

Federalism, Subsidiarity & Economics: In search of a unifying theory

Dr Ron Ben-David*

Chairperson
Essential Services Commission (Victoria)

Dr Ron Ben-David was appointed Chairperson of the Essential Services Commission in December 2008. The Essential Services Commission is the economic utility regulator in Victoria. Dr Ben-David was invited in April 2011 to provide a discussant's perspective on a paper prepared by Professor Peter Dawkins and Professor Bhajan Grewal from Victoria University titled, *Regulation and Commonwealth-State Relations: The Case of Education*.** In this discussion paper, Dr Ben-David draws on the paper by Dawkins and Grewal to explore how economics might provide a useful conceptual framework for better understanding and organising regulatory responsibilities in Australia.

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* The opinions expressed in this presentation are those of the author alone. They do not represent the views of the Essential Services Commission, its staff or the Victorian Government. The author takes full responsibility for any errors, omissions or conjectures made herein.

** The paper by Dawkins and Grewal can be found the Victorian Competition and Efficiency Commission website.

A discussant's perspective on: *Regulation and Commonwealth-State Relations: The Case of Education*, prepared by **Professor Peter Dawkins** and **Professor Bhajan Grewal** from Victoria University. Presented at the *Improving Regulatory Performance Conference* hosted by the Victorian Competition and Efficiency Commission (1 April 2011).¹

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Abstract

It is often said that subsidiarity underpins federalism.

The Australian experience with subsidiarity and federalism is explored by Dawkins and Grewal through the lens of education policy over many decades. I draw on the observations made by these authors to demonstrate that it is no longer possible to sustain the argument that “subsidiarity underpins federalism”. Contemporary Australian federal arrangements have left subsidiarity as a minnow against the juggernaut of centralisation. As Justice French² noted in 2008, “The pressure seems to be in one direction only.”

In this discussion paper, I contend that economics has been applied too narrowly to understanding the challenges of federalism. Rather than viewing regulation as an exogenous constraint, this paper suggests that it can also be viewed as an input into the economy’s production process. In so doing, I suggest that new and interesting insights may emerge about the optimal allocation of regulatory responsibilities in Australia.

² French, Justice R (2008), *The Incredible Shrinking Federation – A Voyage to a Singular State*, Address to the Future of Federalism conference, July.

I must begin with a personal declaration. I am a card-carrying constitutional devolutionist. I *believe* that a division of powers (vertically), and the separation of powers (horizontally), is a desirable pursuit in its own right. Maybe this is because the first thing I associate with the year 1776 is the United States' *Declaration of Independence* rather than Adam Smith's *Wealth of Nations*. Of course, these two historical moments are more closely related than most people realise.

Nevertheless, while I may be a devolutionist, I am also a realist.

I want there to be a tension between different levels of government. Constructive tension is one of the very clever institutional features built into our Constitution. It ensures that Australians cannot easily become subjected to a single view unless there is a prevailing and broad-based community acceptance of that view.

In many regards, I see Constitutional responsibility for education being firmly placed within the hands of the States, as one of the key protections against the centre imposing its will beyond reason upon the people — even within the great complacency that generally marks Australian political history.

It was therefore with some despondence that I read Peter's paper.

I have no idea about the contents of the national curriculum, though *prima facie*, I see its emergence as an undesirable development. Even if for now there are checks-and-balances and constructive tensions through the involvement of the States, there is nothing in Peter's paper that gives me comfort that inevitably the Commonwealth won't attain full control of the national curriculum

What I appreciate most about the paper, is that it pieces together a series of stills — different images taken from different parts of the education sector and at different times over the last few decades — and by stringing together these snapshots, it provides a time-lapsed series of images that, when seen as a continuum, shows a seemingly inevitable process.

First, the Commonwealth shows an interest in a policy area within the States' domain. (Sometimes this might happen at the instigation of third parties.) Then, having shown an interest, it starts trying to influence that area of policy. In time, it draws upon its superior financial resources to amplify any moral suasion that it might have through funding grants. At first this is all done very gently and in the interests of greater cooperation.

But slowly-slowly the drug is administered in ever higher doses. The States' dependence grows as they commit their resources elsewhere. At the same time, the Commonwealth begins investing in developing its own institutional capacity in this policy area in order to inform its growing influence.³

At some point, the Commonwealth Government becomes, what someone else liked to call, the "dominant funder". It now, somewhat understandably, asserts that it has primary responsibility for the underlying service. It therefore starts seeking ways to move beyond influence and on to control. Again, it does so gently and, at first cooperatively. Usually this involves a requirement that it consult with the States; maybe through a Ministerial Council or some other process. The States are chuffed because they are viewed as valued contributors and they agree to refer their powers across. Commonwealth legislation is enacted to give effect to the new deal.

