Competition and the Public Interest

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A core principle of the National Competition Policy (NCP) is that governments should retain (or introduce) restrictions on competition only where they can demonstrate that the benefits to the community exceed the costs. The factors relevant to making such an assessment – which have come to be known as the 'public interest test' – are enshrined in Clause 1(3) of the Competition Principles Agreement. They include:

- government legislation and policies relating to ecologically sustainable development;
- social welfare and equity considerations, including community service obligations;
- government legislation and policies relating to matters such as occupational health and safety, industrial relations and access and equity;
- economic and regional development, including employment and investment growth;
- the interests of consumers generally or of a class of consumers;
- the competitiveness of Australian businesses; and
- the efficient allocation of resources.

* A paper prepared for the National Competition Council Workshop, *The Public Interest Test Under National Competition Policy*, Colonial Stadium, Melbourne, 12 July 2001

A radical initiative?

A requirement for governments to demonstrate that their regulatory arrangements are in the interests of the community would at face value seem not only unexceptionable but essential to democratic governance (abstracting for the moment from questions of implementation).

And the policy's presumption in favour of competition can be seen as a logical extension of the approach taken in the *Trade Practices Act, 1974*. The Act prohibits anti-competitive conduct by private corporations, but allows the ACCC to 'authorise' some such conduct – including exclusive dealing or mergers that substantially lessen competition – if it can be shown to provide sufficient public benefit to exceed the anti-competitive detriment.

Nevertheless, the extension of this approach to government restrictions on competition has proven contentious. This is so for a number of reasons, which I shall explore. Not least of these is that it has essentially turned on its head a long-standing approach in this country to policy formulation and reform.

For one thing, many of the restrictions on competition that have been targeted under the National Competition Policy (and related reforms) got there in the first place because the wider effects on the community had not been adequately accounted for. Indeed in many cases the interests of particular groups were the dominant consideration.

Secondly, the NCP has reversed the traditional onus of proof in policy reform, whereby it has generally been up to the *proponents* of change to demonstrate that change will be worthwhile. As a general rule this principle has much to commend it. Change can be disruptive. People organise their lives and expectations around existing rules. They even find ways of minimising the impact of bad rules. Given the costs and uncertainties in changing established ways of doing things, it is not unreasonable to require a good case to be made for change.

Indeed, establishing a public interest case *for* policy reform has been the modus operandi of my own organisation, the Productivity Commission, and its predecessors over many years. In coming to judgements about the merits of particular reform options to put before government the Commission, as an independent statutory body, is required to have regard to a series of 'policy guidelines' in its Act. These reflect social and environmental as well as economic goals, and underpin the community-wide perspective that the Commission seeks to

bring to all of its work. The Commission's statutory guidelines are not dissimilar to the provisions in Clause 1(3) of the Competition Principles Act or, for that matter, the factors considered as part of the ACCC's authorisation process.

In the case of competition policy reforms, governments have essentially taken the view that reversing the onus of proof is justified on the grounds that removing restrictions on competition *will* typically be in the public interest.

This was clearly the position advocated by the Hilmer Committee in the 1993 report to COAG which formed the basis for the NCP. It observed:

> "Competition provides the spur for businesses to improve their performance, develop new products and respond to changing circumstances. Competition offers the promise of lower prices and improved choice for consumers and greater efficiency, higher economic growth and increased employment opportunities for the economy as a whole." (Hilmer et al, 1993, p.1)

The need for reform

Indeed, the Hilmer Committee Review was initiated by governments in recognition of the costs stemming from the lack of competitive disciplines and incentives facing many government business enterprises, previously highlighted by a succession of State and national reviews (see, for example, IAC, 1989).

Government monopolies in the energy, transport and communications sectors were characterised by low productivity, poor service and high costs. As barriers to international trade and investment declined, it became evident that the poor performance of these domestic services was handicapping the competitiveness of Australian industries and, notwithstanding the cross-subsidisation of households, reducing the income of the Australian community.

In a report commissioned by COAG in 1995 to guide judgements about the tax revenue implications of the NCP, the Industry Commission estimated that identified pro-competitive reforms to public utilities and certain regulatory restrictions could eventually lift Australia's GDP by some $23 billion – 5½ per cent above what it would otherwise be.

Like all model-based constructs of complex economic relationships, the estimates could be no more than broadly indicative. They nevertheless were accepted as the basis for subsequent negotiation by the States and Territories on the 'competition

payments' to be delivered by the Commonwealth. They were also criticised by some observers as being too optimistic.

The productivity dividend

In the event, as the OECD has recently concluded, the surge in Australia's aggregate productivity and output growth in the 1990s – one percentage point or more above the previous trend for at least six years – is broadly consistent with the Industry Commission's projections, notwithstanding that some reforms are yet to be fully implemented. Indeed, the surge in Australia's productivity performance is hard to explain by factors other than the microeconomic reforms of the 1980s and 1990s.

The fact that this productivity boom was sustained through the 1990s despite the collapse of key export markets in Asia, is itself hard to explain other than as a result of our economy's enhanced flexibility and adaptability. That Australia was one of only a few high-income countries to lift its performance in the 1990s, reinforces the point that the major explanation must lie in domestic influences.

