



# BRITAIN'S GOT TALENT

Unlocking the demand for skills

John Springford and Ian Mulheirn

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Ian has worked in a variety of policy areas including child poverty, savings and investment, welfare to work and higher education funding. He has also undertaken research into the drivers of worklessness in London and evaluation of the Working Tax Credit and the National Minimum Wage. He has recently been appointed to the Mayor of London's Employment and Skills Working Group.

## FOREWORD

At the City & Guilds Centre for Skills Development (CSD) promoting open debate about significant challenges faced by the education and skills sector is core to our role. At a time of low economic growth and limited resources, policymakers are seeking the answers to two questions: how do we raise productivity and stimulate growth, and are we using the resources we have effectively. We believe that because of the significance of adult skills it should be included in this debate.

Few would disagree that it is essential that funding for adult skills provision is directed towards high quality learning opportunities which make a real difference to learners' chances in the labour market, but there are different ideas about how this should be achieved.

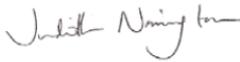
We currently have a system whereby Government makes decisions about what should be provided, but colleges (and learners) ultimately feel the effects of these decisions. The SMF makes the case for shifting these decisions to the parties who are closest to the market for training and ultimately have the most at stake.

CSD is committed to bringing together practitioners, policy makers, researchers – and others with a stake in the sector – to discuss how best these challenges could be addressed and produce new, evidence-based solutions for policy and practice. With this in mind we sponsored this project by SMF to explore whether a system of payment by labour market results could improve alignment between the needs of the labour market and the provision of adult skills. What would a system that rewarded colleges for meeting labour market demand look like? What would be the benefits and what would be the challenges? How would success be measured?

This report makes the case for payment by results in adult skills provision. Fundamentally, it argues that FE providers are best placed to determine local labour market needs and that the system should be changed to incentivise them to do so, raising productivity, and in turn promoting growth.

The next steps are to explore how the system that the SMF proposes might work in practice and further work needs to be done to understand the challenges and practicalities of implementation. We look forward to hearing the perspectives of FE providers and others in the sector who are best placed to help us understand those challenges.

We hope this publication will contribute to a vigorous and informed debate on how success should be measured and whether and how funding should be linked to outcomes. The costs of policy changes in the sector have been high, and future changes should be justified by demonstrating that they would really enable providers to respond flexibly to the demands of the labour market, and also their students, and increase the stability of the system in the longer term.



Judith Norrington,  
Group Director of Policy,  
Research and Regulation, City & Guilds

## EXECUTIVE SUMMARY

Britain's workforce desperately needs new skills. The country faces a sustained period of high unemployment, with workers' skills decaying at a rapid rate. Even in the boom years, many people struggled to find a job, and many were employed in poorly paid, low-skilled occupations. But government skills spending does not translate directly into a more highly skilled workforce. The money must be invested well. This means investing in training that leads to jobs and pay rises, by giving people skills that are in demand. At the core of its long-term growth strategy, the Government needs a plan to boost the nation's stock of human capital in a cost-effective way, especially as it has less money to invest than before.

Unemployment is high. In the first quarter of 2012, 8.5% of the working-age population were unemployed.<sup>1</sup> The continuing debt crisis in the euro zone may damage the UK economy further in 2012 and 2013, with several indicators pointing to renewed recession in the UK's largest trading partner. This may push up unemployment still further. As the economy stagnates, the proportion of people who are long-term unemployed increases. The proportion of unemployed people who haven't found work for a year or more rose from 25% to 32% between 2009 and 2011. The proportion out of work for two years or more rose from 10% to 16%.<sup>2</sup>

The Government faces further difficult macro-economic policy decisions to get Britain growing and thus to reduce the unemployment rate. But a complementary policy for growth must be efficient investment in adult skills to make the labour force more productive. This would help to create a supply of labour that more closely matched the demands of employers. It would help the long-term unemployed, many of whom have struggled to find

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1 Office for National Statistics, *Unemployment data, April 2012*. <http://www.ons.gov.uk/ons/taxonomy/index.html?nscl=Unemployment+Rates>.

2 Ibid.

sustained work since the recessions of the 1980s and 1990s, by guarding the skills they have from atrophy and giving them new ones. And it would make labour markets more efficient in the long term, helping people cope with an increasingly dynamic economy with a fast pace of sectoral boom and decline.

## IS GOVERNMENT INVESTMENT IN ADULT SKILLS 'DEMAND LED'?

Does the skills system respond to the 'demand for skills' – the human capital employers need to work with their physical capital? Many adult skills courses offer excellent wage returns, and the average return for vocational qualifications the Government funds is 8%. However, too much of the UK's provision fails to match the underlying demand. This is because the main government lever – subsidy of training – tends to aggravate misplaced incentives for learners and employers.

Would-be learners lack information about the skills that are most likely to secure the best employment outcomes, and so err towards courses they find interesting, rather than skills that will maximise their productivity. When government subsidises individuals, by offering them a range of free or reduced-cost courses to take, it reinforces the tendency to pick a course based upon its 'consumption' value, instead of a hard-headed appraisal of the benefits. While the extent to which a learner enjoys a course is an entirely legitimate aspect for teachers and learners to consider, it should not be the primary consideration of public subsidy, which should aim to maximise the productivity and employability of learners. Where learners are not putting their own money on the line – or less of it – they need appraise the course less as an investment and more as something to consume. Subsidy handed to individuals therefore weakens the link between government investment and employers' demand for skills.

So why not hand money to employers? Employers fear that investments they make in their workers' skills might not pay off, as other employers may poach trained employees. To stop other employers reaping the rewards of such transferable training, they will focus on skills necessary for their own particular production process. The training commissioned by any given employer therefore tends not to be a good reflection of wider skills demand of employers as a whole. Ironically, a single employer has poor incentives to invest government subsidy in all of its skills needs.

Successive governments have tried to solve this problem by controlling course content, to ensure that it provides transferable, core skills as well as the sector-specific, vocational skills the economy needs. An array of bodies – the UK Commission for Employment and Skills, Government Departments, qualification awarding bodies, Sector Skills Councils – try to map skills gaps in the economy, plan courses, and decide how they should be subsidised.

This bureaucratic attempt to capture the underlying demand for skills in the economy will always be imprecise. Planners must rely on statistical techniques to discover demand, which are always faulty, and their plans fail to keep pace with the changing skills needs of the economy. Central planning can also weaken provider accountability. Because qualifications are centrally planned, providers are told which courses they should make available and funded by the number of learners they enrol and get to pass the qualification. They therefore have a strong financial incentive to deliver as many of these courses as possible, and weak accountability for the labour market value of the skills they impart.

## **THE VARIABLE VALUE OF GOVERNMENT SKILLS INVESTMENT**

A skills system with weak accountability for labour market outcomes inevitably leads to variable returns on investment. Three

broad reasons for patchy results can be identified: variations in qualification type, subject usefulness and provider quality.

The earnings premium attached to vocational qualifications is good, but highly variable for different courses. The lack of accountability for labour market returns means that providers can continue to supply qualifications that employers do not recognise or value. The better qualifications show good wage returns – between 11% and 14% on average. Apprenticeships lead to a wage gain of nearly 16% on average. However, National Vocational Qualifications (NVQs) are associated with very small wage gains, at an average of 1%. And because so much government investment flows to NVQs, a large amount of funding is wasted. Eliminating NVQs would push up average returns, massively increasing value for taxpayers' money.

The system's poor labour market accountability also means that while some learners take subjects that are highly valued in the labour market, others pursue subjects that employers do not value. Learners taking courses in leisure, travel and tourism at Level 2 showed lower average earnings than people with the qualification below or no qualifications. On the other hand, those in construction, planning and the built environment saw an 8% return. If learners switched to subjects that employers demanded, there may be large gains to be made, but the incentives to do so are weak.

The third dimension of variable quality is provider quality. Students may pick better qualifications in more highly demanded subjects, but may still suffer from poor quality teaching. Ofsted's evaluations of providers show wide variability in the quality of teaching. In 2011 inspections: while nearly 50% are rated 'good', over 40% are rated 'satisfactory' for overall effectiveness, and there are very few examples of outstanding provision.

Improving the system's performance depends upon strengthening accountability in order to reduce the number of:

- Types of qualification taken that do not lead to good employment or earnings outcomes
- Subjects taken within those qualifications that employers do not value
- Providers that teach to a mediocre or poor standard.

The Government therefore needs a mechanism to encourage learners to take the types of qualification and those subjects that add value, and which puts pressure on poor and mediocre quality providers to improve. Marginal improvements on each dimension could have a substantial impact on labour market outcomes, and hence the productivity of government skills spending.

## THE COALITION GOVERNMENT'S REFORMS APPRAISED

Will the Coalition Government's reforms to the system achieve such impacts? Citing the fiscal deficit, the Government is cutting the adult skills budget by £1.1 billion (25%) over the course of this parliament. This will mean that fewer people will receive training. Given that adult skills do raise workforce productivity and that large numbers of unemployed people are currently losing skills this policy is questionable. And it is not apparent that the substantial investment – £2.5 billion in 2013–14 – that the state will continue to make will be invested much more wisely than previously. The Government is merely cutting the budget without doing enough to get more bang for its buck.

The Government is introducing income-contingent loans, along the lines of the student loans model in higher education. This reform will ensure that learners over 25 and those who already have qualifications must co-invest alongside the state. This should encourage learners to view training as an investment and appraise the costs and benefits of each course. But it will swap poor state investment under a more subsidised regime for under-investment by individuals under the new regime, as people are less likely to take a course if they have to invest themselves.

Providers are being given more control over how their money is spent. Central government will no longer ringfence funding for different individual-led qualifications at different levels of skill, freeing providers to supply training they believe is most in demand in their local area. However, there is no corresponding accountability mechanism to ensure that providers invest wisely: they face no reward if their training matches learners with employers.

Curiously, the Government is continuing to direct funding from the centre in some areas. It is abolishing the expensive, employer-led Train to Gain programme and re-investing some of the money in at least 100,000 more apprenticeships. The Department for Business, Innovation and Skills believes that apprenticeships provide work experience and on-the-job training that is more valuable than classroom-based learning. This is rational on the face of it: those apprenticeships currently provided do lead to better returns on average. However, flooding the market with apprenticeships may weaken the qualification's brand, especially if many are taken in some service sectors where labour market demand is weaker. There is no accountability mechanism to ensure that providers of the new apprenticeships focus on demand.

In sum, Coalition reforms will not lead to the emergence of a demand-led skills system, but one that is a partial rearrangement of the pre-existing model. Some people may choose better qualifications and courses, but the overall take-up of training will fall, as subsidy is replaced by fees and loans. Provider accountability for labour market returns remains weak. The new apprenticeships may be of variable quality.

## **PAYMENT BY RESULTS**

The state's investment in human capital would be far more efficient if an actor in the system was liable for the labour market value of the skills delivered. Providers are the obvious candidate. They are

embedded in local economies, so are in a position to understand, forecast and supply the skills local employers need, and steer candidates towards more profitable courses. Exposing providers to the demands of the labour market would also make them more accountable for how well they impart skills employers value: the quality of their teaching as defined by the labour market.

A payment by results model would achieve this. Providers could be paid according to learners' pay uplift and employment rates upon finishing courses. This would incentivise providers to act upon the 'prices' set by the demand for skills – higher pay and employment rates arise for those skills that are in relatively short supply. As they would be paid a premium for a course that led to good employment outcomes, providers could have strong incentives to invest in skills that local employers demand, and which allow workers to build the transferable skills that allow them to navigate the market.

Under such a system, providers would offer courses in, and steer individuals towards, skills that are most likely to lead to labour market success. Providers would have an incentive to seek out information from employers about what mix of skills they need and supply suitably trained workers.

There are clear theoretical gains from a payment by results model. But how should it be implemented?

The Government must be clear on what it means by 'results'. State skills investment must aim to boost productivity. There are two ways of measuring this – and two payment by results systems would have to be implemented, based on the measures. The first system, for people who are taking courses while in work, should be based upon **wage uplift**. In competitive labour markets, more productive workers will on average be paid more than unproductive workers. If firms pay wages that are lower than the additional

output a worker generates, rival firms are likely to poach their labour with a better offer. If firms pay more than the additional output, its high labour costs would make its products more expensive than its competitors'. While this relationship between productivity and pay may not be true for particular, non-competitive sectors of our economy, across the labour market as a whole, the relationship holds. So, for people training while in work, it is possible to measure how much the training has increased productivity by how much wages rise in the period after the course is finished.

For unemployed people, this measure of productivity is inaccurate. In order for someone to exhibit any measurable productivity at all, they need to be in paid employment. So, the payment by results model for unemployed people needs to be based upon **employment outcomes**, which will show how successful particular skills interventions are at making people more productive and hence attractive to employers.

Therefore, the SMF suggests two payment by results models: one for those in the **employed group** and another for the **workless group**.

### Employed group

A proportion of providers' funding could be paid according to the labour market outcomes of in-work trainees. But there are a number of obstacles that must be overcome to measure the value added. It should be measured in three ways.

- The Skills Funding Agency, using HMRC tax data, should measure how much *wage uplift* providers' students received, by measuring their pay before and after training.
- It would then calculate the *average wage uplift* at each qualification level. It would find the average pre- and post-learning pay at each skill level – Level 1 (equivalent to a poor GCSE), Level 2 (equivalent to a good GCSE) and so on – at each institution it funds. This would ensure that providers only

supplying courses at higher levels, with typically higher wage premiums for their training, would not be rewarded unfairly.

- This would then be turned into a percentage, to make the wage uplift measurement *proportionate*. A £2 wage increase from a £10 pre-existing hourly wage would become a 20% increase. This should strip out any systematic differences between regional pay levels. If providers in both a low-wage and high-wage region increased wages by £3, the provider in the poor region would receive a higher reward as it had added proportionately more value.
- The institutions would then be *ranked according to relative performance*. This would strip out the effects of the economic cycle. In a recession, all institutions would face a stagnant labour market, but those who managed to boost pay anyway would be rewarded more than those who failed to do so.

Once providers had been ranked, the outcome payments could be distributed according to performance.

### Workless group

The workless group has diverse needs. Some may be recently unemployed, and have productive skills. They therefore may need a 'work first' strategy, with emphasis on job matching. Some people may need training to make them productive, which suggests a 'skills first' strategy, with job matching to follow. As both training and job matching are needed to get people into work, the skills funding system must link up with existing welfare-to-work provision. If not, skills providers may be paid for effective interventions by Jobcentre Plus or Work Programme providers, and vice versa.

For **short-term unemployed people** referred for training by Jobcentre Plus, skills providers could again be ranked according to success. They would be paid by the relative employment outcomes of their trainees, and outcome payments would be distributed accordingly.

For **long-term unemployed people** on the Work Programme (WP), stronger incentives are needed to ensure that people in need of training receive it. The programme is primarily a 'work first', job brokerage solution. Providers in the programme are heavily incentivised to get people into work as quickly as possible, so they typically concentrate on job search, CV building and interview techniques. Some people may actually benefit from more extensive training, but at present WP providers have little incentive or funding to deliver it.

WP providers need the right incentives to correctly assess which people need training so that they don't park difficult clients. Therefore, WP contractors could access skills provision for their clients by passing learners to designated skills providers with access to Skills Funding Agency cash. Skills providers themselves would not be paid by results. WP providers (together with their clients) would choose which training providers and courses would be most effective, and would be held accountable for that decision by the Work Programme payment by results funding.

WP providers currently have 104 weeks to get their clients into work after referral. This makes training somewhat incompatible with the scheme since time away from job search reduces the likelihood of a job outcome payment, as the clock keeps ticking. To prevent providers from parking difficult clients, once training is commissioned the 'clock' should stop, to start again only once jobseekers have returned to their job search. This would ensure that providers would face the same costs of job brokerage for all their clients, whether they need training or not.

## USING MARKET SIGNALS TO CREATE A DEMAND-LED SYSTEM

Government investment in skills provision in its current form leads to weaker 'price signals' for different courses. When subsidy is offered to individuals, they are freer to take courses that do not

have substantial labour market value. Paying providers by results would encourage them to steer learners towards courses that employers demand, making government skills investment respond to the 'prices' for different qualifications – wages and employment rates. This can be achieved by transferring some of the financial risk for good labour market outcomes to the providers themselves and giving them the freedom to respond.

