behaviour is located primarily within some private RTOs. This is not to imply that opportunism and unethical behaviour do not occur in public VET providers, rather the weight of publicly available evidence would suggest the locus of these problems is in private providers. The imposition of increasingly stringent and costly regulation on the whole VET system, that is designed to maintain quality and protect the interests of students and taxpayers, has arguably, been necessitated primarily by expansion of private VET provision. Despite this, the Commission apparently endorses moves to expand the scale of private provision and competitive tendering. The Commission fails to undertake a comprehensive analysis of the cost of this more extensive and intensive regulation against the anticipated benefit from increased private provision of publicly funded VET. Moreover, the Commission has failed to assess the adequacy of the

newly proposed national regulatory regime or acknowledge the significant risks for quality and efficiency arising from ineffective regulation and regulatory capture.²⁷ In its discussion of the new regulatory regime the Commission gives considerable weight to publishing information on the performance of RTOs based on regulators' audits. This is designed to enhance consumer sovereignty and market efficiency.

The Commission judges, further, that greater transparency of audit results is needed, to give consumers and funders of the services of RTOs greater confidence in the quality of the product on offer. Transparency would also incentivise providers to focus on the quality of training and assessment, and encourage quality of the auditors' activity (PC 2010: XLVIII).

However, the Commission needs to acknowledge the limits of information provision to the public as a means of increasing market efficiency. This is not just due to search costs and 'bounded rationality'. Under some circumstances it can be rational for producers to engage in opportunism and 'obfuscation', such as providing information which makes it difficult to compare the attributes of their product with that of other producers (Ellison and Wolitzky 2009). There are many everyday examples of such obfuscation such as mobile phone plans, superannuation, banking services and health insurance where information from each provider is presented in such a way as to make direct comparison difficult or impossible. Indeed, third party businesses have been created out of consumers' need for comparable information. 'Outsourcing' this search activity however, does come at a price for consumers. Marketing efforts by RTOs could offset to varying degrees the effect of regulators making public the results of official audits. Moreover, current audit results by regulators, such as that undertaken by the National Strategic Industry Audit (2010) and NSW Vocational Education and Training (2008) are quite opaque to the lay reader. They simply list whether an RTO is compliant or not complaint against a large number of criteria.

Moves by regulators to ensure the veracity of marketing claims made by RTOs about the benefits of their courses with respect to matters such as employment and earnings of graduates, international recognition of their qualifications and credit transfers to higher VET or university, opens up a potentially new and expensive field of VET regulation.

4.6 Risk of unintended consequences

Finally, in many other contexts the Commission is consistently critical of calls for government intervention, even those that may address a variety of 'market failures', due to the potential for adverse 'unintended consequences' from such intervention. The Report provides some examples of these adverse consequences. One arises from the shift to outcomes based funding of VET where providers are paid for module or course completions. The Commission endorses this shift despite acknowledging that:

²⁷ The Commission does note that more intensive compliance activity reduces the attractiveness of the VET working environment for VET managers and teachers (PC 2010: 7.28).

This might...create a shift in trainers' and assessors' teaching practices, such that they need to be more attentive to students' ongoing attendance and performance. An alternative consequence is that it could lead to some reduction in VET standards, if successful completions are paramount (PC 2010: 6.13).

Despite noting this possible adverse outcome the Commission offers no solution.

5. Contemporary human resource practice

The Commission strongly advocates that TAFE adopt 'contemporary human resource practices' to improve its efficiency and quality of delivery (PC 2010: 7.38). The Commission does not explicitly define these practices but it is clear the three core elements are increased managerial prerogative through decentralised industrial relations bargaining, extension of workforce casualisation and use of performance based pay. The purpose of these changes is to promote numerical and functional flexibility in the deployment of labour and wage flexibility within and across different categories of labour. The Commission presents no evidence that these practices constitute contemporary human resource practice; no evidence as to their effect on productivity, efficiency, effectiveness and quality and no evidence as to the appropriateness of applying these practices to the delivery of VET training. Moreover, the demands for greater managerial prerogative and workplace flexibility directly contradict the achievement of a number of improvements to the quality of the VET system recommended by the Commission. These include improved recruitment and retention of teachers and more investment by teachers and employers in professional development and higher qualifications. This reflects a degree of incoherence in the Report due to incompatibility between a number of key findings and recommendations.