The final step is a small one. The Commonwealth Government-of-the-day amends its legislation giving itself full determinative powers over that area of policy.

The long perspective provided by the paper brings into relief a seemingly deterministic historical process by which the Commonwealth asserts itself over the States. Four distinct stages can be identified: *interest*; followed by *persuasion*; then *influence*; then finally, *control*.

As the paper also highlights, in some areas, influence and control are attained without necessarily funding the States directly. But the effect is the same. As we also know, in other areas the High Court has provided a short cut through this historical process.

I am not sure if the paper is looking to make foreboding predictions. I suspect not. Peter is far too polite and circumspect; but after reading the paper, I don't think the reader can do anything *but* conclude that within a decade-or-two, everything about school and tertiary education in Australia will become singularly determined by Canberra.

The paper's quote from Justice French reinforces this conclusion:

³ This institutional capacity is also often required so that the Commonwealth Government can administer, and account for, the funding that it is providing.

“For every topic which is treated as national becomes potentially a matter which, somewhere along the line, it can be argued is best dealt with by a national Government.”

Indeed, French pursues the argument to its inevitable conclusion with a statement not quoted in the paper:

“The pressure seems to be in one direction only.”

* * *

It would seem that for as long as the centripetal forces of constitutional and economic rationalisation, and the gravitational draw of the federal purse, remain intact, then the indomitable pull of the centre must prevail. In which case, State powers will continue to accrete to the centre; towards a supposed *pax Canberrica*; until States are left as hollowed vassals of the Commonwealth Government.

I do not accept that this is the inevitable or preferred end of our federation.

In 2009, I wrote a paper to this effect which I published in the Australian utility regulators’ newsletter. The paper was, somewhat jocularly titled: *Can economic regulators save federalism in Australia?* It can be found on our website if anyone is interested.⁴

Today’s forum is about efficient regulation; and this session questions efficient regulatory design within the context of the federation.

How are we to think about this question?

Peter’s paper, along with many others, relies on the principle of subsidiarity as the answer to the question about how we might better construct regulatory arrangements in our federation. It states:

“The concept of Federalism is based upon the principle of subsidiarity whereby responsibility, in theory should be held at the most decentralised level that is competent to undertake the role.”

This definition of subsidiarity is as good as any.

⁴ See: www.esc.vic.gov.au/public/About+ESC/Publications/Research+papers/Chairpersons+Research+Papers/

But before I go any further, I need to tell you a somewhat funny but *very* enlightening story about a friendly discussion I had about three years ago with two soon-to-be *very* senior Commonwealth public servants. It was in relation to climate change policies and the appropriate division of responsibilities between Commonwealth and State governments. We were agreeing quite liberally about subsidiarity being a useful organising principle for allocating responsibility.

After a while, I realised that although we had all adopted subsidiarity as our guiding principle, it was taking us to very different conclusions. After a little questioning I realised why. My colleagues were defining subsidiarity to mean (and I paraphrase):

all authority and responsibility resides with the centre and policy only becomes the responsibility of another level of government if that level of government can administer its implementation more efficiently.

That moment of realisation remains one of the most important insights I have had in my public service career. It neatly encapsulates many of the observed behaviours of respective federal governments and their officials.

In my experience, those within the orbit of Canberra quite genuinely believe that *they* are the centre. They therefore believe that *they* have a responsibility for all matters of policy; and, that it is *they* who must determine whether anyone other than themselves ought to be administering policy implementation.

This is an inversion of the subsidiarity principle writ large; but one that explains so much of what we observe occurring in our federal system — whether in the areas of education as discussed in Peter’s paper or in just about every other area of State responsibility.

So which organising principle is right: subsidiarity as per Dawkins and Grewal or ‘inverted subsidiarity’ as per my discussion in Canberra some years ago? Can either subsidiarity or ‘inverted subsidiarity’ ever be elevated from a mere assertion to a theory to a theorem to a law? I suspect not. I doubt that either approach readily lends itself to confirmation or falsification through evidence-based analysis.

But does it even matter?