On the employer side, government subsidy may be spent predominantly on skills interventions that do not offer transferable skills. Firms are unwilling to do all of the training they need – they are only willing to make investments they can capture, and workers with transferable skills may go elsewhere. Under a payment by results system, apprenticeship providers would have an incentive to ensure that apprentices learnt the best mix of transferable and firm-specific skills, because this would lead to long-term labour market success.

Only a market-based solution could create a truly demand-led skills system, with measurable improvements in the productivity of training. The Government's finances remain in a parlous state, and more cuts may be made to the adult skills budget in the spending review expected next autumn. There are good reasons to argue why this is a bad strategy: the Government's skills investments do on average increase productivity and with it, economic growth. But in this funding environment, policies tying expenditure to proven economic gains are great ammunition for arguments with the Treasury.

Such a system is not without challenges, not least ensuring that productivity gains are measured accurately; that providers do not face risks they cannot control; and that poor providers are allowed to fail. This publication suggests ways to alleviate these concerns. The gains from such a system are potentially huge. Given that accountability for labour market outcomes is currently non-existent, payment by results can drive up standards of training and make sure it matches the needs of a fast-changing economy.

## INTRODUCTION

Britain is in the middle of a prolonged economic stagnation on a similar scale to the early 1980s. It threatens a repeat of the massive social and economic failures of those times: high and sustained unemployment, with many low-skilled workers dumped on the scrap heap. After the financial crisis beginning in September 2008, the unemployment rate leapt from 6.4%, peaking at 8% in the first quarter of 2010, before reaching a plateau of 7.8% to 7.9% for the next two years.<sup>3</sup> Since the middle of 2011, unemployment has begun to rise again. At the time of writing, the UK economy has slipped back into recession, potentially increasing unemployment still further in the second half of 2012.

The rate of long-term unemployment has also risen sharply. In the second quarter of 2011, 33.8% of unemployed people had been out of work for more than a year, compared to just 22.6% in the last quarter of 2008.<sup>4</sup> The long-term unemployed lose skills, have higher levels of depression and other mental illnesses than employed people, and find it increasingly difficult to find work as time goes by as their skills deteriorate or become obsolete.<sup>5</sup> Low-skilled workers also suffer from greater job insecurity and longer spells of unemployment.

Even during the long boom between 1993 and 2008, Britain's workforce had a large number of low and unskilled workers, who stumbled in and out of the labour market. These workers were likely to be first to be fired in a recession and could be displaced by unemployed people with higher skills 'trading down' to

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3 Office for National Statistics, *Unemployment data*, September 2011. <http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/september-2011/statistical-bulletin.html#tab-Unemployment>.

4 Office for National Statistics, *Unemployment by age and duration data*, September 2011. <http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/september-2011/statistical-bulletin.html#tab-Data-tables>.

5 Andries de Grip and Jasper Van Loo, "The economics of skills obsolescence: a review", in *The economics of skills obsolescence*, 21(2002).

employment in lower-skilled jobs. Unemployment among people formerly employed in elementary (low skilled) occupations rose by 54% from 2008 to 2011, to 434,000.<sup>6</sup>

Therefore, in addition to the immediate problems of recession and rising unemployment, the UK must grapple with a generation-long rise in the level of economic inactivity that was impervious to the strong economic growth of the last decade. In 2008, before the recession struck, one quarter of adults lived in a workless household, as did 28% of children.<sup>7</sup> While the overall level of worklessness among the low-skilled declined during the long boom between 1993 and 2007, in many regions it was static.<sup>8</sup>

This is in part the result of the longstanding effects of globalisation. The world's low-skilled work is increasingly being conducted in emerging economies. Thus, in the UK, wages for the low-skilled have not kept pace with the average as they are pinned back by emerging market competition, and by jobs being lost overseas.

Resolving the acute crisis of worklessness alongside the long-term skills deficit will not be easy. But improving the UK's poor adult skills is an urgent necessity. Better adult skills provision is essential to improve workers' job prospects. It would also make the economy as a whole far more productive.

So low-skilled Britons are in dire need of education, in order to raise their productivity and secure well-paid employment. But is the further education sector in a position to deliver?

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6 NOMIS database, "Claimant count by occupation", January 2008 – September 2011 data. [https://www.nomisweb.co.uk/home/release\\_dates.asp#g24](https://www.nomisweb.co.uk/home/release_dates.asp#g24)

7 Office of National Statistics, *State of the nation report: poverty and worklessness in the UK*, (London: 2010) 9.

8 HM Treasury, *Employment opportunity for all: tackling worklessness in London*, (London: HMSO, 2007); Helen Barnes, Elizabeth Ganatt, David McLennan and Michael Noble, *Understanding the worklessness dynamics and characteristics of deprived areas*, (London: Department of Work and Pensions, 2011).

Adult further education is frequently cast as the neglected, 'Cinderella' sector of education, compared to schools and universities. In this publication, 'adult skills' is defined as the education and training that adults over 19 take in vocational and academic subjects up to Level 3 – the equivalent of an A-level – as well as vocational qualifications at higher levels. It is perceived as a 'second chance' for people who have failed at school, rather than a keystone of skills provision. Successive governments have failed to reform a complex system, with a range of qualifications that few employers understand; a confusing array of funding, qualification and advisory bodies that do not direct the system according to clear and simple principles; and a provider base that is incentivised to focus on the number of qualifications delivered, rather than the labour market outcomes of their learners. Reform is imperative, if we are to tackle unemployment, and make the UK economy more productive in the future.

## WILL THE CURRENT GOVERNMENT'S REFORM PLAN WORK?

Unlike in other public services, the Coalition Government is not combining real terms spending cuts in adult skills with radical reform of service delivery. It is making swingeing cuts to the sector's overall budget – cuts that correspond to a third of many colleges' budgets. It has abolished Labour's expensive Train to Gain programme, citing the heavy cost of skills provision employers would either have paid for without government subsidy, or provision they did not want.<sup>9</sup> However, this makes it all the more important to improve the productivity – the 'bang for taxpayers' buck' – of adult skills provision. Yet the Government is leaving the current model of skills funding largely untouched. Where it is changing, the reform plan swaps government failure for market failure, and gives few incentives for providers to focus on labour market outcomes.

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<sup>9</sup> Department for Education and Skills, *The impact of employer training pilots on the take-up of training among employers and employees*, (London: HMSO, 2006). National Audit Office, *Train to Gain: developing the skills of the workforce*, (London: NAO, 2009).

The Department for Business, Innovation and Skills is cutting the number of 'ringfenced' funds, freeing colleges and private providers to make choices about the courses they deliver. But providers are still paid for the wrong things: according to the number of qualifications they deliver, whether or not those qualifications lead to jobs or wage increases for recipients. Provider accountability for labour market demand is therefore weak.

While the Government is in some respects decentralising decision-making to providers, it continues to direct money from the centre towards education provision it considers to be most effective. It is using part of the money spent on Train to Gain to increase the number of apprenticeships by at least 100,000 in five years, shifting provision from workplace based 'learning', where many employees gained qualifications through classroom or online teaching, to workplace based 'training', as apprenticeships are delivered more through on the job training. Apprenticeships show good labour market outcomes. However, ramping up the number of places may come at the expense of quality, if the new apprenticeships are taken in those service sectors where job outcomes are worse.

This failure to reform is surprising, given the Government's moves in other areas to introduce more market mechanisms, decentralising decision-making about methods of delivery to providers themselves, while holding them to account for the broader outcomes of the spending. In welfare to work services, for instance, the Government is paying providers by how many people they get back into sustained employment, while leaving frontline providers to determine how to do so. When paid by outcomes, providers have to face up to the risk that their methods will not work. Poor performers can therefore learn from the best. Those whose methods *do* work will be paid more, and have opportunities to expand at the expense of weaker performers. This should drive up the quality of the service across the system.

The adult skills system is ripe for this type of reform. The system could far better serve the skills needs of the economy. There are three reasons why. First, local labour markets need different skills. In the South East, for example, where business services are a major employer, secretarial and accountancy skills are needed. In many cities in the Midlands and the North, the challenges are somewhat different – the economy is still switching over from an industrial economy to one led by services – and local economies will change in diverse ways, and have different training needs.

Second, the current system is unresponsive to the evolving skills needs of the economy at a point of seismic economic change. Making the system more sensitive to changing patterns of skills demand would allow workers to more easily shift between sectors. The UK's economy is undergoing major upheaval: bubble sectors like construction and business services are deflating, and the next period of economic growth may be based upon demand in other sectors.

Third, even where the right training programmes are offered, providers are not held accountable for how well their teaching imparts skills in a way that employers need. Evidence suggests that employer demand for courses is highly variable, with some adding no apparent value. This must change so that employers are better served.

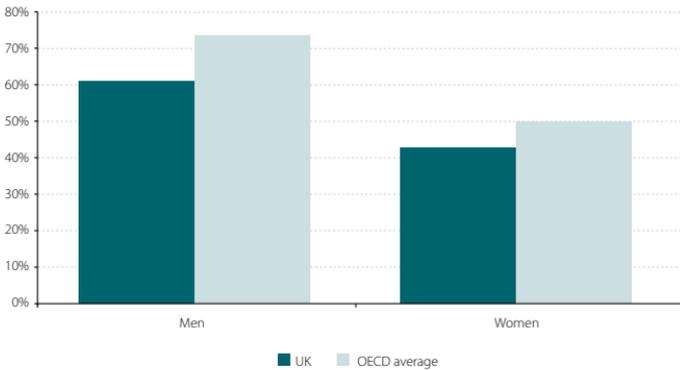
Colleges and other training providers need to address these problems. But the current funding system does not encourage such a shift, as providers are paid by how many students enrol, turn up each week and pass the course, instead of how valuable the skills they learn are. This publication examines how and whether a truly 'demand led' adult skills system can be constructed around a payment by results funding model for skills providers – the further education colleges and private providers that currently receive public funding.

This publication sets out a plan for introducing a payment by results system for adult skills, grounded in economic theory and evidence. The approach offers an effective way to achieve the much-discussed goal of integrating employment and skills policy. In Chapter 1, we re-examine the economic rationale for the public subsidy of skills provision, by discussing the market failures in human capital investment. It goes on to explain the inherent difficulties governments face when handing subsidy to individuals or employers. Chapter 2 offers a critique of recent attempts to make the skills funding system more 'demand led', so that skills provision matches what employers as a whole need. Chapter 3 discusses the theoretical advantages of a payment by results system and examines how a payment by results system can be created for skills training for both people in work and the unemployed. Chapter 4 provides 'troubleshooting' answers to some of the potential problems with the system.

## CHAPTER 1: WHY AND HOW SHOULD THE STATE INVEST IN SKILLS?

The UK has had a productivity problem for many years. While it has a relatively good record on the employment rate of the entire population – this exceeds the OECD average – it also has a large base of low productivity jobs, which are poorly paid. These roles are occupied by people with poor skills and patchy employment records. In 2010, the employment rate for men who left school at 16 was 61%, compared to an OECD average of 74%. For similarly skilled women, the performance was also poor: 43% were in employment compared to an OECD average of 50% (see Chart 1.1). This is despite the UK having a better employment rate for all men overall, and a far higher employment rate for women overall than the OECD average.

**Chart 1.1: Employment rates for men and women with lower secondary qualifications only, UK and OECD average**



Source: OECD, *Education at a glance*, (Paris: OECD, 2010), 110.

The Labour Government's *Leitch Review of Skills*, published in 2006, found that seven million adults lacked functional numeracy and five million lacked functional literacy. Seventeen million

adults did not have 'Level 1' numeracy, which is equivalent to a low level GCSE.<sup>10</sup>

The development of 'human capital' has long been recognised as a key driver of economic growth. In order to continue to grow, developed economies need constantly to improve the skills of their workforces, and ensure that the skills they have correspond to the changing needs of employers.

There are two long term economic forces which make improving adult skills provision an urgent priority: skill-biased technological change and trade.

Revolutionary innovations in technology – improvements in machinery, information technology, transportation – need workers that are trained to make use of them. Work and wages increasingly flow to workers who have skills that *complement* technology. Meanwhile, as the technological frontier expands, ever-greater returns flow to those who can keep up, while the technologically excluded get left behind. Low-skilled work is under constant threat of being *replaced* by technology.<sup>11</sup>

Furthermore, reductions in transportation costs have made economic activity far more global. A continuous process of 'offshoring' has developed, so that low value-added production has shifted to emerging and developing economies, because the cost of labour is lower. This has led to a 'hollowing out' of many developed economies' labour markets, with wages of the low skilled held down, and increasing returns to more highly skilled workers.<sup>12</sup>

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10 Department of Innovation, Universities and Skills (DIUS), *Leitch review of skills: prosperity for all in the global economy*, (London: HMSO, 2006) 10.

11 Robert Solow, "A contribution to the theory of economic growth", *Quarterly journal of economics* (1956); David Autor, Laurence Katz and Melissa Kearney, "The skill content of recent technical change: an empirical investigation", *Quarterly Journal of Economics* (2003); Per Krusell, Lee E. Ohanian, José Victor Rios-Rull and Giovanni L. Violante, "Capital skill complementarity and inequality: a macroeconomic analysis", *Econometrica* (2000).

12 Alan Blinder, "Offshoring: the new industrial revolution?", *Foreign Affairs* (2006); Robert Feenstra, *Offshoring in the global economy: microeconomic structure and macroeconomic implications* (Cambridge, Mass.: MIT Press, 2003).

These forces erode low-skilled employment and hold down wages, leading to more inequality, and the UK's failure to tackle poor skills holds back its economic potential. It is therefore an economic and social imperative to boost skill levels and attract higher value-adding employment.

In this context, the UK's adult skills system needs to effectively respond to shifts in labour demand, which are themselves a function of international competition, and shifting consumer tastes and needs. The system must train workers to improve their skills. But these improvements should not be calculated simply by the state's ability to move a large proportion of workers from 'Level 2' to 'Level 3' (see Box 1.1 for definitions of key skills terms) on a qualifications scale that employers do not understand and that does not signal the labour market value of different skills. It must instead help to develop skills that employers value, rather than central planners.

### **Box 1.1: Key skills terms explained**

#### **Train to Gain – employer-led**

- Train to Gain was a government initiative to provide vocational training to low skilled employees in the UK.
- The scheme provided funding to employers to provide vocational training to their employees.
- The scheme primarily targeted those over 25, although was also available to those under 25 but ineligible for apprenticeships.
- The coalition closed the Train to Gain service on the 31st of July 2011, citing the heavy 'deadweight' cost: employers used the money for training they would have done anyway.

#### **Apprenticeships – employer-led**

- Apprenticeships have been around for centuries, but government subsidy and regulation has increased.
- The system was fully centralised through the Modern Apprenticeship scheme, which started in 1995.

- Apprenticeships allow people over the age of 16 to learn skills and gain qualifications while working for an employer and earning a weekly wage, although the minimum wage for apprentices is lower than that of other employees. Apprenticeships have a curriculum and qualification component, as well as work experience.
- The Coalition is increasing the number of apprenticeships by 100,000 per year by 2015.

### **Skills for Life – individual-led**

- Skills for Life was a government strategy launched in 2001 to help adults achieve basic skills qualifications.
- Skills for Life qualifications offer basic qualifications to those that have left compulsory full-time education and do not have an English or maths qualification at level 2 on the National Qualifications Framework (such as a GCSE).
- Qualifications are available in adult literacy, adult numeracy, information and communications technology and English for Speakers of Other Languages (ESOL).

### **National Vocational Qualifications (NVQs) – individual-led**

- NVQs are vocational, ‘competence-based’ qualifications based on national standards for various occupations.
- These give students the ability to learn practical skills that relate to a specific industry or sector. Some courses also assess and provide formal qualifications for skills that people have already acquired.
- NVQs are available to young people and adults that are either employed or studying at a college with access to a work placement.

### **National Qualifications Framework (NQF)**

- The NQF was introduced to help employers compare the many qualifications available in England, Wales and Northern Ireland.
- It ranks qualifications on a 1–8 scale. Level 1 is equivalent to a poor GCSE, Level 2 to a GCSE at A\*–C, Level 3 to an A level, and so on.

To understand the skills policy dilemma, and the solution to it, we need to explore the rationale for the public subsidy of skills. Therein lies the solution to the failures of recent years. Only by understanding the problems that state intervention is trying to resolve can we understand why it has failed and what a better system might look like.

Therefore, this chapter provides a theoretical framework to answer three questions:

- Why should the state subsidise skills?
- How do we create the conditions for an optimal level of investment in skills, by employers, workers and the state?
- How do we ensure that investment flows to the 'right' types of education and training?