5.1 Decentralised Industrial Relations Bargaining and Managerial Prerogative

The Commission is critical of the current industrial relations system in TAFE.

There is a case for improving the efficiency and productivity of the workforce through adoption of more contemporary work practices across the sector...In the TAFE sector, existing state-wide agreements apply homogenised levels of pay, based on tenure and, to a lesser extent, qualifications...They set up workforce rigidities that limit the ability of TAFEs to recruit according to need, reward better performance and compete with private providers (who tend to enjoy greater freedom in setting pay and conditions)' (PC 2010: p. XLIII).

The specific changes the Commission requests are greater functional flexibility in the deployment of labour, greater wage flexibility within and across TAFE colleges and occupations and greater numerical flexibility, especially removing limits on both the use of casuals and other forms of employment. This is to be achieved by replacing state wide industrial relations instruments with bargaining at the 'enterprise level' (PC 2010: XLIV).

More managerial autonomy for TAFEs to link performance with pay, set wages and engage people on the most appropriate employment arrangements for their specific needs would help with recruiting and retaining necessary staff (PC 2010: p.7.1).

In terms of functional flexibility there should be few limits on the place, time or activity undertaken by teachers, subject to the activity being within the competence of the teacher. ‘The Commission considers that employment contracts in the TAFE sector should specify ordinary work time for trainers and assessors and not overly prescribe when, where and how that time should be spent’ (PC 2010: p.7.37).

The Commission recommends greater wage flexibility and notes that current wage levels in TAFE appear to be higher than those applying amongst private RTOs. It calculates the maximum effective hourly pay rate for teachers in private RTOs based on the Modern Award is \$47.50 compared to \$68.14 in NSW TAFE (PC 2010: Table 7.2). It is also concerned that these pay rates and increments apply irrespective of teaching occupation or region across TAFE. ‘The uniform wage setting arrangements in TAFE, which do not differentiate between industry skills, might lead to higher salaries being provided to some VET staff than is necessary to attract suitable workers to the sector (PC 2010: xliv).

The following identifies problems in terms of the evidence base for the findings and recommendations and internal consistency with the overall arguments.

5.1.1 Problems with and costs of decentralised industrial relations bargaining

The Commission fails to consider the problems and costs associated with TAFE adopting more decentralised industrial relations bargaining. First, greater managerial discretion to set for example, wage levels and hire and fire can undermine transparency and accountability in decision making in human resources and in the use of taxpayer funds. A recent study comparing human resource practices in TAFE and private RTOs is instructive. It found that:

With the exception of some of the larger private registered training organisations (only 15% of respondents to the survey), human resource management in these organisations is usually controlled directly by the CEO rather than by a human resource specialist. This means that human resource management often reflects the idiosyncrasies of the CEO (Smith and Hawke 2008: 36).²⁸

The study did note though that 50 per cent of private RTOs reported having written HR procedures and policies.

In contrast:

the underlying principles behind the human resource policies that govern TAFE institutes are focused on procedural fairness. This is a very important principle,

²⁸ In ‘general the model of human resource management prevailing in private registered training organisations resembles that found in small business, and is relatively informal, non-proceduralised and not serviced by specialised human resource management staff’ (Smith and Hawke 2008: 27).

but a move towards more strategic integration of human resource management will also demand a focus on performance through greater flexibility of the workforce (Hawke and Smith 2008: 36).