Possibly not. Potentially, the two approaches lead to exactly the same outcome — though I need to think about this more — but if that be true,

then it will only be true under at least one absolutely binding condition; namely, the absence of ambiguity. Where there is ambiguity, so too will there be disputes about the direction in which the benefit-of-the-doubt lies. These are exactly the disputes that we have been observing for decades in Australia; and we will continue to observe for decades more. Why? Because, for as long as there is an Australian federation and a Constitution that remains silent with respect to a national organising *principle*, there will remain an irreducible level of ambiguity when it comes to interpreting the Constitution's *intentions*. Interpreting the Constitution's underlying and unstated intentions will therefore remain a matter for our political leaders and the High Court to resolve. And just maybe, on occasion, the people will have a say in how they wish to be governed.

So in the absence of constitutional or evidentiary clarity about subsidiarity versus 'inverted subsidiarity', how else might we think about the organisation of responsibilities in the federation?

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Rightly, Peter's paper does not simply assert subsidiarity as an axiom of federalism; a self-evident principle that requires no proof. The paper, albeit briefly, links subsidiarity to welfare economics. It does so by drawing on the proposal that subsidiarity ensures a closer alignment between service delivery and local preferences. The paper also links subsidiarity to public choice theory, whereby consumers (in this case, the general citizenry) can either vote via the ballot box or with their feet in order to drive alignment between their preferences and the services being delivered by their government. In this way, it is suggested, some degree of 'competition' emerges between different jurisdictions.

I do not disagree with the suggestion that welfare economics and public choice theory are linked to the notion of subsidiarity. This suggested association certainly passes the test of plausibility. However, there seems to be an over-reliance on mere plausibility in the literature that I have read in relation to subsidiarity and federalism. While plausibility is a necessary condition, it is not a sufficient condition for providing the foundations of a compelling argument in support of subsidiarity.

What I suggest is missing from this debate about federalism is a comprehensive conceptual framework from which subsidiarity may emerge as an organising principle; and then, the conditions under which it would be applied.

Maybe the reason that so little attention has been devoted to developing a unifying conceptual framework, is because subsidiarity is almost always discussed within the context of service delivery — that is, when we are thinking in terms of service delivery transactions; transactions typically involving public providers (or publicly funded providers) and private recipients. In this transactional context, welfare economics and public choice theory seem intuitively appealing. It passes some notional plausibility test.

That intuition, however, becomes harder to sustain when we start moving away from physical (or at least, tangible) transactions and we start thinking about non-transactional interactions between government and households; or government and business — in other words, when we start thinking about regulation.

Of course, the term ‘regulation’ describes an entire universe of interventions by governments. Indeed, the term ‘regulation’ probably conjures different images for each and every one of us in this room. I am not going to address that definitional issue today. For mere ease of exposition, let’s just say that regulation is some form of intervention that is largely non-transactional and is designed to influence the behaviour of someone, somewhere at some time.

This proposition can now be restated from an economic perspective — that is, much regulation can be seen as representing an intervention designed to affect the production decisions or process of economic players: be they households or businesses; or even government agencies.

That being the case, regulation can also be viewed as an input in economic decision-making or production processes more generally — and, as an input, it can then be thought of as something akin to an intermediate good flowing through the economy’s value-adding chain.

Now, I know this is a rather unconventional way of thinking about regulation. We probably all tend to view regulation as a constraint rather than as an element in the objective function of any optimisation problem — be it with regard to production, labour supply or human capital.

But if you accept for a moment this analogy-cum-hypothesis about regulation being an input or an intermediate good, then we can start thinking differently about how regulation is supplied. We can even think in terms of there being a “market” for the production of regulation — a

“market” for the production of regulation rather than the regulation of product markets.

And if we are prepared to think in terms of “market” structures in relation to the production of regulation, then there are some standard economic insights that can help us frame how we think about the *who, how, what* and *when* of regulation within Australian federalism.

For example, we are all familiar with the economic concept of a ‘missing market’. The production of regulation by governments (or their agencies) can be viewed as the creation of a missing input; an intermediate input into a production process somewhere in the economy. Without *this* input, the mix of *outputs* would be sub-optimal with respect to satisfying the community’s overall preference set. These outputs could be: the quality of teachers in schools, the state of the natural environment or service standards in retail energy contracts.

There are some even more useful insights to be drawn from thinking about a “market” for the production of regulation.

We tend to think of the production of regulation as a natural monopoly that is most efficiently provided by governments. By and large, this view is correct and draws from the coercive powers of the Crown (though there are some exceptions where industries (and maybe communities) have managed to self-regulate). The natural monopoly aspect of the regulatory production process also means that only one government can serve as the regulator, at any point in time, for any particular regulatory intervention. I do not need to further elaborate today on the potential inefficiency from regulatory crowding-out (amongst regulators) or regulatory forum-shopping (by regulated entities).