## THE DRIVERS OF SKILLS POLICY

There are two main actors – individuals and employers – in a market for skills, each with at times competing and complementary interests and motives to invest in human capital. Any effective skills system needs to piece these actors together and align their incentives as far as possible for them to pursue the same goal. A brief overview of the incentives to invest for each actor follows.

However, first we should define '**demand for skills**' in economic terms. This is the holy grail of skills policy, and politicians tend to aim to achieve a system that is 'demand-led' in the sense of providing skills the economy needs. It is the right goal but one that is very difficult to achieve. This is partly because it is often poorly defined. Indeed, loose definition of the term has, in the past, been used to justify policy approaches that fundamentally fail to serve the demand for skills. A proper understanding of the real meaning of the term is therefore essential.

Capital is needed in two forms to produce goods and services: physical capital and human capital. Employers demand human capital (i.e. skills) that complements the physical capital they have to create whatever it is that they sell.<sup>13</sup>

The aggregated skills needs of the generality of employers therefore constitutes the demand for skills.

The problem lies in identifying who is best placed to discover that underlying demand and invest in the right skills to meet it. Is it individuals, who have a strong interest in getting the skills that employers want? Or is it employers, who have the best information about what skills are needed? Or is it government, taking a strategic view in some way? First we must understand why government has a role in skills policy in the first place.

## A SIMPLE MODEL OF SKILLS ACQUISITION

As skills lead to financial rewards for individuals and employers, why should government fund skills acquisition at all? From an economic perspective, education and training are investments in human capital, to make people more productive. This should lead to higher wages for the people trained, and higher productivity for employers. This logic suggests that the individual and the employer, rather than the taxpayer, should find the capital to invest themselves.

It would be rational for a person to invest if the extra wages received from the training exceeded the cost of training, and the loss of earnings from not working while training. Under conditions of perfect information and foresight on the part of the individual, and no credit constraints, there is little need for any state intervention or subsidy in this simple model (leaving externalities aside).

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13 On human capital theory see Gary Becker, "Investment in human capital: a theoretical analysis", *Journal of Political Economy* (1962) and *Human Capital* (Chicago: University of Chicago, 1993); James Heckman and Peter Klenow, *Human capital policy*, (Chicago: University of Chicago, 1997).

### Box 1.2. A rational skills investment

Chart 1.2 shows a profitable investment for a hypothetical person who can either undertake training for two years, between 23 and 25, for the cost of £6,600<sup>14</sup> (represented as area A on the chart) plus two years' salary (area B), or decide to continue working. If the person decides to do the training, the cost is equal to the direct cost of the course plus the cost of foregone earnings. The person also loses some labour market experience, hence perhaps rejoining the market at a lower wage than they would have been at had they stayed in work. But over time, the investment pays off with progression and pay rises moving ahead of what would have happened without training. In this case, it is rational to invest, because the premium (area C) is £118,600, much more than the £6,600 training cost (A) plus the foregone salary (B), which amounts to £50,600.<sup>15</sup>

Chart 1.2: Hypothetical returns to a training course



Source: Julian Le Grand, Sarah Smith and Carol Propper, *The economics of social problems*, (Basingstoke: Palgrave Macmillan, 2008) 53.

14 In 2009/10, the average cost of a year's training was £3,346, according to the Skills Funding Agency 2009/10 *Allocations to providers* data.

15 If a standard discount rate of 2.2% is applied, this premium falls to £21,189.

Table 1.1: Actors' incentives in the skills system

Actor	Incentives to invest	Market/government failures
Worker	Increased future earnings	<p><i>Information failures</i></p> <ul style="list-style-type: none"> <li>• Lack of information about wage/employment gains from training</li> <li>• Credit constraints</li> </ul> <p><i>Externalities</i></p> <ul style="list-style-type: none"> <li>• Spillover benefits to employers, other workers and society more generally</li> <li>• Reduced benefit costs</li> </ul> <p><i>Social background</i></p> <ul style="list-style-type: none"> <li>• Low perceived value of education and training</li> </ul>
Employers	Fill skill gaps Increase productivity	<p><i>Externalities</i></p> <ul style="list-style-type: none"> <li>• Fear that workers leave, rendering their investment in their human capital unprofitable</li> <li>• Spillover benefits to other employers</li> </ul>
Government	Increased productivity of economy Reduce taxpayer externalities	<p><i>Information failures</i></p> <ul style="list-style-type: none"> <li>• Mal-investment in skills because planners' choices do not correspond to labour market needs</li> </ul>

In this simplified world, we could largely leave the market for skills to operate freely, with wages signalling the productivity of different skills. Such a system would ensure a price mechanism would balance supply and demand for skills in the labour market. Workers with perfect information would spot skills that earned more money, and demand the necessary training, funded with readily available credit. The training market would react efficiently

to changes in the labour market; if the economy had enough hairdressers, wages would fall, reducing demand for hairdressing courses.<sup>16</sup>

But this simple model is not a good representation of the real world. There are several reasons why a free market, left to its own devices, would lead to a lack of aggregate investment in skills, and also investment in the wrong types of skills.

Table 1.1 lays out the incentives and disincentives to invest in human capital for the three main actors in the system. Individuals may under-invest because information failures prevent them from capturing or perceiving the benefits of training. Employers may under-invest because they fear the worker will move on and they will not recoup their investment. But as well as information failures, skills provision is also riven with what economists refer to as 'externalities': positive benefits from training that accrue to people other than the trainee themselves. Each type of problem is considered opposite.

## Individuals

There are five reasons why individuals may underinvest in their own human capital.

First, people lack information about current skills demand. Individuals need skills that are both general – numeracy, literacy and ICT skills – and specific to particular sectors of production. Would-be trainees are likely to be hazy about the relative merits of different courses, making it hard to ground their decisions in a careful appraisal of the costs and benefits of one course against another. As a result, they may choose training that does not lead to employment or wage increases. Given these difficulties, individuals

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<sup>16</sup> However, there are social benefits to skills provision that individuals cannot capture when they invest. This would mean that investment in skills would not be optimal without government action. This is discussed in more detail below.

are liable to err on the side of courses they simply find interesting rather than those that might be more highly valued in the labour market. Choosing courses solely on the basis of such 'consumption value' is justification for individuals to spend their own money on a course, but does not serve the underlying 'demand for skills' and hence should not be the focus of public funding. Learners need to find courses interesting to engage, but the courses also need to serve the demand for skills.

Second, wage signals now are not perfect predictors of the future demand for skills. All investments are risky, and skills investments are no different. If anything they are more so. Individuals may pick a sector-specific skill leading to employment in a declining industry. A general skill may lead to higher income *in the long term*, as it allows the individual to minimise spells of unemployment. No prospective trainee can know for certain what a training premium would be, and may prefer the status quo out of rational risk aversion. This may reduce total investment in skills, distorting the labour market towards low-productivity and low-skilled work.

Third, individuals may understand the benefit of training, but be unable to finance it. Banks may not be willing to extend credit at an affordable rate, particularly to poorer people without assets, discouraging those who are risk averse. Wage differentials between jobs are highly volatile over time, as some sectors shrink and others grow, and some skills fall into disuse and others become central to the economy (IT technicians being a classic example). This makes investment in skills risky, and so borrowing to invest may be costly. Most important, people who have low incomes will find it hardest to find the capital to retrain, because they are most likely to be made unemployed, creating a highly unequal society and reducing social mobility.

Fourth, the social return to investment in skills is higher than the private return. When benefits to society as a whole exceed

the private benefits, a private market will not lead to the socially optimal level of investment (see Box 1.3). There are three major spillovers to society from investment in education.

- Skilled workers improve the productivity of their less-skilled colleagues. This occurs through more efficient management, as skilled workers show the less-skilled how to work more productively. Skilled workers are also more able to use new technology, and be innovative themselves.
- A more highly skilled workforce reduces the Government's benefits bill. These workers are likely to spend less time unemployed and take fewer out-of-work benefits. They are also likely to be paid more, reducing in-work benefits like tax credits.
- There may be broader social benefits that arise from education and training. Adult skills provision may help reduce crime, drug addiction and other social ills by helping people into work.

### **Box 1.3: Human capital investment terms defined**

**Socially optimal level of investment:** this is the point where the demand for skills matches the supply of training. The demand for skills is derived from productivity gains that could be made by training workers. Where the potential productivity gains are higher than the cost of supplying the training, investment is profitable. Where the productivity gains are lower, the investment incurs a loss.

**Under-investment:** where the sum of skills investment by individuals, employers and the state is less than the potential productivity gains available.

**Skills mal-investment:** where individuals, employers or the state make investments in skills that do not lead to productivity gains as high as those available from alternative skills investments.

In addition to these economic ‘externalities’, there is strong evidence that educational outcomes are to a certain extent inherited – as is willingness to invest time, effort and money in education. The level of a mother’s educational attainment is the best predictor of her child’s, irrespective of the child’s underlying intelligence.<sup>17</sup> Many children from deprived backgrounds also lack the non-cognitive skills – or parents that instil them – that are necessary for educational success, like application, self-confidence and emotional control. The lack of these skills is strongly associated with lower incomes later in life.<sup>18</sup> Poor educational attainment, poor non-cognitive skills and disaffection with formal education compound, making it less likely that people from deprived backgrounds will invest in their own education as adults, even if it is economically rational to do so.<sup>19</sup> Government can stimulate educational investment – in the form of time and effort – by these groups, by reducing its financial cost.

## Employers

Left to individuals, the skills market is plagued by market failures and social problems that result in an under-skilled workforce. So, can employers fill the gap? Employers do not suffer from the same information problems as individuals: they know more about future and present skills needs in their own industry. Larger employers have access to cheaper capital, and can therefore make more skills investments while spreading the risk.

Employers do, of course, train workers themselves. If the training costs and loss of labour while the worker trains are less than the wages they would have to pay on the labour market for a skilled worker, the investment could be profitable.

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17 James Heckman, “Policies to promote human capital”, *Research in economics*, (2000).

18 Jo Blanden, Paul Gregg and Lindsey Macmillan, *Accounting for intergenerational income persistence: non-cognitive skills, ability and education*, (London: LSE Centre for the Economics of Education, 2006).

19 OECD, “A family affair: intergenerational social mobility across OECD countries”, in OECD, *Going for growth: economic policy reforms* (Paris: OECD, 2010).

However, human capital is held by the individual, who is free to move between sectors of the economy and firms within particular sectors. This means that the owners of physical capital (employers) do not have property rights over the human capital they need for production. Computers don't resign, but freshly trained employees may do.

Employers need broad skills, such as literacy, numeracy and ICT. But these are applicable across all sectors. A firm will invest in people only if they can capture the returns from doing so. For this reason, when it comes to **transferable skills** the interests of any one firm diverge from those of employers in general.

Employers are unwilling to invest in skills that are transferable, for fear that the skilled worker will be poached by another employer. In a free labour market, there are very weak incentives for individual employers to spend even modest amounts on training their staff, if skilled labour is scarce. If they invest in training, other employers can poach the labour by offering a marginally higher wage. The poachers therefore free-ride, and the employer who invested in training does not recoup the cost of training by having more productive staff. So decisions made by one employer do not satisfy even their own skills needs, let alone the wider demand for skills in the economy. As a result of this threat to their investment, firms will tend to favour investment in **firm-specific** skills.

The empirical evidence for this theory is supportive, with caveats. Employers do invest to a degree in formally provided general skills, although individual and state investment is higher by several orders of magnitude. Studies have found that employer-led general training in 'clusters' of firms located near each other is lower than firms which are located further apart. This suggests that employers are less willing to train workers when these employees can easily

move to another firm.<sup>20</sup> Workers on part-time and temporary contracts receive less training from firms than permanent full-time staff for fear that the investment will not pay off.<sup>21</sup>

There is evidence that employers will pay for general training and pay workers lower wages to compensate – but this is more apparent in imperfectly competitive labour markets with strong labour rights than in the UK.<sup>22</sup> There are undoubtedly uncompetitive areas of the labour market in which employers may more readily invest in general skills. But across the entire labour market, the tendency is for employers to do no more than ‘top up’ general and sector-specific skills with firm-specific skills if they cannot tie individuals to the firm.

As a result, firms’ investment in general and sector-specific skills is sub-optimal, from an economic perspective, and they fail to fill the gap left by individual under-investment. The fact that firms find it hard to co-operate in order to invest in skills and minimise free-riding means that individual firms’ training activities paradoxically fail to reflect the human capital requirements of employers in aggregate.

There are a number of potential solutions to this that do not involve government money. Employers could band together to jointly invest in training, which would reduce the labour costs of highly skilled labour over time. This would solve the free rider problem among the incumbents. However, this would only work in industries where firms’ skills needs are very similar and homogenous, such as construction. Where firms need a wide array of skills – a bank needs tellers, administrators, secretaries, risk

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20 Gioglio Brunello and Francesca Gambarotto, “Agglomeration effects on employer-provided training: evidence from the UK”, *CESifo economic studies* (2004).

21 Wiji Arulampalam and Alison Booth, “Training and labour market flexibility: is there a trade-off?”, *British journal of industrial relations* (1998).

22 Daron Acemoglu and Jörn-Steffen Pischke, *The structure of wages and investment in general training*, (Washington, DC: National Bureau of Economic Research, 1998).

managers, and so on – a skills club would be very difficult and costly to co-ordinate. Workers with transferable skills, such as secretaries, could also move to other industries. Furthermore, new start-ups in the market would be able to free-ride on firms who trained their employees, unless the state was to mandate a contribution to skills investment, in the form of a sector levy.<sup>23</sup> While government may be ready to intervene and regulate in specific industries, it is unlikely to wish to do so across industry as a whole.

The problems outlined above mean that neither employers nor individuals can overcome the barriers to adequate levels of transferable and sector specific skills training. The result is chronic under-investment in human capital. Clearly, therefore, there is a role for government in addressing these multiple market failures.

But government subsidy creates its own problems. There is the risk of swapping under-investment in a free market for mal-investment in a system where public money is deployed. This could be in the form of people taking courses which do not serve the ultimate needs of employers. Alternatively, mal-investment could be the result of the right courses being poorly delivered due to weak accountability for providers and trainees. Under-investment by employers and individuals make it inevitable that government becomes heavily involved in skills provision, but how?

### What role for government?

A free market adult skills system leads to a sub-optimal level of investment, from a macro-economic perspective. This makes it difficult for an economy to achieve its productive potential. The social and financial externalities of a poorly skilled workforce also necessitate state subsidy. These costs suggest that state investment through subsidy is good policy in principle.

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23 Such levies exist in construction in the UK, and the Coalition hopes to introduce more. See Department for Business, Innovation & Skills (BIS), *Skills for sustainable growth*, (London: HMSO, 2010), 23.

However, in providing subsidy, the state risks investing in the wrong types of skills. Handing cash directly to individuals or employers simply exacerbates the failures outlined above. In addition to the usual problems at the individual level, state funding raises a new problem: individuals have less incentive to find out what courses would be most valuable since they are no longer spending their own money. Neither of these routes is likely to satisfy the demand for skills in the wider economy.

If subsidising individuals and firms is problematic should the state plan skills needs from the centre? It faces multiple challenges in trying to do so, each of which will lead to varying degrees of mal-investment.

Planners have limited knowledge about what training is most likely to lead to employment or wage increases. The state can use central planner's tools – statistical attempts to map changing patterns of demand for labour in the economy, and the contracting of service providers to deliver training it expects to satisfy that demand. It can create a set of subsidised qualifications, with specified curricula or work-based training, that accords with its statistical map of skills demand. This will help to accredit skills, turning them into qualifications that employers can recognise as a signal that a person can do particular tasks. But there will inevitably be provision of skills training that does not lead to productive labour market outcomes; so a good proportion of the investment by government will be wasted. This is because:

- Planners have **limited knowledge** about local labour market conditions.
- Planners find it difficult to keep up with **new skills demand**.
- The **quality of provision** is difficult for the central planner to ensure.

Labour market demand for skills is in essence the sum of the thousands of wage agreements by employers and workers for the productive deployment of a certain skill or set of skills. The central planner's tools will always be inadequate because these agreements are made in decentralised, local labour markets, and demand for different skills varies between them.

Governments are far less efficient investors than employers and individuals in satisfying the demand for skills because they have even poorer information. Markets more efficiently use information, through the price mechanism, to invest in the right things. A worker can assess, if imperfectly, what jobs are available in their local area and find out what training is required to get one. An employer has a better sense of the skills needed to do a job than a central government agency has, even if they choose not to invest in them for the reasons described above. Furthermore, in a given area, there may be a surfeit of a particular skill, meaning that the labour market returns to training in that skill may not be as high locally as they are nationally.