The study further noted of private RTOs, ‘in some cases flexibility may have come at the cost of equity and procedural fairness’ (Smith and Hawke 2010: 37). These authors find there is a trade-off between greater managerial autonomy in TAFE and preserving ‘procedural fairness’. Procedural fairness, otherwise known as natural justice, entails a range of practices that are designed to impose transparency and accountability on decision makers and promote ethical standards.²⁹ A reduced priority to procedural fairness can, for example, reduce the barriers to managers engaging in favouritism and nepotism in staff appointments and wage decisions. The Commission should make the existence of this trade-off explicit. (The Commission cited the study by Smith and Hawke 2008 extensively but did not address this finding). The importance of procedural fairness in creating employee commitment, improving retention and inducing greater effort is well established in the academic management literature (Folger and Konovsky 1989).

Alternatively, attempting to retain procedural fairness practices within a decentralised industrial relations system could impose costs that would negate the potential efficiency gains in moving towards a less ‘regulated’ system. These costs will include requiring extensive documentation to establish an audit trail for decision making for wage setting, performance appraisals and hiring and firing decisions for each worker and establishing transparent appeals processes against these decisions.

The Commission also fails to quantify the additional cost to the public purse if each TAFE college or Institute contracts with individual workers or groups across the many different categories of worker employed in TAFE. Some of these direct costs include the need to engage HR specialists and industrial lawyers at each college or Institute and the time of individual workers or groups of workers bargaining with management, presumably during paid working hours. (Additional costs in decentralised wage bargaining are outlined in 5.1.3).

One of the key arguments put forward by the Commission to support its recommendation for more decentralised industrial relations bargaining and greater managerial autonomy is that TAFE will be put at a competitive disadvantage against the private RTOs in recruiting teachers. The Commission presents no evidence for this claim. This claim is contradicted by the Commission’s own calculations which demonstrate that TAFE pays a higher average minimum and maximum effective hourly pay rate for teachers than private RTOs. The Commission presents no

²⁹ The concept is typically examined in the context of the justice system, but its application to public sector decision making is much wider. ‘Procedural fairness refers to a process that provides fairness to all parties. It includes the right to be heard, the right to be treated without bias, the right to be informed of allegations being made and to be provided with an opportunity to respond to them and the right to information regarding the status of the complaint NSW’ (Department of education and Training 2011).

quantitative evidence as to the variation of pay rates within private RTOs or the extent to which these rates can, on occasion, exceed those in TAFE. The Commission also did not consider that greater comparative recruitment difficulties for TAFE (if they exist) could be due to much higher standards required of prospective teachers in TAFE. TAFE teachers are much better formally qualified than their private RTO counterparts and have much more experience working in the VET system. (This is detailed below). In addition, TAFE provides most of the trades based training conducted in Australia. A recent study by the Department of Employment, Education and Workplace Relations (2010: Slide 12) found that trade based teachers in VET were the most difficult teacher category to recruit.³⁰ Other evidence presented in the Report also contradicts the claim that TAFE has particular difficulties in recruiting *viz a vis* private RTOs. The Report cites the example of Polytechnic West, which in 2007, ‘ran a radio campaign to recruit 108 tradespersons into teaching. The campaign was very successful, in terms of generating interest (1000 enquiries) and applications (1027)’ (PC 2010: 7.22).

Given the lack of comparability of teaching labour that is recruited in TAFE and private RTOs it is not at all clear what a metric such as ‘recruitment difficulty’ is intended to measure and what policy inferences can be validly inferred from it. An argument could be made that TAFE and private RTOs draw on distinct labour pools. The more pertinent indicator is the extent to which TAFE has been constrained from delivering courses or other activities as a result of recruitment difficulties. The Commission has presented no evidence as to this effect.

5.1.2 Problems with demands for greater functional flexibility

The Commission’s demand for greater functional flexibility means that for teachers there are no limits on the type of activity to be undertaken within ‘ordinary hours’. Such a provision will be open to abuse by management by imposing excessive teaching hours. Increasing teaching hours diminishes the capacity to fulfil other important functions of teachers. TAFE teachers are required and/or expected to engage in keeping up to date with new technologies and industry practices by visits to local firms and undertake other forms of professional development. The Commission acknowledges the importance of professional development yet this recommendation could contradict the achievement of this goal.