But, I suggest, if we are too hasty in dismissing the ‘market for regulators’ as a natural monopoly, then we may end up at too narrow a conclusion about who ought to be doing the regulating within our federal system — particularly if, as is often asserted, there are also administrative economies of scale in the regulatory production process. If we simply submit ourselves to these arguments regarding natural monopoly and economies of scale, then we must also submit ourselves to the inevitable centralisation of the regulatory function; perhaps in the form of a super-sized ACCC.

But let me quickly proffer an alternative model that may better describe the “market” for the production of regulation.

It is a market model that, unfortunately, despite being so much more practical, is rarely discussed in normal economic discourse, let alone within the context that I am about to place it — and that is, monopolistic competition.

In monopolistic competition price exceeds marginal cost even in equilibrium, yet there are no monopoly rents. This outcome reflects society's desire for freedom of choice and product differentiation. Variety, rather than perfect economic efficiency, is welfare maximising.

As with product variety, it is worth considering whether the welfare of society can be enhanced by regulatory variety. Unlike product variety, regulatory variety cannot be viewed in terms of a single point-in-time or a single point-in-space. Regulatory variety only makes sense when considered as a marketplace for ideas. Ideas are not bound by time or place. Regulatory ideas that may have been developed decades ago may still be relevant today. Regulatory ideas developed in one jurisdiction may benefit residents of another jurisdiction.

We can think of Australian society as being broken up into eight 'buying groups', each buying regulatory ideas from its regulators. Under such circumstances, an exogenously imposed monopoly-like regulator implementing uniform national regulations may have adverse consequences for the welfare of society. Fewer new ideas will be generated. The regulatory learning process will be slower. Bad and inefficient regulation will be harder to dislodge. The lack of diversification will leave the entire regulatory structure exposed and susceptible to exogenous shocks. Much social welfare will be at the mercy of just one regulatory decision-maker.

This being the case, the weight of efficiencies to be gained from economies of scale in regulatory administration and regulatory compliance, must be balanced against the welfare-maximising benefits of regulatory variety; statically and dynamically.

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There are many other economic concepts applied to product markets that can be drawn into the debate about the regulatory arrangements in a federation. For example, as economists we are well familiar with spillovers and externalities.

In this case, I am not referring to spillovers and externalities arising from regulatory interventions in the production of goods and services; rather, I am suggesting we should be questioning whether the activities of one regulator is more likely to have a positive or negative spillover effect on the activities of other regulators? And subsequently, the markets they in turn regulate.

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I don't want to belabour my analogy-cum-hypothesis that we should be giving more weight to the economics of the production of regulation — rather than constantly focussing on the regulation of product markets.

However, if we fail to produce a comprehensive conceptual framework for the allocation of responsibilities in a federal system, then Justice French will be proven right. The gravitational reality of our collapsing regulatory federation — that reality so clearly demonstrated in Peter's time-lapsed story about arrangements in the education sphere — if we don't rebalance the debate, then the relentless 'vanillarisation' of our regulatory systems will continue.

Some will argue that this will result in a higher quality regulatory outcome: regulatory chocolate rather than vanilla, if you like. But dare I say it, even chocolate becomes monotonous and boring after a while.

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As economists, I believe we have insights and instruments that can inform and motivate the debate — or at least the debate we should be having — about whether we want regulatory vanilla, chocolate or neopolitan.

In the context of any discussion that is currently taking place around these issues, I fear the notion of 'subsidiarity' is a minnow against the juggernaut of centralisation. Today, that juggernaut goes by the name of: 'the national seamless economy'.

The national seamless economy. Seamlessness. It's an interesting metaphor, isn't it? The only seamless garment of which I am aware, is the toga.⁵ Yes, the toga. And in this day and age, the toga really only has two purposes: togas are good for parties (yes, the pun is fully intended)

⁵ Actually, there's also the sari.

and/or togas can still be quite handy for those with imperial aspirations or aspirations of national conquest.

I fear and suspect that promulgation of the ‘national seamless economy’ may have become captive to exactly these aspirations.

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I began this presentation with a personal declaration. I must now conclude it with a personal assurance. None of the arguments I have made today should be construed as arguing for more, or for less, regulation; whether by states or by the Commonwealth.

As someone who is deeply concerned about the state of our federal system of government, I want there to be an open and informed debate about the future. I believe that as economists we have some very powerful insights to bring to bear on that debate — but we may need to think a little unconventionally.

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