Government also finds it hard to ensure that its subsidised qualifications meet the evolving needs of the labour market, where training needs are constantly changing as new technology, and production and delivery processes, are deployed. The qualifications it agrees to fund are unlikely to keep pace with the new skills necessary, delaying the match between skills supply and skills demand.

So there is a strong case for government subsidy of adult skills provision, in order to increase the level of investment in skills in the economy. But the state itself lacks the information necessary to allocate resources for particular qualifications in an efficient way. There is a clear need to find a better solution to the problems of inefficient **mal-investment** in human capital in a subsidised system, and the **sub-optimal level** of investment in a free-market one.

## THE ROLE OF PROVIDERS

There is a strong rationale for passing decision-making about skills provision to providers of skills training. Currently, providers are agents of individuals' and employers' demand for training and the state's centrally planned provision. And under the current system, they have little incentive to resolve the problems that each actor faces. They are not encouraged or rewarded for achieving the one role necessary to create a demand-led skills system – to coordinate the needs of a wide variety of employers with individuals who already have some skills, but who need training to boost their productivity. As providers are paid by the number of qualifications they deliver, they naturally seek to fill rolls and ensure that they teach and train learners well, but have little incentive to focus on the labour market outcomes of their learners.

But their role could be very different. Providers are in a unique position to identify and forecast demand for particular skills among employers, because they are embedded in local labour markets. They can forge relationships with employers in sectors that are expanding, or which require new skills, and provide the qualifications necessary to work in them. Providers can seek to understand different sectors, and help trainees make rational decisions about what skills will lead to better employment prospects in their local labour market. They are thus able to match the pre-existing skills of workers to jobs and, of course, provide the training necessary to make people ready for employment. Many providers supply firm-specific training to particular companies, and have good links with the major firms in their area. They can also use local labour market data to steer learners towards qualifications they know are in demand.

Providers are well placed to act as stewards of the labour market, matching the supply of skills with the demand for them. Furthermore, a market would create strong incentives to learn:

where one provider processed information better than others, it would perform better and other providers could copy its techniques. Thus competitive forces would improve the flow of information about what training works. Decentralising decisions about the allocation of skills funding to providers could help to untangle the knot of misplaced incentives and information constraints and lubricate a market with many frictions.

In sum, the state has a crucial role in overcoming the under-investment that would prevail in a free market for investment in adult education and skills. But, in distributing the subsidy, it can exacerbate mal-investment.

- If it hands subsidy to the individual, the individual may invest poorly. The individual faces less investment risk, and is freer to pursue courses that are more interesting or easy but less likely to lead to a good job. The individual also still does not know which courses are most likely to lead to good jobs, and has weaker incentives to find out.
- If it hands subsidy to employers, they are likely to co-opt funding to their own ends, leading to fewer transferable skills than the economy needs.
- If the state directs skills provision from the centre, it is likely to invest poorly because it has poor information about skills demand; and because it has to rely on colleges and other providers without clear incentives to focus on what skills are in demand locally.

The state can pick one or more of these routes to pursue its adult skills policy. But each has substantial drawbacks. The next chapter examines recent policy shifts in this context. This report then goes on to look at a better solution to these perennial problems – one that puts skills providers at the heart of the system and charges them with the all-important role of co-ordination.

## CHAPTER 2: FROM THEORY TO PRACTICE

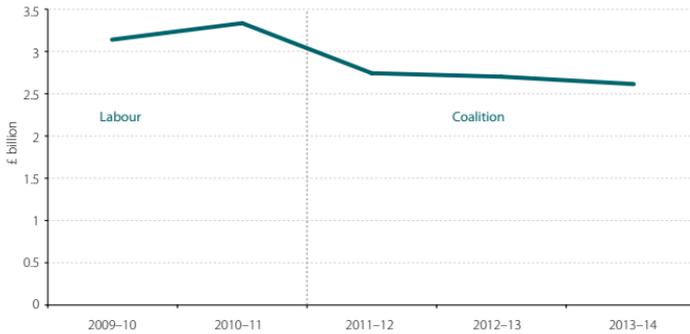
Successive governments have struggled with the dilemma the subsidy of skills provision throws up. It is extremely hard to ensure that funding serves the demand for skills in the economy. Subsidising individuals leads many to choose unproductive courses, not least because individuals are no longer spending their own money. Subsidising employers results in less general skills training than the economy needs, since even subsidised investment in poachable skills is a poor investment for most. In practice, successive governments have fudged the issue by trying to ride both horses at once. By subsidising both individuals and employers – and adding in a greater or lesser degree of central prescription of qualification design – they have hoped that they can identify and serve the underlying demand for skills.

This chapter offers an analysis of recent skills policy changes from Labour's Leitch Review of Skills in 2006 to the Coalition Government's emerging plans. It shows how Labour and the current Government have switched resources between actors in the system to try to discover demand for skills. In each case, the inevitable result is that one set of market failures is swapped for another, illustrating the need for a more fundamental rethink of the problem.

### THE RECENT EVOLUTION OF SKILLS POLICY

The Labour and Coalition Governments have faced vastly different fiscal circumstances in which to invest in adult skills. During the long boom, Labour increased the amount of expenditure on skills provision, and extended its scope. The Coalition decided to reduce the fiscal deficit quickly, and have thus decided to cut the adult skills budget significantly by 2013. (See Chart 2.1.)

Chart 2.1: Total adult skills participation funding, 2008–2013,  
(2010 constant prices)



Sources: BIS, *Skills investment strategy 2010–11*, (London: HMSO, 2009) 10; BIS, *Investing skills for sustainable growth*, (London: HMSO, 2010) 26–27.

In keeping with the analysis in Chapter 1, Labour identified under-investment by individuals and employers as the main problem. Lord Leitch’s Review noted the significant number of low-skilled workers that acts as a drag on the UK’s labour productivity. The Review suggested a target-driven approach to increase skill levels, which Labour duly implemented. The targets for the year 2020 were:

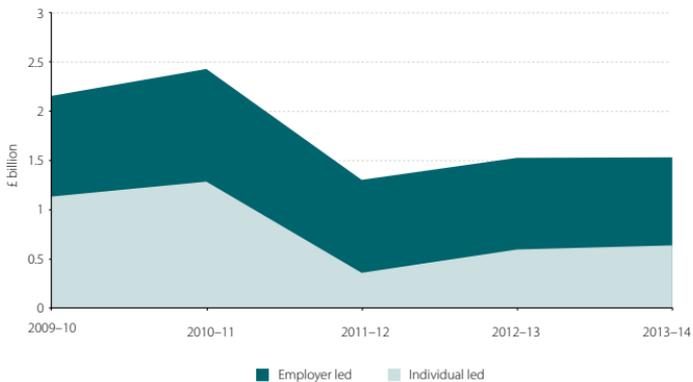
- 95% of adults to achieve basic skills of functional literacy and numeracy, from 85% literacy and 79% numeracy in 2005.
- More than 90% of adults to be qualified to Level 2, from 69% in 2005.
- “Shifting the balance of intermediate skills from Level 2 to Level 3”, with 1.9 million more Level 3 qualifications.<sup>24</sup>

To achieve these targets, the Labour Government expanded subsidy to both individuals and employers. Between 2007 and 2010, it increased funding by £320 million. On the individual side, it prioritised funding basic skills in literacy and numeracy (Skills for Life), and first courses at Level 2, and expanded access to all levels

<sup>24</sup> Ibid., 3.

of education for the unemployed. By offering more free courses – but courses whose curricula were determined by central agencies – more individuals took them up. But since individuals were in many cases fully subsidised and had no great incentive to understand employers’ needs, many took courses that had insignificant wage returns (see the evidence below).

Chart 2.2: Funding by type of training, 2008–2013, 2010 prices



Sources: BIS, 'Skills investment strategy 2010–11', (November 2009) 10; BIS, 'Investing skills for sustainable growth', (November 2010) 26–7.<sup>25</sup>

Note: These figures do not include all funding lines for adult skills: capital spending, skills provision for prisoners and Adult Safeguarded Learning (ASL) are not included. These funding lines are either unchanged (ASL) or changes to them have not yet been announced (capital spending, prisoner skills).

Partly because of these problems of individual subsidy, Labour increasingly backed the employer subsidy route, in an attempt to make training more 'demand led'. The Government's prioritisation of workplace funding led to steep increases in funds available for both Train to Gain and apprenticeships, both of which rose by 19% between 2007 and 2010.<sup>26</sup> (See Chart 2.2 for funding changes). The Train to Gain budget peaked at £920 million, larger than any other budget line for

25 The Coalition has removed ring fences around budgets for learner-led provision, so providers are freer to supply courses at Levels 1 to 4 as they see fit. The 2010–13 data for funding for Skills for Life, Levels 2, 3 and 4 is based upon the average proportion of total funding spent on these courses between 2008–09 and 2009–10.

26 Skills Funding Agency budget, 2010–11.

adult education and skills. Under the scheme, employers contracted training providers for general skills, releasing government money. Various agencies tried to ensure that this money was not co-opted by firms for entirely their own specific training needs.

As part of the programme to cut the deficit, the Coalition is cutting the overall adult skills budget by £1.1 billion (25%) to 2014–15. As Chart 2.2 shows, the biggest cut will come from the employer side: £496 million in total. The Government has abolished Train to Gain, cutting £980 million, arguing that much of the training under the programme would have been conducted by employers in the absence of subsidy, anyway. Part of that cut is being recycled into more apprenticeship places, prioritising on-the-job training over Train to Gain's classroom skills courses: funding will increase from £360 million to £648 million by 2012–13. Thus, the Coalition is assuming that funding apprenticeships at the expense of other forms of in-work training will help to identify underlying skills demand, hoping that apprentices will develop skills through work, and employers will retain them, boosting the level of sustained employment.

For individual-led funding, the Government is reducing subsidy to some adults who already have qualifications, for people who are employed, and for adults over 24. Income contingent loans will be introduced to replace them. (Table 2.1 outlines the main funding changes.) Entitlements are protected for younger learners and for the low-skilled unemployed.

The Government expects that "learners and employers will co-invest alongside Government in the costs of intermediate and higher level training courses from which they derive private benefits".<sup>27</sup> By making learners feel the cost of making a poor investment, it is hoped they will demand more from the courses they take and choose courses giving skills that employers want.

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27 Ibid.

Table 2.1: Coalition changes to funding entitlements, from 2014–15;  
 Grey = Labour, Green = Coalition

	Learning level	19–24	24+	Unemployed and on active benefits
Adult learner-led funding	First full level qualification 2	100% government subsidy	100% government subsidy	100% government subsidy
		100% government subsidy	50% subsidy, 50% loan	100% government subsidy
	Full level qualification 3	50% government subsidy, 50% tuition fee	50% government subsidy, 50% tuition fee	50% government subsidy, 50% tuition fee
		100% government subsidy	100% loan	100% subsidy for those under 23. Loans for those aged 24+
	Full level qualification 4	50% government subsidy, 50% tuition fee	50% government subsidy, 50% tuition fee	50% government subsidy, 50% tuition fee
		50% government subsidy, 50% loan	100% loan	100% subsidy for those under 23. Loans for those aged 24+
Employer-led funding	Adult apprenticeships	Employers pay apprentices a wage over £80 per week for the first year of training. Government subsidises formal training to different degrees, depending on the age of the apprentice and the sector the apprenticeship is taken in		
		Employers pay apprentices £2.60 per hour minimum wage. Government pays for all formal training		
	Train to Gain	Employers 'expected' to contribute, with larger contributions for higher levels of skill. Wage costs subsidised where working time lost, varying upon size of company		
		Abolished		

Sources: BIS, *Skills for sustainable growth*, (London: BIS, 2010) 11; BIS, *Skills investment strategy 2010–11* (London: BIS, 2009).

Thus successive Governments have struggled to ensure that individual provision is not wasted on poor quality courses, and to stop employers from using subsidy for their own ends. So policymakers have been cycling between different types of provision, supplementing individual-led funding with employer-led funding – and then picking different forms of employer-led funding – in an attempt to ensure that subsidy leads to the right combination of general, and sector-specific skills that the economy needs.

A symptom of their failure to achieve this has been policymakers' attempts to try to control the provision on the front line. 'Agency creep' has been a major feature of the skills system. While offering subsidy to individuals and employers for training, government has tried to control the content of training to ensure it provides the 'right' training for particular sectors. These agencies also tried both to 'hear' the general skills needs of employers and prevent them getting subsidy for training they would otherwise have paid for themselves. The UK Commission for Education and Skills, the business department, Sector Skills Councils, the qualifications regulator Ofqual, and Regional Development Agencies, all had a hand in trying to identify the underlying skills needs and ensure that provision is 'demand led'. The Coalition has culled several of these and given others different remits, but it has also added some, such as Local Enterprise Partnerships. These agencies struggle to achieve their goal.

To show why successive governments have found it difficult to subsidise skills in a way that serves the economy's demand for skills, it is necessary to examine the policy changes to individual and employer-led funding in more detail. Each is discussed below, followed by an analysis of the delivery chain that is intended to supply training.

### **Subsidy for individuals**

Increased subsidy for individuals in the Labour years has given way to a sharp reduction in training entitlements under the coalition.

Large increases in funding in an unreformed system under Labour led to more money spent but more wasted as individuals chose courses employers did not want.

By increasing the numbers of adults undertaking training, either in classroom based learning or through in-work learning, Labour increased the total amount of individual-led learning. However, the evidence suggests that a large proportion of this investment did not flow towards skills that employers needed.

The evidence for the economic returns to many qualifications is mixed. Using a range of methods, Dearden et al found that many lower level vocational qualifications were not associated with significant wage returns, while some higher level qualifications brought large and statistically significant wage returns. Higher vocational qualifications were in general better, but not as good as academic qualifications, like GCSEs and A-levels.<sup>28</sup>

The evidence on the returns to Skills for Life, the state's basic skills service for literacy and numeracy, is also mixed. Metcalf et al found no statistically significant earnings premium.<sup>29</sup> McIntosh and Vignoles have found higher wage gains for numeracy provision (8–10%) than for literacy (2–6%).<sup>30</sup>

National Vocational Qualifications (NVQ) offer learners the worst labour market returns. Dearden et al found in 2004 that National Vocational Qualifications (NVQ) at Level 2 – equivalent to a GCSE A\*–C in the National Qualifications Framework – offered *negative* returns compared to similar people who had not taken

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28 Lorraine Dearden, Steven McIntosh, Michael Myck and Anna Vignoles, *The returns to academic and vocational qualifications in Britain*, (Nottingham: Department for Education and Employment, 2000).

29 Hilary Metcalf, Pamela Meadows, Heather Rolfe and Amar Dhudwar, *Evaluation of the impact of Skills for Life learning: longitudinal survey of adult learners on college-based literacy and numeracy courses*, (London: Department of Education and Skills, 2009).

30 Steven McIntosh and Anna Vignoles, "Measuring and assessing the impact of basic skills on labour market outcomes", *Oxford Economic Papers* (2001).

them.<sup>31</sup> This may have been down to 'ability bias' – people who did NVQs at Level 2 tended to be of lower ability of people who had the same qualifications but did not take them. Nonetheless, it is difficult to tell whether holding a low level NVQ is a bad qualification signal in the labour market or a good one, suggesting that many of these qualifications are not a wise investment of government money.

So, some courses lead on average to higher wages, while some do not. As our theory suggested in Chapter 1, subsidising the individual led to a large increase in the number of people attaining a Level 2 or Level 3 qualification irrespective of the employment prospects of that particular course. There were weak incentives for individuals to take courses that led to better employment prospects, because courses with varying economic value were subsidised equally.

Under the Coalition's plans, more trainees will be expected to co-invest alongside state subsidy. This development is to be welcomed insofar as it will encourage trainees to examine which courses will lead to improved wages and employment. It will lead to an aggregate fall in learner demand for training, however, even as it focuses the remaining demand on skills needed in the labour market. The Coalition is also reducing the amount of subsidy to higher courses, where labour market returns to the individual are more apparent. The subsidy will be replaced by loans, along the lines of the Coalition's funding model for higher education, with no repayment until the trainee is earning over £21,000 per year. The investment risk is thus shared between government and the trainee; it encourages trainees to focus on training that works, in that they have to pay back the cost of their training over time, but mitigates the risk that the training will not lead to improved wages.