An expansion of teaching hours will be encouraged by moves, endorsed by the Commission, to shift public funding of VET towards an outcomes based funding model. Outcomes are defined as payments to providers for course and/or module completion. The shift to outcomes based funding will create a powerful incentive for

³⁰ This study provides conflicting evidence on the comparative recruitment difficulties of TAFE. On the one hand 63 % of TAFE respondents reported they had recruitment difficulties due to wages being ‘not competitive’ compared to just 10 % of private RTOs reporting such difficulties (DEEWR 2010: Slide 14). Also 82 % of TAFE managers reported recruitment difficulties compared to 62% of private RTOs (DEEWR 2010: Slide 12). On the other hand, 15.8 % of private RTOs reported having unfilled teacher vacancies compared to just 4.4% of TAFE colleges (DEEWR 2010: Slide 8). As noted above the recorded recruitment difficulties could be due to the higher standards required of TAFE recruits.

managers in public and private RTOs to maximise teaching hours and reduce non-teaching duties.

5.1.3 Problems with increased wage flexibility

The Commission recommends greater wage flexibility across occupations and regions to reflect differences in relative labour supply and demand and to promote greater allocative efficiency. However, the Commission fails to identify its attendant costs and problems.

There are significant search costs in requiring each TAFE college or Institute to ‘test the market’ to establish a wage rate for skills in demand. This could involve for example the engagement of HR specialists and/or remuneration consultants to identify appropriate rates and negotiate individual remuneration packages. The notion of establishing a ‘market rate’ for VET teaching skills is also problematic. What exactly is the wage comparator say for a teacher of diesel mechanics that will be used to establish a market rate? Is it to be an experienced diesel mechanic in industry that has no teaching experience or teaching qualifications? Teaching diesel mechanics and being a diesel mechanic are quite distinct occupations requiring distinct attributes and with different pecuniary and non-pecuniary rewards.

There are also practical issues, once an appointment is made for a ‘hard to fill’ teaching position how frequently will the market need to be tested to ensure that a college is not paying too much or too little? Allocative efficiency would demand that there be quite regular market reviews. Any change in pay rates based on these regular market reviews would require further negotiation. There are likely to be adverse effects on morale and effort if teachers’ salaries are reduced following such reviews. Finally, paying people different rates of pay for doing an identical job, that is, VET teaching, can offend people’s sense of distributive justice. Less formally, there is an expectation of equal pay for equal work. A lack of distributive justice in the workplace has been shown to reduce worker co-operation and staff morale (Folger and Konovsky 1989).

Another aspect of the Commission’s concern to promote greater wage flexibility was the difference in hourly effective rates of pay between TAFE and private RTOs. (The actual difference in pay level was detailed earlier). TAFE may be either paying too much or too little to attract teachers in competition with the private sector. Two inter-related explanations can plausibly explain the higher average pay rate between public and private providers. These are a higher quality of labour demanded by TAFE and the operation of ‘efficiency wages’ in the public sector. These alternative explanations should have been considered and assessed by the Commission.

The claim that TAFE demands and attracts on average higher quality labour is supported by three significant differences in the attributes of TAFE and private RTO teachers. First, TAFE teachers have higher formal qualifications. Human capital theory has established that, *ceteris paribus*, higher qualifications are associated with

higher pay (Becker 1994). Alternatively, higher qualifications act as an efficient device for signalling to employers differences in desirable attributes, such as persistence, sociability and intelligence, which command a premium in the labour market (Weiss 1995). As the Commission notes: ‘The payment of higher wages to people with higher levels of education reflects that they are likely to be more productive than people with lower educational attainment’ (PC 2010: 4.2).

Table 1 reveals that one in six non-TAFE VET teachers have no post-school qualifications. TAFE teachers have a 50 per cent higher rate of possession of Certificate and post-graduate qualifications. Other studies reveal even larger differences in the level of qualifications between TAFE and private RTO teachers (DEEWR 2010: Slide 25).

