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What is market design?

Market design involves the creation of a marketplace where suppliers offer services and consumers exercise choice at a freely and fairly agreed rate of exchange. It is now an increasingly critical responsibility of government. As the Beveridge welfare state of the post-war settlement has unwound, so the role of government in public service delivery has changed. Increasingly, governments no longer provide essential services directly, but outsource their provision to the private and non-profit sectors. In many cases, this requires new markets for services. These markets do not emerge organically, and so require careful design.

Market design offers scope for innovation in public service provision on two levels. Firstly, the creation of new markets for public goods and services is in itself innovative, enabling gains from trade in commodities which are genuinely new, like carbon emissions or broadband spectrum, and others not previously traded, like employment services or port capacity. Secondly, by introducing vigorous competition, good market design provides incentives for innovation to suppliers in these new markets, increasing quality and driving down costs.

What are the key elements of market design?

Broadly, there are at least two conditions which must be present to warrant government embarking on an exercise in market design. Firstly, the circumstances of existing provision are such that the introduction of competitive forces is likely to improve cost and/or quality. Secondly, private provision alone

is likely to generate significant market failure. These failures might include concentration of market power, externalities, information asymmetry or underprovision of public goods. Where both of these conditions are met, governments face a genuine market design problem.

The essence of the design task is to set “the rules of the game” so as to align producer and consumer incentives with public policy goals. It is more than just regulation; market design involves consideration of producer concentration, socially optimal volumes, the impact of externalities, and the role of financiers and specifiers in the purchasing decision.

What is the philosophy behind “market design” and what are its benefits?

Early attempts at market design were responses to a classic combination of these conditions. For decades, governments had controlled capital-intensive natural monopolies like electricity, gas and telecoms networks precisely because the increasing returns to scale in these sectors led to a concentration of market power open to abuse in private ownership. Over time however, governments realised that by owning the single monopolist provider, they were foregoing the considerable benefits of competitive provision. How to break the conundrum?

The search for a solution led to the first significant market design exercises in the 1990's. The design solution often, but not always, involved privatisation of the state-owned network assets. More important than the specific issue of ownership, governments incorporated market mechanisms which stimulated competitive behaviour. These included trading pools, auctions and contestable contracts, the effects of which were to encourage investment and increase supplier numbers.

Once the market design approach had been established in the natural monopolies, governments turned their focus to human services, most notably

employment services and aged care. These sectors were not obvious candidates for market failure in the way the monopolies were, but the perception remained that cost and quality would benefit from the introduction of competition. There were other factors at play too. Sustained prosperity, technological advances and availability of information had changed the nature of human services and the public's expectations of them. Traditionally public services were undifferentiated, operating on a one-size-fits-all approach and offered by public agencies increasingly focused on internal processes rather than user needs. As taxpayer expectations have grown, governments have turned to markets to provide greater personalisation of public services and innovation in service delivery.

Human services, such as health and education, required a different type of market design: rather than one purchaser with contestable provision, it was 'user pays', with the implication of increasing marketisation of providers even where they continued to receive public funding (as has occurred with universities supposedly incentivised by differential fees).

Doubts over universal provision provided further rationale for deliberate use of market design in human services. Governments and academics had begun to question whether universal free access to public services was either fair or sustainable in an increasingly prosperous society. The introduction of Medicare co-payments and the development of the HECS scheme were each attempts to manage demand and reduce spiralling public costs.

This trend has accompanied a shift in the notion of equity in public services. Previously, governments sought to treat all citizens equally without fear or favour, by ensuring that the services and entitlements they received were standardised; nowadays 'equality of outcomes' or 'equality of opportunity' is more likely to be the governing principle, in recognition of the differing needs of public service users. As a result, public service management strategies

increasingly focus on how to differentiate in response to more diverse needs and demands, while simultaneously achieving fairness, efficiency *and* fiscal sustainability.

How should TAFE institutes respond to a market design landscape?

The contestability created under a market design framework brings both opportunities and challenges for TAFE institutes.

Governments are now saying to TAFEs and private providers: you decide how many places to offer, in which disciplines and (sometimes) at which price, and we'll subsidise however many students you can attract. This works because VET providers have the best aggregate information on the skills needs of the Australian economy and Australian businesses. VET providers know what students are looking for right now, and have a pretty good take on what they'll be looking for in 2-3 years time.

The best institutions should thrive because they are able to attract more students, and they will emerge from both public and private sectors. These providers will respond rapidly and flexibly to changes in skills needs of both students and the wider economy.

However, there are also important challenges presented by contestability:

- Contestability may squeeze disadvantaged students out of the system by encouraging providers to cherry pick the lowest cost, easiest to teach students in high volume courses. Governments have moved to prevent this situation developing by quarantining fully subsidized places for structural adjustment or disadvantaged students;
- Public institutions may struggle to compete on cost because they have infrastructure capital requirements and higher wage structures than many private RTOs. Governments have sought to ensure that public TAFE

providers are not held back by these higher cost burdens. The Teaching and Learning Capital Fund will provide \$500m in 2009-10 in much needed workforce investment in the VET sector;

- Finally, we need to provide better funding of infrastructure and workforce and access for disadvantaged students so that access is not denied to anyone on the basis of ability to pay or background.