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31 Lorraine Dearden, Leslie McGranahan and Barbara Sianesi, *An in-depth analysis of the returns to National Vocational Qualifications obtained at Level 2*, (London: London School of Economics Centre for the Economics of Education, 2004).

People will be more likely to demand courses that lead to higher wages than if all of the costs were covered by the state.

However, with less subsidy, fewer people will take courses. The Government's own impact assessment projects that the reduced entitlement will end up costing the economy £7.9 billion over the next 40 years, as demand for courses drops and the associated productivity improvements are not made.<sup>32</sup> This fall in demand for courses reflect the fact that people are less willing or less able to invest in their own money courses where the returns are uncertain.

Large reductions in funding for individuals under the Coalition are a reaction to past mal-investment, as well as part of a fiscal strategy that requires savings to be made in almost all areas of public spending. However, this reduction has led to less investment overall, and little attempt to direct the investment at courses demanded by employers. As a result, some skills provision that is valued in the labour market will disappear, as will some provision that is not. The adult skills reforms are reducing mal-investment, but losing much profitable investment with it. Instead, government should be looking at ways to get better outcomes for its money.

### Subsidy for employers

Solving the market failures in funding individuals is tricky, hence the Coalition Government's attempts at reform. A similar set of issues is leading to a re-organisation of employer-led training. As Chapter 1 notes, the state faces a dilemma when passing subsidy for training to employers.

The evidence suggests that training subsidy for employers has been poorly invested in the past. Labour's flagship employer-led training programme, Train to Gain, shifted from the provision of such general skills that employers would not engage with it, to

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32 BIS, *Amending legislative skills entitlements: impact assessment*, (London: HMSO, 2010), 4.

such firm-specific skills that the deadweight costs – in the sense of investment that would have been undertaken by firms in the absence of any subsidy – rose. Initially, under the Train to Gain programme, the Government placed fairly stringent rules on the courses that would be offered public funding. The courses had to be the trainee's first full level 2 course, and they had to be 'full' courses, offering transferable skills. However, these rules meant demand was too low among employers to meet the targets the Government had set for take-up. So the rules were relaxed, and employers were allowed to undertake far more firm-specific training as a sweetener.

So, the theoretical picture of Chapter 1 was borne out in practice. If government mandates that the training must be transferable, employers tend to be unwilling to take it up, even if all of the direct training cost is borne by the public purse. Employers appear reluctant to bear the attendant cost of lost labour while workers train if they cannot capture the benefit from the training, since workers may leave the company.

In order to get employers engaged Labour policymakers had to give them more of a say in what skills were taught. But when employers are able to control the content of the subsidised training, they will inevitably try to ensure that it is as firm-specific as possible, to overcome the poaching problem. By definition, this will not match the economy wide demand for transferable skills. The 'deadweight' cost of the programme increased: the National Audit Office found that half of the employers who had used Train to Gain would have provided similar training without any public funding.<sup>33</sup>

For these reasons, the Coalition has abolished Train to Gain, and instead sought to boost the number of apprenticeships. The Government argues that apprenticeships entail 'co-investment'

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33 National Audit Office, *Train to Gain: developing the skills of the workforce*, (London: NAO, 2009), 25–9.

because employers have to offer a minimum wage of £2.60 per hour, while the Government subsidises formal training to different degrees, depending on the age of the apprentice and the sector the apprenticeship is taken in. Apprenticeships combine on the job experience with formal training, but as apprentices are relatively unproductive, a wage subsidy is necessary for employers to engage. This continues the centralised channelling of cash from the centre to employers in the form of training, in the hope that apprentices will learn valuable skills on-the-job.

Many apprenticeships are excellent. The average wage returns in employment are between 12% (Level 2) and 22% (Level 3) compared to people who have not been apprentices.<sup>34</sup> But the evidence also suggests that some apprenticeships are of questionable value. Apprentices only have to spend two hours a week in formal training in the UK.<sup>35</sup> Many courses require much more formal training, but this depends on the skill content of the job they are training for. Some employers may be unwilling to accept much more time away from work, because hiring and supervising an apprentice entails bureaucratic cost which must be recouped through productive work for the firm.

There is evidence that the surge in government funding for apprenticeships may come at the expense of quality. Low wages contribute to a high drop-out rate, averaging just over a quarter over the last two years.<sup>36</sup> To date, apprenticeships have been associated with higher wages than some taught courses at low levels, but this may be due to the sectors the apprenticeships have been in: in the past many apprenticeships were offered in higher skilled work like engineering, manufacturing or construction.

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34 BIS, *Returns to intermediate and low-level vocational qualifications*, (London: HMSO, 2011).

35 European Commission, *Structures of education and training systems in Europe: Germany 2009/10*, (Brussels: European Commission, 2010) 38.

36 Skills Data Service, 'Statistical first release, 2011', Table 7.3. [http://www.thedataservice.org.uk/statistics/statisticalfirstrelease/sfr\\_archive/](http://www.thedataservice.org.uk/statistics/statisticalfirstrelease/sfr_archive/).

However, many more apprenticeships are now undertaken in the service sector. The proportion of all apprenticeships taken in business, administration and law has increased from 22% in 2002–03 to 29% in 2010–11. Nineteen per cent were taken in health, public services and care in 2010–11, compared with 11% in 2002–03. Meanwhile, engineering and manufacturing apprenticeships have declined from a quarter of all those taken to just one-in-ten over the same period, while the share of construction, planning and the built environment has shrunk from 18% to 6%.<sup>37</sup>

Evidence suggests that apprenticeships in the service sector yield low or undetectable returns. Steven McIntosh at Sheffield University found statistically significant higher wages for people with apprenticeships in only four of eleven services sectors in 2004.<sup>38</sup> If the Government simply floods the market with apprenticeships, there is a significant risk that many will be taken in economic sectors where they don't lead to sustainable jobs and higher wages.

Cycling from one form of employer-led funding to another will not solve the state's dilemma. Both apprenticeships and Train to Gain are intended to give workers transferable skills while they acquire on-the-job experience. What is needed is an accountability mechanism for the quality of these apprenticeships and the on-the-job training they entail.

## WILL PROVIDERS FOCUS ON THE UNDERLYING DEMAND FOR SKILLS?

It is hard to get individuals and individual employers to focus on the underlying demand for skills when subsidy is involved. What about providers and other intermediaries? Successive governments have attempted to resolve the information constraints for individuals

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37 Skills Data Service, "Apprenticeship supplementary tables, 2010/11". Sector subject area data. [http://www.thedataservice.org.uk/statistics/statisticalfirstrelease/sfr\\_archive/](http://www.thedataservice.org.uk/statistics/statisticalfirstrelease/sfr_archive/).

38 Steven McIntosh, *The returns to apprenticeship training*, (London: LSE, 2004), 16.

and divergent incentives for employers through central control of the form and content of education and training. Governments have attempted to create a mix of transferable basic skills and sector-specific vocational training by planning. But government knows far less what content is needed to make a particular course valued in the labour market than employers do.

So, the state has attempted to draw in employers to the skills planning system to help discover the underlying demand for skills. While doing so, government has tried to hold them at far enough remove to prevent them from designing courses that under-provide transferable skills training. Twenty-five Sector Skills Councils (SSCs) were established in 2001 to help design qualifications and mandate apprenticeship content. The reports of these councils were then turned into curriculum content by qualification awards bodies, with advice from the UK Commission on Employment and Skills.

Under Labour, SSCs tended to be self-interested, and failed to create the right mix of skills. Where members of the council were involved in very similar forms of production, SSCs had strong incentives to create vocational qualifications that were highly sector specific, ignoring the more transferable skills that serve the skills demands of the economy. Conversely, SSCs with broader membership argued qualifications down to a common denominator that failed to make workers more productive in that sector or in the wider labour market.<sup>39</sup>

The system relied heavily on a combination of technocratic and employer 'voice' so that the state could 'hear' the underlying demand for skills in the wider economy. This process will always be faulty in a dynamic market economy with a fast rate of industrial and technological change.

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39 Ewart Keep and Susan James, *What incentives to learn at the bottom end of the labour market?*, (Oxford: SKOPE, 2010) 11.

To try to counter this problem, the Coalition is trying to improve information employers receive about different types of training, and encourage consolidation in the sector, freeing-up providers to follow employer demand, where possible. SSCs will no longer have such an active role in producing qualifications with the awarding bodies – instead, they will work to boost demand for training among employers. The multiple individual-led funding streams to colleges and other providers will be reduced, to allow them to provide courses they consider to be in demand.

However, the greater power being handed to colleges to 'hear' the underlying labour market demand and act upon it does not come with greater accountability. By reducing employer input, the Coalition is effectively giving more control to individuals over which courses are provided, since providers will see their role as providing what learners want to learn. This may lead to more mal-investment as some individuals take unproductive courses, unless providers guide them away from such courses. But being asked only to 'listen' to employers is not much of an incentive to guide learners toward skills that are in demand.

Incentives for colleges to ensure that training leads to successful labour market outcomes will remain weak. This leaves providers largely unaccountable for poor provision. Provider funding is offered per learner trained. This means that colleges can offer any qualification accredited as 'Level 1' or 'Level 2', and if the trainee has low skills or is on benefits, the Government will automatically offer funding regardless of labour market outcomes.

Where colleges are paid by results, it is on output, rather than outcome: a proportion of funding is available based upon qualification pass rates. Yet these qualifications are not a sufficient condition for success. They do not necessarily translate into labour market value, so basing a measure of success on qualification pass rates is a highly questionable form of accountability.

## THE SKILLS SYSTEM'S PERFORMANCE TO DATE: A VARIABLE PICTURE

The Coalition's reforms are yet to take full effect. But there is little to suggest a radical break with the past in terms of how effective adult skills provision will be in improving employee productivity. It is therefore worth examining just how effective the adult skills system currently is.

The picture is hugely varied. Much government money is wasted on courses that do not lead to better wages as a result. The previous and current Governments' funding arrangements encourage providers to focus on getting learners into the classroom for any course that the Government agrees to fund. Providers have no incentive to steer learners towards courses that will lead to better labour market results: higher pay or a better chance of securing sustained employment.

In this environment of weak accountability, there are three dimensions along which the variation in labour market performance of trainees is substantial: variation in the outcomes from different types of qualification undertaken; variation in outcomes according to the subject studied; and variation in the performance of different colleges. We examine each in turn.

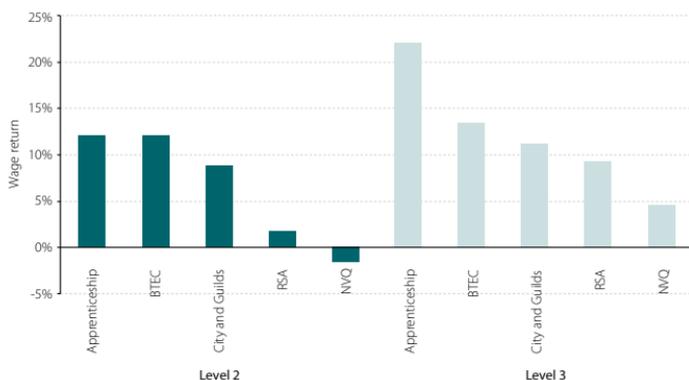
### Variable impact of qualification types

Chart 2.3 shows the wage uplift associated with different types of qualification at Levels 2 and 3, controlling for the characteristics of those taking each type of qualification. This shows the average wage gain for an adult who has a given qualification compared to people who have the level of qualification immediately below: people with a Level 2 BTEC were compared to people who only had a Level 1 qualification.

In recent years apprenticeships have led to the best outcomes, with a 12% yearly wage gain at Level 2 and a 22% yearly wage gain

at Level 3 over people with the level below. BTEC and City & Guilds qualifications show good wage returns, with between 8% and 13% gains at Levels 2 and 3 respectively. RSA qualifications show poor wage returns at Level 2 (2%) but reasonable returns at Level 3 (9%). However, NVQs are associated with negative wage gains at Level 2 compared to the control group, and a small – 5% – wage gain at Level 3. This variation in earnings returns suggests that there are large gains to be made from diverting learners from NVQ to other types of qualification. There would be significant overall gains from squeezing out the poorer courses.

**Chart 2.3: Earnings impact of different vocational qualifications**

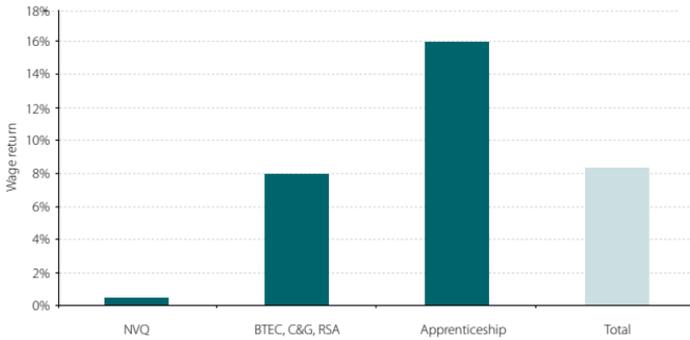


Sources: BIS, *Returns to intermediate and low-level vocational qualifications* (London: HMSO, 2011); Andrew Jenkins, Charley Greenwood and Anna Vignoles *The returns to qualifications in England: updating the evidence base on level 2 and level 3 vocational qualifications*, (London: LSE, 2007).

Providers receive funding for all types of qualification irrespective of economic value, which gives them little incentive to divert learners to the best courses. As a consequence, a large amount of government funding is wasted. Chart 2.4 shows the earnings uplift associated with NVQs, BTEC, City & Guilds and RSA qualifications, and apprenticeships, weighted by the numbers of students taking the qualification at each level in 2009–10. The earnings uplift for all courses is only 8%, despite strong returns for BTEC, City & Guilds,

RSA and apprenticeships. The large investment in NVQs drags the average wage uplift down. Eliminating NVQs would push the weighted average returns up, massively increasing the Government's return on investment. But, as described above, the content behind these labels is not fixed: thus improving the return on investment may not be as simple as redeploying the funding to apprenticeships.

**Chart 2.4: Earnings impact of vocational qualifications, weighted by level and by distribution of government funding, 2009–10**



Sources: Author's calculations based upon Skills Data Service, statistical first release institutional level data, 2009–10 <http://www.thedataservice.org.uk/statistics/>; BIS, *Returns to intermediate and low-level vocational qualifications*, (September 2011); Andrew Jenkins, Charley Greenwood and Anna Vignoles *The returns to qualifications in England: updating the evidence base on level 2 and level 3 vocational qualifications*.

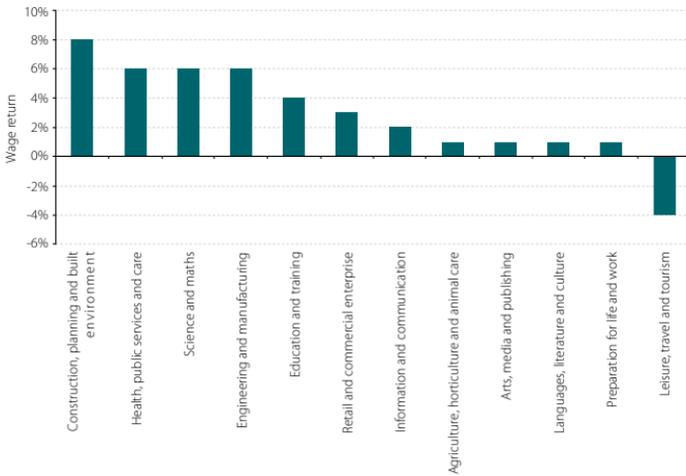
### Variable impact of subjects

It is not just the type of qualification that yields wildly differing labour market results, but the subjects studied too. The current funding system does not encourage providers to steer learners towards subjects that lead to good outcomes.

In the returns to education literature no one has conducted a robust regression analysis of the returns to particular subject areas. This means that students taking some subjects may do worse in the labour market than students taking other subjects because

they are on average less able, rather than because the subject is of little relevance to employers. Nevertheless, it is unlikely that this selection problem accounts for all of the variation in outcomes among students who take different subjects. Chart 2.5 shows just how wide the dispersal in the average earnings is for people taking different subjects.