Table 1: VET teachers. Highest level of qualification. Australia. 2006.

	Post-grad	Bachelor degree or Diploma	Certificate	No post school
Tafe	25.9	42.4	31.2	.06
Non Tafe	16.8	44	21.7	17.5

Source: PC 2010: Table C.10

In addition, TAFE teachers have a far higher rate of investment in human capital specific to their education role. 47.7 per cent of TAFE teachers’ highest qualifications are in an ‘education’ field of study compared to just 21.1 per cent of non-TAFE teachers. One in 20 TAFE teachers’ highest qualifications is in ‘VET education’ compared to one in a hundred and fifty non-TAFE teachers (PC 2010: C.12). Greater capital specificity, either physical capital or human, is not only associated with higher productivity, it also requires a higher rate of return to justify the risk arising from such investments. The greater the specificity of an investment, or the fewer alternative uses that can be found for an investment in a market, the greater the risk to the owner of the investment.³¹

Second, TAFE teachers have much more experience in teaching than those in private RTOs. Table 2 shows that under one quarter of TAFE teachers have less than five years experience in VET compared to well over half in private RTOs. Well over half of all TAFE teachers have more than ten years teaching experience in VET compared to less than one in five private RTO teachers. Human capital theory suggests, and empirical studies strongly confirm, the existence of productivity and associated wage gains with rising tenure. These productivity gains have been variously described as learning or experience curves.³²

³¹ This argument is well established in the labour economics literature, primarily in discussion about the incentives for individuals to invest in general versus industry specific skills. The common example is the different incentive structures required to encourage people to invest in industry specific skills, such as apprenticeships, as opposed to general college education (Thelen 2004). That greater capital and labour specificity is more productive has been established since Adam Smith’s analysis of the topic of the division of labour.

³² A quantitative study of 14 European nations, Japan, and the US on the relationship between productivity growth and job tenure over the period 1992 to 2002 found that a one per cent increase in the average rate of

Table 2. Length of service (years) in VET. Teachers, 2010. Australia

	Years of service in VET		
	<5	5≤10	≥10
TAFE	24	20	56
Private RTO	58	23	19

Source DEEWR 2010: Slide 25

Finally, TAFE teachers are on average older; 47.6 per cent are 50 or over compared to 30.3 per cent for teachers in private RTOs (PC 2010: Table C.13). It is to be expected that such a substantial difference in age distribution between sectors would be associated with significant wage differentials. For example, average weekly earnings for persons aged 30 and under are around 15 per cent lower compared to persons aged over 50 (ABS 2010). Age, tenure and qualification effects on earnings are clearly correlated.

The second explanation of higher average teacher wage rates between the public and private sector VET providers is the ‘efficiency wages hypothesis’. This theory holds that there is a relation between worker effort and pay rates so that, within limits,

labor productivity depends on the real wage paid by the firm...[There are] four benefits of higher wage payments: reduced shirking of work by employees due to a higher cost of job loss; lower turnover, improvement in the average quality of job applicants, and improved morale (Akerlof and Yellen 1986: 2).³³

In other words, higher wages attract higher quality workers and these workers, keen to maintain their wage premium, will exert greater effort or be more productive than if they received a lower real wage.³⁴ The fact that TAFE is largely a monopsony (monopoly buyer) for the services of higher quality teachers reinforces the efficiency wage effect. The previous analysis of the characteristics of TAFE teachers that may account for their higher wages is consistent with the public sector placing a premium on attracting higher quality workers.

Workers engaging in self monitoring and self regulation of performance, that is, ‘reduced shirking’ can substantially reduce management costs arising from supervision and dispute resolution. There is some support for this proposition in a recent study of human resource practices across public and private sector VET providers. The study asked managers to identify the ‘closeness of staff supervision’ across key job types. This was intended to determine the ‘the level of autonomy’

tenure would increase productivity by 0.16 per cent. The benefit of job stability reaches a peak at 13.6 years and declines slowly thereafter (Auer et al 2005: 7)

³³ The efficiency wage concept depends on the following labour market conditions, involuntary unemployment; the elasticity of effort with respect to the wage is unity; and the efficiency wage is above the reservation wage (Akerlof and Yellen 1986: 3).

³⁴ Being ‘more productive’ does not necessarily imply the conventional economics idea of cost minimisation or profit maximisation. For TAFE teachers it means pursuing the objectives of the organisation with more effort.

exercised by different groups (Smith and Hawke 2008: 33). Tables 3-4 show that a higher proportion of managers in private RTOs reported that all categories of teaching staff were ‘Very closely supervised’. Conversely a higher proportion of managers in TAFE reported that all categories of teaching staff were subject to ‘Little Supervision’.³⁵

Table 3 Closeness of staff supervision on teachers (private registered training organisations), percentages

	Very closely Supervised	Quite closely supervised	Little Supervision	No supervision
Teaching staff (permanent)	10	40	48	1
Teaching staff (contract)	11	53	34	3
Casual/sessional teaching staff	16	60	24	0

Source: Smith and Hawke 2010: Table 14. Note: the data records the proportion of managers’ responses.

Table 4 Closeness of staff supervision on teachers (TAFE institutes), percentages

	Very closely Supervised	Quite closely supervised	Little supervision	No supervision
Teaching staff (permanent)	4	43	54	0
Teaching staff (contract)	0	46	54	0
Casual/sessional teaching staff	4	59	37	0

Source: Smith and Hawke 2010: Table 7 Note: the data records the proportion of managers’ responses.

5.2 Extending workforce casualisation

‘Casual employment can provide the VET sector with both numerical and functional flexibility’ (PC 2010: 7.32). Accordingly, the Commission recommends removing limits on the employment of casuals (PC 2010: 7.34).

There is *prima facie* a problem with the Commission’s premise that casual forms of employment for VET teachers are an either a pre-condition for, or indicator of efficiency: private RTOs have not extensively adopted this form of employment.

³⁵ The results for ‘non-teaching’ staff are mixed, though no TAFE managers reported these groups were ‘Very closely Supervised’ compared to 13 per cent for private RTO managers.

Table 5 reveals that rates of casualisation in TAFE are 3.5 times larger than in private providers.

Table 5: Forms of Employment for VET Teachers and Assessors. Australia. Percent

	Permanent/ongoing	Part-time	Casual
TAFE	40	25*	60
Non-TAFE	66	33**	17

*Only relates to permanent or ongoing employees **All non-tafe teachers and assessors

Further, the Report provides a considerable body of evidence which suggests that current high rates of casualisation in TAFE have a variety of distinct negative effects on the performance of the VET system. The task of recruiting, supervising, co-ordinating and developing casual employees falls to permanent employees. Managing this increasingly ‘contingent workforce’ is an additional load imposed on more senior teachers who have their own teaching duties and other responsibilities such as long term planning and meeting with industry (PC 2010: 7.33).

The Commission notes that reduced career opportunities and job security are features of casual forms of employment. It also notes that these impair the ability of TAFE to attract and retain teachers (PC 2010: Table C.37). The Commission used econometric techniques to model the variables that increased or decreased the likelihood of current teachers leaving TAFE. The study found that non-standard forms of employment were strongly associated with ceasing employment.

As hours worked increase, individuals become less likely to leave TAFE. This could reflect greater satisfaction with full-time than with part-time positions. Increases in hourly wages make TAFE positions more attractive, relative to competing positions, reducing the probability of exit to more lucrative jobs. Ongoing staff are 83 per cent less likely to leave than staff on fixed-term contracts (PC 2010: 3.18).