**Chart 2.5: Earnings impact of vocational qualifications, selected subjects at Level 2**



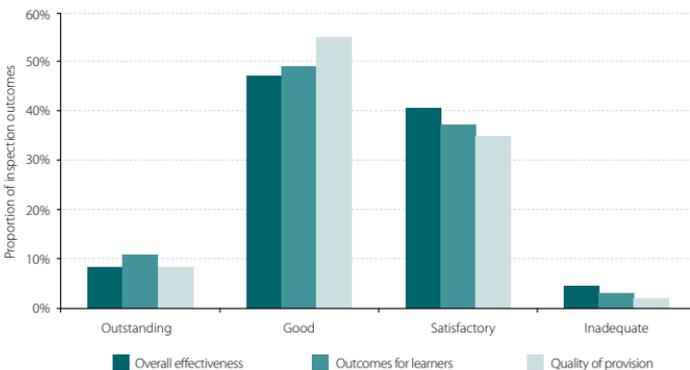
Source: BIS, *Reporting on employment and earnings based upon experimental matched data*, (London: HMSO, 2011).

The chart shows that learners taking courses in leisure, travel and tourism at Level 2 had lower average earnings than people with the qualification below or no qualifications. Those in construction, planning and the built environment saw an 8% return. Again, some of this variation may be due to innate characteristics of the people taking the courses that the data did not capture. But it nevertheless suggests that there is large variation in the employer demand for different subjects' skills. If learners switched to subjects that employers demanded, there may be large gains to be made. But again, providers have little incentive to convey that message to their customers.

Even if students were guided to take better qualifications in more highly demanded subjects, it could still be the case that the quality of teaching might let them down. Currently methods for holding providers to account are largely technocratic with Ofsted conducting inspections and ensuring quality of provision. Providers are also given a certain degree of payment by output, which is released once the qualification awarder has independently assessed the exams and coursework, and work placements have been delivered. These targets are measures of the quality of the training process. However, providers do not need to take account of labour market outcomes, so accountability for how well they teach skills for the labour market is weak.

There is also weak accountability for the quality of education more generally. Data on the Ofsted inspections of adult education show that provision is mediocre. Chart 2.6 shows the outcomes of 2011 inspections: around 50% are rated good, but over 40% are rated just 'satisfactory' for overall effectiveness, with very few examples of outstanding provision.

**Chart 2.6: Ofsted provider ratings, 2011**



Source: Ofsted inspections data, adult education, 2011. <http://www.ofsted.gov.uk/resources/annualreport1011>.

So there are many aspects to the indifferent outcomes from adult skills spending. Improving the performance of FE in England depends upon strengthening accountability in order to reduce the variability of provision in each of the above dimensions, focusing on the courses and subjects that employers value and putting pressure on poor providers to improve. Marginal improvements on each dimension could have a substantial impact on labour market outcomes. The question is how this can be achieved.

## THE COALITION'S REFORMS: A SOLUTION?

There is a pressing need to hold providers to account for labour market outcomes, and to improve accountability more generally in the system. Despite Coalition reforms and the change in the rhetoric, the system for holding providers to account remains as weak as ever.

Providers will continue to be funded primarily through a combination of grant per learner and payments for students completing courses.

Overall, the same basic structure of skills delivery and funding will continue, while the Government reduces subsidy for some learners and employers and increases it for others. UKCES and SSCs will continue to analyse the market and try to boost demand among employers. The qualification awarding bodies will continue to create vocational qualifications in 'Levels' that attempt (and fail) to approximate academic stages of educational progression. The centre will still find it difficult to identify qualifications that are useful to employers.

On the employer side, the demand for skills will continue to be communicated to providers by 'voice', rather than using the price signals of wages. Providers will be encouraged to work with employers to provide skills they want, but will face no penalty if they

fail to do so, nor reward for doing this vital role well. If they do work with employers more closely in this world of weak accountability, there is a risk that they will be captured by the loudest voices and offer training in highly firm specific skills that do not allow workers to move between jobs. Furthermore, the content of the 'learner-led' qualifications – NVQs, BTECs and so on – will continue to be decided by the centre, and so will not necessarily match with demand for skills from the labour market.

As well as all of these problems of information to ensure that the right skills are taught, nothing in the proposed reforms strengthens the accountability of providers in delivering those skills. The focus on process will continue to lead to wide disparities in the value providers add from negative to strongly positive.

This is not a demand-led skills system, but one that is a partial rearrangement of Labour's. It swaps some market failures for others, and mal-investment for under-investment, while neglecting to create the right incentives for co-ordination.

The above analysis shows that there is substantial variability in the returns to different types of qualification, different subjects of study and different colleges. The scope for increasing the return on investment in adult skills provision is huge, but it will require radical change that puts providers more firmly in control while also strengthening accountability. Payment by results can help in this task.

A payment by results model would encourage providers to deliver education and training that the labour market demands. It can solve the pervasive information problems in this market by rewarding someone for playing the all-important co-ordination role that has been lacking to date. It can overcome the problems of unaccountable delivery by rewarding only those providers and accreditors who can demonstrate that they add value.

Such a system would put an end to the teaching of the weaker qualifications and less valuable subjects, and force out the poorly performing providers who are failing their trainees.

The Government is trialling a small job outcome payment where the learner is undertaking training and is on benefits. This allows the provider to draw down a proportion of the fees they would have received if the learner had completed, in the event that they leave the course to take up work, and move off benefits.<sup>40</sup> This creates an incentive for providers not to try to keep the unemployed in training when they could be in work. For some unemployed people, training is what they need, while others just need to find employment. The following chapter describes how a comprehensive payment by results system could be constructed for the two key groups – those who are unemployed, and those who are in work but are improving or changing their skills.

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40 Skills Funding Agency, *A new streamlined funding system for adult skills*, (London: SFA, 2012), 10.

## CHAPTER 3: THE CASE FOR PAYMENT BY RESULTS

It should now be clear that there are major problems with using specific employers and individuals as agents of skills demand in the broader labour market. Changes in policy in recent years have reflected different aspects of these concerns. But less has been done to determine the right incentives for training providers. Consequently accountability is weak because the public skills subsidy as currently delivered muffles the price signals of the labour market.

Paying adult skills providers by labour market outcomes for trainees will encourage them to discover the true demand from employers in general and serve it.

If skills supply is to match demand, providers need to be exposed to the needs of the labour market. Providers need to take on some risk that their training is not demanded by employers, or that it is not well delivered. They would then have strong incentives to steer learners towards those courses which are most likely to lead to jobs and higher wages, and to improve delivery.

As for employer-led funding, providers would win more funding if their apprenticeships led to sustained employment and better wages. Colleges and private providers would have an incentive to seek out information from employers about what mix of skills they needed. In addition they would be encouraged to offer a combination of transferable and sector-specific skills that employers want, but are unwilling to invest in.

As well as encouraging learners to choose the right courses, such a model would also reward the best quality teaching and training. Providers whose teachers imparted the right skills would be rewarded and poor ones squeezed out.

The principles behind payment by results in skills are clear, but how can such a system be implemented? This chapter explains what kind of 'outcomes' should be used to measure provider performance. First, this chapter discusses how higher trainee productivity must be the outcome that providers are paid for achieving. Since this is impossible to observe directly, proxy measures of productivity must be identified. These will be different for trainees who are already in work compared to those without employment. So the chapter goes on to explore how to pay providers by results for people who are already in work. The chapter ends by recommending how providers can be paid by results for the short-term unemployed – and how skills provision can best be joined up to welfare-to-work services for the long-term unemployed.

## PAYING FOR PRODUCTIVITY

Government investment in adult skills must be focussed on increasing the productivity of learners. Where the benefits are non-pecuniary – a subject matter the learner finds interesting, for example – there is no strong case for state subsidy, especially at a time when deep funding cuts are occurring across the public services. None of this is to diminish the value of such benefits, merely to establish that their attainment is only a secondary goal of public policy. Given the parlous state of the Government finances, every pound the state spends on training needs to be focussed on improving the productivity of the labour force. So, the state needs to focus the skills system on providing courses that make people more productive.

The UK's poor economic performance over the past year means that further substantial spending cuts will be required in the next spending review, due to take effect from 2015–16.<sup>41</sup> It is likely that areas of public spending that are unable convincingly to

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41 Office for Budget Responsibility, *Economic and Fiscal Outlook November 2011* (London: OBR, 2011), 15.

demonstrate the value they add will bear the brunt of new cuts. This makes it all the more important that the adult skills sector can clearly demonstrate improved workforce productivity if it is to retain current levels of funding.

Labour productivity is defined as output per unit of labour employed. Since that productivity is hard to observe directly, it is necessary to identify proxies for higher productivity. Basic economic theory points out that, where labour and product markets are competitive, wages will correspond to the extra revenue that a worker generates for the company, the so-called 'marginal product'. If a firm paid a worker less than the output she generates then she could leave for another company that would pay more. If the firm paid her more, high labour costs would make its prices uncompetitive.

That's the theory, but is it true in reality? There is much debate about whether wages reflect the marginal product of employees. We know that in some sectors labour markets are far from perfectly competitive, and hence wages in these sectors are not a close reflection of individual worker productivity. For example, trade unions can also push wages above marginal product, forcing management to pass higher pay on in increased costs to the taxpayer or prices to consumers.<sup>42</sup> In markets with very limited labour mobility wages can be forced below marginal product by employers, who know that employees cannot or will not leave to higher paying jobs in other firms. Limited labour mobility means that workers do not respond to wage signals and migrate to higher paying jobs.<sup>43</sup>

However, in more competitive labour markets, the observed relationship between employee productivity and pay is much

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42 William Boal and Michael Ransom, 'Monopsony in the labor market', *Journal of Economic Literature* (1997) 86–112.

43 Marios Michaelides, 'Labour market oligopsonistic competition: The effect of worker immobility on wages', *Labour Economics* (2010), 230–239.

stronger.<sup>44</sup> In all companies facing some competition (the vast majority), increases in wages ultimately have to be paid out of productivity gains. Although there are many imperfections in the labour market, overall there is a tendency towards a proportionate relationship between an individual's wages and their marginal product. So, while the pay of any given individual may not accurately reflect their productivity, at some level of aggregation wages (and wage gains) do tend to reflect labour force productivity (and its growth).

Therefore, government should be able to pay providers by the extent to which they raise productivity of their trainees. At an aggregated level, it is possible to use increases in trainee pay as an effective proxy for this.

Take two groups of people who are otherwise identical. If one group is effectively trained, and the other is not, and the former's earnings increase faster than those of the untrained group, the training provider has added value, *all other things being equal*. Indeed, if the two groups are trained by different providers and there are different wage rates thereafter, one provider must have done better at raising workforce productivity.

## TWO DIFFERENT LABOUR MARKET OUTCOMES

But it is not possible to use wage increases as a measure of increased productivity for all trainees. There are three groups of people that an adult skills provider educates and trains:

- Employed people.
- People who have voluntarily left work, to undertake full time learning.
- Involuntarily unemployed people, undertaking training to improve their skills and get back to work.

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44 Pieter Serneels, *Do wages reflect productivity?* (Global Poverty Research Group, 2005).

The first two of these are effectively the same. Their current or previous wage can act as an indicator of their productivity. The third group, many of whom have been out of work for a while, effectively have unobservable productivity since they are not employed and we do not know what wage they might command. This creates some difficulty for identifying a proxy for productivity improvements among the workless trainee group. First, in order for someone to exhibit any measurable productivity at all, they need to be in paid employment. Second, if they are in sustained employment, rather than cycling in and out of work, their measured productivity will be higher. This implies the need for a different proxy measure for the productivity of workless trainees. The sustained employment rate is therefore the best measure of improved productivity for this group.

Reflecting this need for different productivity measures, therefore, any adult skills payment by results model needs two systems for the two main groups:

- The **employed group**: those in work who are also undertaking education and training, or those who have left work to undertake it.
- The **workless group**: people who are seeking work.

For the **employed group**, incentives need to be based upon the wage uplift providers achieve for their students when they return to work. For in-work learners, or those taking time out to train, productivity-enhancing qualifications should lead to pay rises, or the training has not raised the trainees' productivity.

For the **workless group**, ensuring that the skills they learn are necessary to get them 'job ready' is essential. There is much debate about whether pre-work training or getting people into work first is the best welfare-to-work strategy. Some people may need some training to be able to compete in the labour market. For others,

more effective work search, as well as help with CV writing and interview techniques, is the most cost-effective answer. Getting the approach wrong for a given person can be costly for both the jobseeker and the state. Pursuing a 'work first' strategy for people with poor skills can mean that a large number of those found work will quickly return to unemployment.<sup>45</sup>

The truth is that whether a 'work first' or 'skills first' strategy is right depends upon the person in question. Therefore, the true challenge is to personalise front-line services to allow the appropriate strategy to be pursued for each jobseeker. The question is: how? Poor bureaucratic efforts at integration of employment and skills policy have encouraged a reliance on 'work first' approaches. The challenge is to integrate the two agendas so that front line providers can tailor cost-effective interventions for clients to take account of their specific needs. We discuss how to construct payment by results models for each group in turn below.

## IN-EMPLOYMENT PAYMENT BY RESULTS MODEL

Payment by results systems work most effectively where there is a single outcome that providers are paid by. The government can thus measure final outcomes, giving providers maximum room for innovation within the so-called 'black box'. For the in-employment group, the Skills Funding Agency (SFA) could link a proportion of providers' funding to the relative change in their students' subsequent pay on re-entering employment. These outcome payments should only be a proportion of a provider's total funding, to ensure that providers do not face excessive risk. The system needs to allow them the flexibility to experiment – and can achieve this by handing over some of the financial risk.

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45 Pamela Meadows, *What works with tackling worklessness?* (London: London Development Agency, 2008), 5.

How would the SFA measure and reward performance? In simplified terms, the SFA could take the wage of each learner before training was undertaken. Observing the wage of each learner after the qualification had ended, they could calculate the average increase in hourly wages for the entire cohort of learners that were educated and trained in a given academic year.

This performance measure, aggregated across the cohort of learners in each college, can form the basis for outcome payments. While there is huge variance around the labour market outcomes for individuals, in large groups it becomes possible to assess the impact the training provider has had on the group's outcomes and hence to pay on that basis. Table 3.1 shows how such a calculation might be made, for a hypothetical college with four learners.

**Table 3.1: Measuring a hypothetical provider's performance at Level 2**

Hypothetical College	Pre-training hourly wage	Post-training hourly wage	Proportionate wage increase
Learner 1	£7.56	£7.56	0%
Learner 2	£10.95	£10.95	0%
Learner 3	£13.50	£15.90	17.8%
Learner 4	£6.90	£7.60	10.1%

This hourly wage increase is evidence of higher productivity added by training. Hence it should form the basis of determining which providers secure more public money.

There are three potential challenges to this simple model, which necessitate some refinement to it.

- First, how can the SFA measure the wage rates before and after the training?

- Second, how can the SFA ensure that wage gains derive from the efforts of the skills provider and not the performance of the national or local economy?
- Third, when should payments be made if wage increases take time to emerge?

We tackle each in turn below. A range of other possible objections are dealt with in the following chapter.

### Measuring wage changes

An incentive scheme based upon average hourly wages requires a system for measuring wages for all learners both before and after training. Any such system would need to have high coverage of trainees, be highly accurate, and impose little or no additional burden on employers. Realistically, the tax system provides the most viable option. Happily, reforms to the pay-as-you-earn tax system that are in the pipeline will allow very accurate measurement of the necessary variables. HM Revenue and Customs (HMRC) is creating a system of 'real time information' to enable the Universal Credit reforms. Under the system, employers will provide wage information including hourly wage rates. Self-employed people will have to do the same.<sup>46</sup>

This system could be linked to a payment by results model for adult skills. The 'unique learner number' which is currently used to track people who received subsidised education could be replaced with the National Insurance Number. HMRC would then pass the SFA hourly wage details of adult learners before and after their courses. The SFA would then pay providers by results based on the data received.

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<sup>46</sup> HMRC, *Improving the operation of Pay As You Earn (PAYE): collecting real time information*, (London: HMRC, 2010), 36.

### Paying for wage gains the provider caused

Wage growth rates vary with the economic cycle and regional differences. As wages rise quicker in booms than busts, the SFA risks paying providers for wage increases that they had no influence upon. Alternatively, when wages are stagnant in a recession, providers may be unfairly penalised because wages are not growing and the labour market is performing poorly. Similarly, paying simply for higher wage outcomes could represent an unfair advantage for providers in higher-paying regions.

If providers were paid by ‘absolute’ results – say, 5p for every extra £1 earned by their cohort – they would be unfairly rewarded in booms and unfairly punished in recessions: much of that 5 per cent pay increase would be driven by wage growth in the wider economy, rather than value added through good training. It is essential to reward the latter but not the former if the system is to work to strengthen accountability.