This data is supported by the DEEWR (2010: Slides 29-30) study which found that:

There was a high dissatisfaction with employment status for non-ongoing employees. For those that are employed as casual, fixed-term and sessional, 35% reported being dissatisfied or very dissatisfied with their employment status. This compared with 5% of ongoing/permanent employees. Reasons VET Practitioners from TAFEs were dissatisfied were: Job security (73%); Other job conditions (37%) Pay rates (26%).³⁶

³⁶ The Commission tries to reconcile the contradiction between its support for increased casualisation and the findings that casual forms of employment in TAFE are significantly less attractive to teachers than permanent or ongoing employment. It does this by using labour mobility data to show that over time ‘73 per cent of trainers and assessors who joined the VET sector as casuals or fixed-term employees eventually moved into permanent or ongoing positions’ (PC 2010: 7.24). This data, presented as it is in the Report without qualification, is potentially misleading as the calculation of the transition rate from casual to permanent only applies to teachers who remain in TAFE. It excludes from the denominator all teachers who start as casuals in TAFE and leave whilst still in casual employment.

The Report also observes the negative effect of non-standard forms of employment on employer investment in skills development. Within TAFE industrial instruments provisions for ‘professional development are almost non-existent for casual and sessional staff. No provision is made for professional development in the relevant modern award’ covering private RTOs. (PC 2010: 8.31).

The Commission has compiled this prodigious list of adverse effects that flow directly from current high levels of casualisation. There are, undoubtedly, important benefits in non-standard work forms to employees, such as more flexible working hours, and to employers in accessing current skills and better matching labour utilisation to demand. However, the Commission has not carefully weighed the advantages against the disadvantages; rather it has simply elected to itemise the latter whilst promoting the former. This is an unsound approach to public policy formation.

5.3 Performance based pay

The final element in the Commission’s account of ‘contemporary human resource practice’ is the recommendation to introduce performance based pay into TAFE.

While acknowledging that performance pay arrangements have limitations in all industries, and that teachers have many motivations other than remuneration, the Commission considers that providing more autonomy for TAFEs and other VET providers to link pay to performance, and to set wages more generally, would help with recruiting and retaining the best candidates by rewarding their skills and effort (PC 2010: 7.38).

This recommendation is problematic for a number of reasons. The most fundamental problem is that the Commission has explicitly stated there are no objective measures of performance in education and training. There are no objective measures of efficiency, effectiveness, productivity and quality. In the absence of such objective measures there are two options open to management in the allocation of rewards to teachers. First, rewards can be based on arbitrary or qualitative considerations by management. Alternatively, other more objective measures can be applied, with financial measures being the most easily adapted to this purpose.³⁷ The Commission endorses moves towards outcomes based public funding of VET. Implementing both performance pay and outcomes based funding will create an incentive for management to reward teachers on the basis of direct indicators of financial performance such as revenue generation by teachers and/or reductions in unit cost per

³⁷ Other measures could be used, such as student satisfaction, but these involve each college expending resources on the collection and analysis of data. There is also the expense of devising a system for linking rewards to student ratings. Alternatively, teachers can be rated on the achievement of ‘outcomes’, such as rates of course or module completion, but this is in effect a financial indicator, given the linking of funding to outcomes. One of the great advantages of financial data as a performance indicator is that such data is collected as an inherent activity of a business and its use in performance based pay does not require separate resourcing.

outcome. As the Commission has noted such a system can create perverse incentives on the part of teachers to engage in corruption and/or reduce teaching and assessment quality.

From the point of view of trainers and assessors, an outcomes-based funding scheme could prompt greater emphasis on student completions in training courses. This might, in effect, create a shift in trainers' and assessors' teaching practices, such that they need to be more attentive to students' ongoing attendance and performance. An alternative consequence is that it could lead to some reduction in VET standards, if successful completions are paramount (PC 2010: 6.13).

These risks, which now apply only in the private RTOs part of the VET system, will be exacerbated if TAFE is subjected to outcomes funding and required to use performance based pay.

Second, the Commission has failed to adequately acknowledge that the economics and management literature has identified major adverse effects on productivity and quality arising from performance based pay. In a particularly stinging critique of individual based performance pay:

Edwards W. Deming, the pioneer of total quality management, even decried performance appraisal as one of modern managements most 'deadly diseases...it nourishes short-term performance, annihilates long term planning, builds fear, demolishes team work and nourishes rivalry and politics (Shields 2007: 22).

In a comprehensive analysis of the performance pay literature, John Shields, a world expert on the subject, concludes that:

the findings of studies of apparently effective performance pay initiatives lend only qualified support for such practices...meta analysis suggests a strong positive correlation between incentives and performance *quantity*...the link to performance *quality* is far less robust...This is hardly what an organisation priding itself on customer focus and product quality would want to hear (Shields 2007: 361).

These problems apply especially to individual based incentive schemes which are 'prone to generating competitive behaviours, and they may motivate employees to hoard knowledge and ideas with the objective of achieving a superior performance relative to their colleagues' (OECD 2010: 42).

Finally, there are significant practical problems with the Commission's endorsement of performance pay. The Commission states that its recommendations will not require increased real expenditure on the VET system. This implies there will be no additional funds provided by the taxpayer to create a 'pool' for performance pay. There are three logical inferences from this. Funding for performance based pay will be at the expense

of public spending on other VET activities such as capital grants for buildings equipment or activities such as professional development. Or the pool for performance pay can be created by putting some proportion of a teacher's current pay 'at risk'. Earning current full pay will only be achieved by teachers meeting some additional benchmarks. Finally, performance pay, or more accurately bonus pay system, can be created by putting some proportion of all teachers pay 'at risk' with this pool being distributed to a smaller number of teachers who achieve the highest performance. This implies that the performance pay of one teacher will be financed by reducing the pay of another. This is hardly compatible with collegial worker relations.³⁸

5.4 What are contemporary human resource practices?

The Report's characterisation of 'contemporary human resource practices' fails to engage with established research on this topic. This research reveals a great diversity of human resource systems across the private sector in developed economies. It also finds that each system is closely aligned to and designed to support a particular type of production system. These production systems differ for example in terms of the skill and knowledge base of employees, the extent to which firms compete on the basis of innovation in products and processes; the rapidity of technical change affecting the firm, and the degree of customisation or standardisation of the product or service.

The OECD has developed a typology of human resource practices aligned to four different production systems (OECD 2010). The Commission's prescribed human resource practices of casualisation, (and associated job insecurity), wage flexibility, performance based pay (especially if this is individual piece rate); and increased managerial prerogative are closely aligned with the Taylorist form of production system identified by the OECD. The Taylorist production system is also associated with comparatively lower levels of employer funded workforce training compared to other systems. It should be noted that the Commission found 'opportunities for ongoing professional development within the [VET] sector are not adequate' (PC 2010: 8.1). This is especially the case in the private sector as the Commission noted there is no provision for training or professional development in the modern award covering private RTOs. Despite this low level of support for professional development and training the Commission refused to make any recommendations that would directly address this problem in the private sector. For example it did not suggest that training and professional development should be incorporated into the industrial instrument covering the private sector. The Commission simply suggested more consultation between RTOs and business (PC 2010: 8.37). This amounts to passive acceptance of the status quo. In other words, despite demonstrating the adverse effect of persistent market failure in the provision of professional development in private RTOs the Commission elected not to provide a substantive solution.

³⁸ Alternatively, the Commission may assume that the efficiency gains in the system will be sufficiently large to fund a bonus pay scheme. In such a case there is no overall benefit to the taxpayer as efficiency gains are simply retained and re-distributed across agents within the VET system.

The significance of these results is that the Commission's prescribed human resource practices do not align with, and in fact contradict, the type of human resource practices required of a production system whose output is education and training. This system requires a highly educated workforce; continuous professional development to cope with rapid technical change in industry, high-level problem solving skills, high levels of worker autonomy and group co-operation. It is a production system in which it is difficult for management to monitor and assess worker performance or to establish rewards that do not result in perverse and conflicting incentives. The OECD classifies these work requirements to a 'discretionary learning' production system. Its human resource practices are the opposite of those prescribed by the Commission.

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