Therefore, the providers should be paid according to the **proportionate** wage uplift of their students in a **relative** system. Measuring proportionate wage uplift should strip out any systematic differences between regional pay levels. Paying by the relative performance of providers means that the SFA could strip out the effects of the economic cycle – funding would be independent of the overall state of the labour market, over which providers have no influence.

Once the SFA had calculated the average hourly wage uplift for all providers, it could then rank them. The outcome payments could then be distributed according to rank. There are many options for distributing the outcome payment pot to providers, depending on how much financial incentive is needed to put pressure on the poorest performers to improve or exit. This would probably best be discovered through an experimental pilot, with a group of providers under the payment by results system,

measured against the performance of a group of providers without these incentives.

Table 3.2 shows how such a system would reward a hypothetical group of 7 providers, from a total pot of £100,000 of outcome payments. To create a low-pressure system, the SFA could calculate what percentage of the total average pay uplift each provider contributed. In the table, Provider 1 contributed 27%, while Provider 6 contributed 6%. Then the outcome pot would be divided accordingly, with Provider 1 receiving £27,000 and Provider 6 receiving £6,000. To create a even more competitive system, the SFA could create a tournament, with the best providers receiving most of the gains, and the lower performers receiving nothing.

**Table 3.2: Paying providers by their proportion of the total wage increase**

	Average pay uplift at Level 2	Percentage of total pay uplift	Pay according to contribution	Tournament
Provider 1	15%	27%	£27,000	£50,000
Provider 2	12%	22%	£22,000	£35,000
Provider 3	10%	18%	£18,000	£10,000
Provider 4	8%	15%	£15,000	£5,000
Provider 5	6%	11%	£11,000	£0
Provider 6	3%	6%	£6,000	£0

The optimal level of competitive pressure that should be applied to providers is beyond the scope of this paper to determine: a pilot would be necessary to work out the sensitivity of providers to different degrees of competitive pressure. But the Ofsted performance data shown above implies that some one-in-twenty providers need urgently to improve or should be stopped from teaching. A further 40% or so clearly have substantial scope for

improvement. In setting the sharpness of the financial incentives and the proportion of provider funding that should be outcome contingent, there are trade-offs to be considered between achieving sufficient stability among providers to allow them to focus on teaching, and introducing a measure of competitive pressure to drive up performance.

Returns to higher-level qualifications tend to be much greater than to lower-level ones. Nevertheless, it would clearly be undesirable for all public money to flow to higher qualifications, as would happen in a completely black-box payment by results model. Consequently it would be necessary to continue to ringfence funding for each learning level, so that providers who focus on higher skills do not get unfairly rewarded.

As well as dealing with the wage variations that arise out of the economic cycle, the relative performance nature of the reward system would ensure that the cost of the scheme would be entirely predictable for BIS. By contrast, if the SFA paid providers by an absolute measure of results it would be impossible to predict how large the overall size of the payment pot would be.

### Timing of payments

The effect of education on hourly wages takes time to emerge once people re-enter employment. If the results show up later than the payment period, providers will not be paid enough for the results they have achieved. It would also risk biasing the distribution of funding. Providers may encourage learners to take courses where pay rises typically occur more quickly, even though larger improvements could result from some courses where returns appear later.

On the other hand, if payment periods are very long, providers may get paid for productivity achievements that did not arise through their efforts. Many workers get more productive the

longer they are in work, as they learn on the job. Productivity over time is more easily attributed to experience than to training. Furthermore, the delay between costs to providers – in the form of teaching and capital investment – and the financial return may dampen incentives to focus on the most productive courses.

The evidence for the length of time it takes for returns to appear is mixed. Research suggests that on average, people who attain a Level 1 qualification see higher wage returns than unqualified people within a year. This wage advantage rises quickly to around 3% in the first year, where it levels off. At Levels 2 and 3, wage returns are negative for the first three and five years respectively, before rising steeply. This is because they are often stepping stone qualifications: many of those who take them progress to higher levels, staying in education before entering work. For Level 4, the benefits are apparent in the first year, and rise steeply for seven years.<sup>47</sup>

To capture the full impact of training could take up to five years, as far as qualifications funded by public money are concerned. But for those trainees who do not stay on in education, the results are apparent much sooner. Nevertheless, it may be necessary to monitor the evolution of trainees' wages for a number of years in order to identify the value of training interventions. Three years should be ample time to observe the wage effects of training, provided there is a different approach to the treatment of trainees who stay on in education.

### Dealing with educational progression

Many people who take Level 2 and 3 qualifications go on to further study. If this is not taken into account, providers may have a perverse incentive to hinder educational progression.

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<sup>47</sup> Ibid., 12.

If a learner takes a qualification and then moves to another further education provider or to a university, the original provider may be penalised under a payment by results system. Progression to higher qualifications is strongly associated with higher productivity.<sup>48</sup> Providers need to be rewarded for encouraging educational progression among those who would benefit from it. The way to do so which would create the fewest bad incentives would be to 'stop the clock' for learners who move on to further study, and then award outcome payments once they start work. Ways of managing the provider cashflow difficulties that this might create are discussed below.

Attribution of subsequent labour market success is also an issue where more than one provider is involved. If the learner takes a second course with a different provider, any hourly wage increase they receive will have been the result of their learning with both providers. One solution is to reward both providers equally for the wage uplift.

Where a learner progresses to a university, and then is successful in the labour market, it is impossible to identify and reward the authors of the success – the FE provider or the university. In the case of progression to university, the SFA should pay a flat rate reward that is high enough to incentivise providers to try to get as many learners to progress as possible. The proportion of students progressing to higher educational levels should be reasonably consistent between providers, and any discrepancy should be taken care of in the relative nature of performance measurement.

In conclusion, it is not always possible to establish and attribute outcomes for every learner, but it is possible to use the average outcomes for a large cohort to reward providers who do best at identifying and effectively serving the underlying demand for skills in the labour market.

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48 Meadows, *What works with tackling worklessness?* 26.

## PAYMENT BY RESULTS FOR THE WORKLESS GROUP

For incentives to work and accountability to be strengthened, measured outcomes need to be strongly linked to value added, but that link need not be perfect. For integrating employment and skills services, a separate FE funding system needs to be constructed for the workless group, since we do not have meaningful pre-training wages as a guide to starting productivity. The system also needs to mesh with Department for Work and Pensions policies to get people into employment – Jobcentre Plus and the Work Programme.

For unemployed people, there are a number of potentially overlapping sources of funding for training. This creates problems of misaligned incentives between the different providers of training services. But it also represents an opportunity for effective integration of skills and employment policy, and rationalisation of the system.

There are currently two phases for people who are out of work to access funding for training. Two outcome systems need to be created to match the welfare-to-work provision.

### Jobcentre Plus phase

In the first phase, Jobcentre Plus can refer unemployed people to a college or training provider at any point in their claim, if their advisor thinks that this will help them to return to work.

Jobcentre Plus refers the claimant to the college or provider, not to a particular course.<sup>49</sup> In an ideal world, Jobcentre Plus would be held accountable for their decision as to which college or training provider they refer the claimant to. But because Jobcentre Plus is a public agency with multiple roles – job matching, benefits

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49 Skills Funding Agency, *Skills in the pre-Work Programme Job Centre Plus offer*, (London: BIS, 2011), 2.

processing, checking that claimants are meeting conditions, and so on – it is difficult to design robust accountability methods.

This makes it all the more important that the college or provider should be paid by results. This would ensure that investment in skills provision for the unemployed is effective: where referrals are failing to lead to better work outcomes, payment by results would tend to improve that provision. Providers would also tailor their courses to the specific needs of learners.

Training providers should be paid according to the employment rate they achieve for the Jobcentre Plus referral group. As with the in-employment trainees, employment outcomes for providers should be rewarded relative to the performance of others. Sustained employment outcomes definitions should be similar to those used elsewhere in the welfare-to-work system – such as the six month definition used in the Work Programme. Ranking training providers by the subsequent employment rate of their workless trainees would allow those who do better to be financially rewarded.

### **Work Programme phase**

After a year on Jobseekers' Allowance (nine months for under-25s), the Jobcentre Plus clients are passed to the Work Programme (WP). Under this programme, private and community sector organisations are paid entirely by results for getting people into employment. Payment by results for skills where employment is the outcome risks diluting accountability and clouding attribution – was it the skills provider or the employment service that got a specific client into work? The system therefore needs careful integration with provision of training under a payment by results model.

Currently, private companies hold region-based contracts for delivering WP services. They can then subcontract training from colleges and other providers if they feel it is necessary. However, the WP is in essence a 'work first', job brokerage solution to welfare

to work. Providers in the programme are heavily incentivised to get people into work as quickly as possible, not least because levels of funding are low, so they typically concentrate on job search, CV building and interview techniques.

The Government claims to take an agnostic view about delivery: contractors are free to offer a range of services to their clients, and to offer help that they think is most likely to get the client into a sustainable job. Contractors are then paid by labour market outcomes in the form of employment sustained for up to 18 months. However, the way the outcome payments are structured does not favour a truly 'black box' approach, where providers can choose the interventions that are most likely to work. Rather the system is 'black box' within a system that is 'work first' in origin – a decision set in Whitehall by departmental boundaries.

The potential of a real black box scheme that allowed providers to effectively take on the risks and rewards of distributing training interventions could be profound, allowing the integration of employment and skills provision in spite of Whitehall silos.

WP providers have 104 weeks after referral to move someone into work and claim an outcome payment. There is therefore a strong incentive for WP prime contractors to favour short-term training courses, if they do any training at all, over formal qualifications. Training is costly, and it takes time: providers are rewarded for the speed with which they get clients into employment. For some people who are close to being 'job ready', but just need some brief training to push them over the line, this may be enough. But others may require more attention to their skills.

Studies have shown that the most successful training programmes for the workless are targeted at the requirements of the labour market, have good links with employers, and have a strong 'on the job' component. However, they should also lead

to recognised qualifications where possible. Training in basic skills (maths, English and ICT) can help to set the foundations for more vocational and applied skills.<sup>50</sup> And longer courses with more in depth and concentrated study tend to lead to higher employment rates over the longer term.<sup>51</sup>

Therefore, there is a strong rationale for linking up the WP, which is paid for through the Department of Work and Pensions budget, and formal qualifications, paid for through the Department for Business, Innovation and Skills (BIS). Under BIS's funding rules, benefits claimants may take a state funded course at Level 1 or 2. For higher level qualifications, people under 23 may take a state funded course, while older unemployed people need to fund their own learning, which can be financed by a government-backed income-contingent loan scheme.

So, how can we ensure that WP providers are free to deliver what works? How can we ensure that long-term unemployed people on Jobseeker's Allowance (JSA) and Employment and Support Allowance (ESA) are given skills provision that leads to employment? There are three options for integration, each of which place different incentives on providers. We test them below in more detail:

1. Adult skills funding for workless people could be passed from BIS's budget to WP providers in the form of higher outcome payments for each person they get into sustained employment.
2. An alternative option would integrate skills funding with WP providers, but ring-fence the money by making 'training vouchers' available for WP providers to procure training from FE providers on behalf of their clients.

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50 John Martin and David Grubb, "What works with whom: A review of OECD countries' experiences with active labour market policies", *Swedish Economic Policy Review* (2001).

51 David Greenber, Andreas Cebulla and Stacey Bouchet, *Report on a meta-analysis of welfare-to-work programs*, (Madison: University of Wisconsin Institute for Research on Poverty, 2005). Tracy Anderson, R Dorsett, J Hales, S Lissenburgh and C Pires, *Work-based learning for adults: an evaluation of labour market effects*, (London: Department of Work and Pensions, 2004).

3. A further alternative is an 'injury time' model. The same voucher model as above would be used – but the 'clock' would stop for Work Programme providers while jobseekers undertake training.

We explore each option's merits in turn.

### ***1. Raise outcome payments for WP providers using skills funding.***

A portion of the BIS budget for skills funding could be diverted into WP outcome payments to give providers more scope to fund training. Current tight funding for WP effectively limits any meaningful training. But the risk of this approach is that providers just get paid more for their outcomes but have little incentive to do any more training than they currently do, even if people need it.

The challenge is to ensure that WP providers give the right training to the people who need it. This proposal would merely hand them money for doing the same job in the hope that they would prioritise formal training for those who would benefit from it. But they would have little incentive to spend money and time on expensive training, not least because they would still only have 104 weeks to get clients into employment.

### ***2. WP providers are given vouchers to procure training from FE providers.***

This solution would stop WP providers from being handed extra money in the form of universally higher employment outcome payments, instead giving them access to a ringfenced training fund for their clients. However, while this proposal would mean that providers would have the costs of training fully covered, it remains the case that training will be time-consuming. Since providers face a 104-week deadline to get people into work, time away from job-search is likely to cost them dearly in the form of foregone outcome payments as time runs out. Longer and more intensive FE courses would take up a good deal of that time, giving WP providers less

time to work with the client with job search and softer skills, and causing cashflow pressures.

Under the current system, WP providers have strong incentives to 'park' the people who are most difficult to help. In the knowledge that their chances with some of the most challenging clients are limited, this model could encourage some providers to park their poorer employment prospects on training courses of little benefit to anyone.

This incentive would continue to exist for the most difficult cases. But for the marginal people, who could benefit from the training but might also find work, WP providers would tend not send them to train as it would waste job search time. Such perverse incentives should be avoided. The state needs WP providers to take an unbiased view of the needs of different jobseekers, offering training only where it might improve a person's employment prospects.

### **3. The 'injury time' model**

This model would ensure that WP providers passed FE subcontractors people who really needed longer-term training. As with the concept of 'injury time' in football matches, under this model WP providers would be guaranteed the full 104 weeks' job-search time *in addition* to any time taken up in training. The 'clock' would stop while the jobseeker trained. Providers would therefore bear no cost – in the form of fewer job outcomes or delayed cashflow – from sending someone to undertake a training course. But they would also not receive extra money for doing nothing. Rather, all training would be commissioned with a view to subsequent job placement success, and for no other reason. Those who need training would receive it, and no unfair penalty or reward would arise.

Under this model, unlike the in-employment and Jobcentre Plus proposals, skills providers are not paid directly on labour market outcomes. This is because paying them on employment

outcomes which are primarily in the hands of WP providers would lead to problems in attributing success or failure. Rather than being paid directly by results, FE colleges would have to compete and prove their value to WP providers as part of the latter's supply chain.

### **SMF recommendations for three adult skills models:**

#### **In-employment group**

Pay colleges and private providers according to the proportionate average hourly wage uplift of their students that results from their education and training.

- Rank providers by the performance of their students in employment and distribute the outcome payments according to each provider's position.
- Limit outcome payments to three years after learning has finished.

#### **Workless group – Jobcentre Plus**

- Pay skills providers by employment results for unemployed people passed to them by Jobcentre Plus.
- Rank providers according to the employment outcomes of their trainees, and distribute the outcome payments according to each provider's position.
- Limit outcome payments to three years after learning has finished.

#### **Workless group – Work Programme**

- Work Programme providers commission training for their clients from the best available adult skills providers.
- If commissioned by WP providers, adult skills providers draw down funding from the SFA, but are not paid directly by results.
- The 'clock' stops for Work Programme providers while their client is training. They always have a full 104 weeks to help the jobseeker into sustained employment.
- Work Programme providers are paid by results for achieving sustained employment outcomes as currently, giving them strong incentives to be discerning in their choice of skills provider.

## CHAPTER 4: TROUBLESHOOTING

The previous chapter suggested a payment by results model for adult skills which would help to build a demand led skills system. It would also integrate skills provision with employment services in a cost-effective way. Such a model would make providers take risks. But in return they would get autonomy to use their expertise. They would have to provide training and education based upon the underlying demand for skills. So they would have to invest in provision that they thought would accrue returns in the future.

Our model tries to mitigate those risks to ensure providers can manage them and that they only bear risk for outcomes that are within their power to affect. For example, in a recession, all providers would face higher unemployment rates and slower wage growth. So relative payment based on performance ranking would reward good teaching irrespective of the economic context. Furthermore, the model does not suggest that all of providers' funding should be based on outcome payments. There would be a payment as soon as the learner started the course, with a pot of incentive payments that would be distributed once outcomes are known. The size of this pot should be determined by a pilot, to establish the responsiveness of providers to these financial incentives.

The previous chapter described some solutions to the main problems that the implementation of payment by results poses. This chapter deals with a number of other possible objections that we have encountered in the course of researching the idea. These include the following.

1. **Local economic divergence.** Providers in different regions may face different labour market conditions. So could ranking providers by performance mean that some providers are unfairly penalised, because employment rates and wage growth is worse in their region than others?

2. **Too much risk for small providers?** Would providers with very small numbers of learners be unfairly penalised by the model, because they are more susceptible to decisions by some of their learners not to work than large providers?
3. **Cream-skimming.** If providers are able to pick the most able learners and turn others away, they would be paid for being good at selecting ability, not for being good at training.
4. **Under-provision of lower-level and vocational skills?** Is there a risk that the smaller wage-uplift associated with lower-level and vocational skills might lead providers away from teaching such courses?
5. **FE finance.** Waiting a period of years to be paid for results could create cashflow problems for FE colleges.
6. **Failure.** The aim of payment by results is to drive up performance. An important part of this is allowing poor providers to fail. How can this be allowed to happen without affecting learners?
7. **Why not give trainees information?** Could better information in the hands of students be a simpler approach?
8. **Productivity and the public sector.** In some sectors, productivity and wages are not closely aligned. This is true of the public sector – with national pay bargaining and pay freezes imposed by government – although the direction of misalignment is likely to vary between different parts of the public sector. Will this distort the market for skills?

Not all of these risks need intervention, but they are worth exploring to ensure that the model is robust.

### 1. Could local variation in economic conditions undermine the system?

There may be a risk that providers will be at the mercy of cyclical and structural swings in employment rates and earnings in their local labour market over which they have no control. This could happen if unemployment rates and earnings growth are markedly different in different areas.

The unemployment and earnings growth rates of different areas vary substantially. But for the in-work group, local variation and the impact of the economic cycle should be stripped out by the fact of using *proportionate* wage uplift as the outcome measure. If area A's wages for someone with a Level 3 are higher than those in Area B, the same is likely to be true for Level 2 qualification holders. Hence the proportionate outcome measure would take account of starting differences in pay between areas.

Furthermore, the data on regional wage returns to skills suggest that there is no clear relationship between whether a region is rich or poor and the wage gains available when people move from Level 1 to 2, and from Level 2 to 3. For example, a worker with a Level 2 BTEC qualification in the north west earns 21% more on average than a worker with Level 1 in the same region. But a worker in London with BTEC Level 2 only earns 14% more. On the other hand, people in the north west with a level 3 apprenticeship earn 12% more on average than those without the qualification. Those people in London also earn 12% more.<sup>52</sup> In practice this variation is likely to reflect the skills needs of the area – exactly the thing that providers should have incentives to respond to.

Is there more of a problem with local variation for the workless group? Take the 2006 to 2010 period: four years is the length of time our payment by results model uses to reward providers by performance. The period also saw a major recession. The average increase in unemployment between 2006 and 2010 was 2.4% across all local authorities. But this masked a wide dispersion in fortunes. In 44% of local authorities, the unemployment rate rose by either less than a tenth of this figure (0.24%) or by more than twice this figure (4.8%).<sup>53</sup>

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52 Data from Andrew Jenkins, Charley Greenwood and Anna Vignoles, *The returns to qualifications in England: updating the evidence base on level 2 and level 3 vocational qualifications* (London: LSE, 2007), tables 45 and 50, 101–106.

53 Author's calculations using the Annual Survey of Hours and Earnings, local authority data, 2006–2010. <http://www.ons.gov.uk/ons/search/index.html?newquery=Labour+Mark&sortDirection=ASCENDING&sortBy=title%2CeditionSubtitle&pageSize=25&applyFilters=true&format=print>.

However, this does not mean that intervention is necessary. One could argue that outcome payments to providers should be weighted by the rate of unemployment or wage uplift in their area. But people with higher skill levels tend to commute to where the jobs are, so wage differences are explained better by skilled people 'sorting' by commuting or moving to high wage areas than by an area 'causing' a person to have low wages. Gibbons et al find that this explains 90% of the difference between the top and bottom 10% of regions, ranked by wage rate.<sup>54</sup> This suggests that attaining a given skill level should result in comparable employment prospects for everyone regardless of geography.

If the SFA weighted the payments to providers by the local unemployment rate, they would reward providers unfairly. Those in low wage/employment areas would be rewarded for being in a deprived area, even though many of their trainees would actually have moved to find work.

## 2. Will small providers face uncontrollable levels of risk?

As well as the risks associated with local labour markets, providers could face the risk of random error. If one cohort performs poorly, is that because of poor teaching or failure to serve the demand for skills? Or is it simply because the students were relatively unlucky in their subsequent labour market outcomes?

For instance, smaller providers with predominantly adult intakes may suffer because of random decisions made by their trainees which they cannot control. A provider with 1,000 learners faces much less random error than a provider with just 10. An iron law of probability – the law of large numbers – states that as one increases the sample size, the average result will get increasingly close to the expected value, where the expected value is in this case assumed

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54 Steven Gibbons, Henry Overman and Panu Pelkonen, *Wage disparities in Britain: people or place?* (London: LSE Spatial Economics Research Centre, 2010), 13.

to be related to provider performance. So, with larger and larger cohorts of trainees, the resulting wage uplift will get closer and closer to a fair measurement of the productivity of the provider's training. Smaller cohorts lead to greater statistical risk.

Again, however, this does not necessitate tinkering with the model. The median adult cohort size for all providers who use state adult skills funding was 2,331 in 2009–10.<sup>55</sup> This may well mean that the majority of providers have a large enough adult intake each year to alleviate cohort risk. The likelihood is small that the average productivity of such a large group would differ markedly from that of other colleges through random variation alone. This means that the majority of providers would be able to absorb the cohort risk that comes with being paid by results.

Providers may have much smaller cohorts taking Level 3 courses than Levels 1 and 2. As our payment model suggests that providers should be ranked according to performance at each level, they may face unfair risks at Level 3. Also, small providers of specialist training may struggle. Nevertheless, market dynamics themselves are likely to see providers with small cohorts act in one of three ways to absorb the risk.

- They could merge with larger institutions. This would mean that the cohort size would automatically increase, reducing the financial risk faced through random error.
- Providers who perform a range of activities, with a small adult skills operation, could join together in a risk-sharing fund. So-called 'special purpose vehicles' are commonly used to hedge against risks. Small providers would join up their finances in the fund, which would help them to insure themselves against random fluctuations.

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55 The Data Service, "National success rate tables, institutions, 2009/10." [http://www.thedataservice.org.uk/statistics/lr\\_nsrst](http://www.thedataservice.org.uk/statistics/lr_nsrst).

- Small, specialist providers could also become subcontractors to larger institutions, which are better placed to carry and manage risk. Small providers could be paid by larger ones to provide specialist training. Over time, the number of people trained by the small provider would grow to a size where the cohort risk is no longer a problem, and those providers who were more successful would be clearly identified. This means that the small provider's annual finances would be less unfairly jeopardised. It would also mean that larger providers would have an incentive to subcontract to successful specialists over the medium term, because superior performance would be apparent over time.

### 3. Will providers be able to cream-skim the most able learners?

Payment by results funding systems run the risk of cream-skimming by providers. Where providers know that certain people are more likely to succeed in the labour market, they may try to select more of them for admission and decline less auspicious prospects.<sup>56</sup> Is there a risk that providers may try to select by ability, and discriminate against people with very low skills or those whose subsequent employment might be patchier, such as women?

Currently, local authorities must ensure that there are 'adequate facilities supplied' for part time and full time education for the entire population over the age of 18.<sup>57</sup> For most colleges, this has developed into an 'open door' policy, whereby the college will offer training and education for almost all adults who seek it, if there are facilities available. In order to prevent providers from selecting (or 'cream-skimming') trainees by ability, this 'open door' policy would have to be enshrined in statute. Providers must not

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<sup>56</sup> On the risks of parking in payment by results systems, see Ian Mulheirn and Verena Menne, *The Flexible New Deal: making it work* (London: Social Market Foundation, 2008), 63. Work and Pensions Select Committee, *Work Programme: providers and contracting arrangements* (London: HMSO, 2011), Chapter 4.

<sup>57</sup> 1992 Further and Higher Education Act, Part 1, Section 3(i).

be allowed to refuse to train people using government funding if would-be trainees meet the government's criteria for funding (Table 2.1).

However, using proportionate wage uplift as the key outcome measure should minimise the potential for cream-skimming. While it may be easy to identify those students who are likely to do best at a particular course, higher aptitude is likely also to be reflected in their pre-training wages. So it is less clear to providers which students they might *add the most value* to, and hence get paid for. This fact should eliminate any remaining scope for cream-skimming.

#### 4. Would providers be driven to offer courses at higher levels and drop vocational courses?

As well as the risk of direct cream-skimming by selection, a poorly designed payment by results model could run the risk of providers offering only courses at higher skill levels, because more advanced learners are likely to see higher wage gains. However, the SMF model would compare provider performance at each skill level, in order to prevent such cream-skimming. Where there are wage gains to be made from training at Level 1 and 2, rewards for it will be unaffected by the scale of wage uplift seen at other skill levels. It would thus remain a policy decision about how much funding should be available at each educational level, as is appropriate.

But within educational levels, is it also likely that providers would move away from teaching vocational courses? Measures of the economic returns to education point to similar wage premiums for academic and vocational qualifications, apart from NVQs. But there are likely to be different wage premiums for different *subjects*. There would therefore be a strong incentive for providers to steer learners towards those subjects, and to drop courses that do not help them – such as those NVQs that do not appear to add value. In

general, this is the desired outcome of a payment by results system: providers supplying courses that lead to better employment outcomes for trainees. If qualifications without economic benefits disappear, so much the better.

In practice it is highly unlikely that providers would stop providing many vocational qualifications. As many of them lead to positive wage returns, providers would supply them. Furthermore, providers have to match learners to courses that they are able to do, find interesting, and are keen to engage with, as well as those that would lead to higher earnings and employment. Effective learning requires trainee engagement: thus, if students find courses uninspiring, drop-out rates will be high, and providers will receive less revenue.

So, providers will be incentivised to work with central agencies to create hybrids of literacy, numeracy and academic knowledge with vocational, sector-specific content, and to try to match people to the right courses. There is huge scope for innovation here to create vocational qualifications that command the respect of employers and the application of trainees. Payment by results could provide the framework in which such qualifications can be designed – a role which the state has conspicuously failed to succeed at.

However, it is of critical importance that providers do not have control over examination of trainees. Some vocational courses are examined by providers themselves. Under a payment by results model, they would have strong incentives to inflate the grades and pass rates of trainees. This would allow them to take advantage of the signal the qualification confers: an employer may mistake a substandard prospective worker for someone with higher skills than they actually have. To prevent this, all examinations would have to be conducted by external, independent bodies.

## 5. Finance arrangements under payment by results

Unlike 'payment for process' funding mechanisms, payment by results requires waiting until the results are available before paying the provider. This can cause cashflow problems in circumstances where the wait is long. In this case, a three year wait for full payment is a long time. There are, however, ways to mitigate the cashflow problems that could arise.

First, we do not propose that all, or even the majority of payment is made for outcomes. The continued existence of substantial core funding should mitigate cashflow problems. The exact proportion of payment on results should be determined by the extent of competition desired by policymakers. Too much will destabilise the sector, while too little will only provide weak incentives for change.

Second, while ultimate payment must be made on the basis of results, there is no reason why central government should not provide up-front finance for institutions. Cash could be recovered from those who perform poorly once labour market outcomes are known, through lower budgets.

## 6. Institutional failure

In any case, there will be – and should be – a level of institutional failure if performance in the sector, and trainee productivity are to improve. With the introduction of payment by results, it would therefore be necessary to instigate a failure regime to manage the process without it affecting students. It should be possible to manage the take-over of a failing college, replacement of its management, or outright closure without undue disruption for trainees.

This process could be triggered either by financial necessity or as the result of sustained under-performance, as measured by the labour market prospects of students. Where a provider consistently

comes near the bottom of the wage and employment rates league table, the management could be replaced and another provider, or a new management team, could take over.

### **7. Why not just give learners information about different courses' labour market prospects, and let them choose?**

Plans are underway to make all providers offer information about the labour market outcomes of their courses. So why not just allow individuals to choose based upon that information? First, a payment by results model would encourage providers to link up with employers to find out what skills they really need, and to deliver trained workers. Giving learners information would put less pressure on the provider to question whether course content matches the underlying demand for skills: some courses would merely have more enrolments than others. Second, learners may still take courses that are interesting but unproductive. Third, with information alone there would continue to be weak accountability for the quality of the teaching and training: payment by results rewards teaching quality as well as the supply of courses that matches the underlying demand for skills. Finally, raw data on the subsequent outcomes of trainees is likely primarily to reflect the aptitude of those who took the courses rather than the added value of the institution. Our payment by results model overcomes these shortcomings.

In short, the market for skills provision suffers from multiple market failures outlined in Chapter 2. Learner information availability is just one of the problems. Resolving it alone will not be sufficient to allow individuals effectively to navigate the skills market. Moreover, there is a risk that raw information may be misinterpreted.

### **8. Should training undertaken for in-work trainees employed in the public sector be included?**

In the public sector, productivity is not closely related to pay. Wages are mostly set nationally, through collective bargaining,

which means that wages do not correspond closely to the marginal product of workers. They may be above it or below, depending on the part of the public sector under consideration. Furthermore, in some jobs in the public sector, wages automatically increase once particular courses have been taken: teachers may receive more pay automatically for being specialists in 'safeguarding' children, for example.

For this reason, it would be necessary to exclude data on public sector workers undergoing in-work training from the payment by results system. However, workers who have taken a course and then subsequently found work in the public sector have had to compete for the job: so a training provider that has managed to get more of its trainees into public sector work than others can be said to have done more to raise productivity. For this reason, this group of people should be included.

## CHAPTER 5: CONCLUSION

As unemployment rises, the stock of skills the UK desperately needs to restart growth is being eroded. Unemployment is over 8% of the workforce, and may rise further if growth does not resume soon. The longer people are out of the labour market the more their skills atrophy and the harder it is for them to find their feet again. But this is just an acute relapse of a chronic malady in the UK. A large group of low-skilled people struggled to engage with the labour market even during the boom years of the last decade.

The solution lies in more investment to improve the workforce's skills, while holding providers of training firmly to account for the quality of the provision. But the Coalition Government has decided to reduce funding for adult skills by a quarter, which may reflect a view that adult skills provision does little to improve productivity, and with it, economic prosperity. This is the wrong analysis: the variation in performance is large, with many excellent courses and some poor ones. Boosting investment in the right courses will then boost productivity. Paying providers by the productivity that their training generates, and investing heavily in opportunities for out-of-work people to improve and change their skills, will help to improve the productivity of the workforce.

At a time of stagnant demand, a broken investment channel, and heavy worklessness the Government must prioritise investment in the nation's stock of capital. In doing so, it must ensure that it invests wisely. A market mechanism can help it to do so in the case of human capital. Providers, given financial incentives to seek productive skills investments, will make them on behalf of the Government. They can identify the existing skills of the individual, and provide them with the right mix of additional skills that employers demand. And under payment by results, those that do it best will be rewarded, creating a competitive dynamic that drives up quality throughout the sector.

Ensuring that such a market for skills works will not be easy. There are tricky technical challenges to overcome to make the market work, like measuring wages accurately, getting the distribution of outcome payments right, and finding the right balance of provider reward for student progression to higher levels and for employment success. But the best should not be the enemy of the good. The key test for a payment by results system in adult skills is whether it will generate more human capital that employers demand than an unreformed system and improve employment prospects for trainees. This is highly likely, given that financial accountability for labour market outcomes is currently non-existent.

This report aims to start a discussion about what needs to be done to achieve a properly demand-led skills model by refocusing the system on price signals from the labour market. It is now up to government to take on the challenge of developing the principle further.



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The UK suffers from a chronic skills deficit and the current economic crisis is compounding long-standing problems for low-skilled workers. The skills policies of successive governments have focused on subsidising employers or individuals to train. But this has simply led some employers to get free training they would have conducted anyway, and learners to take courses that are of no or limited value in the wider economy. Bureaucratic remedies have failed to resolve these problems. This is costly for government, unhelpful for employers, and bad for learners whose efforts to achieve sustainable and good quality employment are too often in vain.

This paper makes the case for an entirely new approach using market signals – employment rates and wage levels – to identify and serve the demand for skills. The SMF's model puts Further Education colleges in the driving seat empowering them and rewarding them for giving employers the skilled staff they need and boosting the productivity of the UK workforce.

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