Australia's productivity performance deserves this attention in considering the public interest implications of reform, because productivity growth is the foundation for higher incomes and standards of living. The American economist Paul Krugman once put it as follows, "Productivity isn't everything, but in the long run it is almost everything" (Krugman, 1992). Growth in average incomes accelerated from 1.4 per cent a year in the 1970s and 1980s to 2.5 per cent a year in the 1990s. Faster productivity growth accounted for 90 per cent of that acceleration in average incomes. If Australia's productivity had grown in the 1990s at its previous trend rate, annual income in 2000 would have averaged around $2700 less per person (or roughly $7000 less per household).

Distribution matters too

While productivity growth is the fundamental driver of a country's income levels over the long term, it is the *distribution* of these gains and the transitional impacts of reforms on different groups that have seized most political attention. Concerns that NCP and other microeconomic reforms have been anti-worker or anti-region have been instrumental in a popular backlash against reform.

Understanding and analysing the distributional and adjustment implications of competition reforms is a key issue for all governments. It has not always been done well – in part because it is difficult to do. Nevertheless, such analysis is an important part of the assessments needed in making decisions about policy change under the NCP. And, notwithstanding the availability of general assistance programs to help people deal with change, there are circumstances in which more targeted compensation or assistance to address the adjustment consequences of reforms are called for (see PC, 2001, forthcoming).

What the Commission's own research has shown, however, is that while reforms inevitably create some losers as well as winners, particularly in the short term, the perceptions of a general bias against workers or net losses to regional Australia are not well founded.

Recent Commission research into the distribution of the productivity induced income gains in the 1990s, found that labour maintained its share at the aggregate level throughout that period. A shift in the distribution of income towards capital in some industries was offset by a shift towards labour in other industries. Overall, growth in real wages was accompanied by employment growth and falling unemployment.

In addition, the Commission found that the benefits of productivity gains at the industry level were mostly passed on to consumers in the form of lower prices. This has occurred to a significantly greater extent than in the past, suggesting that increased competition has not only contributed to the generation of productivity gains, but also ensured that those gains have not just been absorbed by profit-taking or higher nominal wage claims.

The passing on of productivity gains to the community through lower prices is likely to have its own distributional effects. These warrant more detailed examination, but there is reason to believe that they would be beneficial. Previous research by the Industry Commission into the effects of price changes for some utility services has revealed that even where the narrowing of cross-subsidies had seen prices to households rise, when the indirect effects through lower business costs were accounted for, most households benefited overall, including those on lower incomes (IC, 1996).

Regional impacts

The regional distribution of gains and losses from reform has been of particular interest in recent years, with many country people attributing the declines in population, services and incomes to NCP. The Productivity Commission's public inquiry on this matter found that those perceptions were generally misplaced. The major drivers of the fortunes of rural and regional Australia remain ongoing technological advances and intensifying competition on export markets, which have relentlessly pushed down rural terms of trade and made farming a much less people-intensive activity.

Many pro-competitive reforms have *helped* rural industries cope with these external pressures, by reducing the costs of major inputs such as energy, rail, transport and communications.

Following widespread public consultation, information gathering and analysis, the Commission concluded that country Australia as a whole would benefit from National Competition Policy. It also found that there was likely to be more variation in the incidence of benefits and costs among regions than among more diversified urban centres. Nevertheless, economic modelling suggested that only one of 57 regions modelled would not show an output gain from NCP. In the majority of regions, employment was estimated either to rise as a result of NCP, or to decline by an amount that could be absorbed by less than one year of recent employment growth.

Of course, such modelling is only indicative and cannot capture all the impacts within particular communities or over time. Nevertheless, it supports other information and analysis in suggesting that NCP will deliver benefits to most Australians.

'Strategic' considerations in NCP

The empirical story lends support to the presumption in favour of competition that governments brought to the design of the NCP. Placing the onus on those defending anti-competitive arrangements might also be seen as having a strategic function. By requiring those who benefit from such restrictions – and thus typically have more incentive to see them retained – to address the wider community effects, it can act as a counterweight to what may otherwise be lop-sided political pressure to ignore the less readily identifiable costs. In other words, the NCP obliges those

who have the most interest in making a case on such matters, to make the right sort of case. Moreover, through the device of the competition payments from the Commonwealth, it creates a fiscal incentive for governments to resist political pressure for restrictive arrangements when such a case has not been made.

NCP is not 'open slather'

Governments recognised, as did the Hilmer Committee, that there are circumstances in which restraints on competition can be justified from a community-wide perspective. Indeed, there is really no such thing as completely unfettered competition in any area of economic life. As on the sports field, market competition occurs within a framework of rules, obligations and rights which constrain the behaviour of the players. To some extent, the question is really about the nature and degree of any constraints and how they affect performance. (For example we would not accept rules in sport that kept aspiring champions out of the game.)

In some situations, competition may need to be more 'fettered' than in others, to address social objectives such as equity of access or quality standards, or to overcome market failures, including environmental externalities and information asymmetries. But restricting the potential entry of (qualified) players will rarely be the best way of meeting such concerns. Indeed, in the case of natural monopoly, government has regulated to ensure that effective competition can occur at all: as in the national regime for third party access to essential infrastructure. NCP needs to be seen in conjunction with other policy measures that are likely to be able to address environmental or social concerns more directly and cost-effectively.

In other words, in implementing national competition policy, the underlying goal is to achieve *appropriate* regulation of market conditions rather than just *de*regulation.

To achieve this, it is important that each case be assessed according to its particular characteristics and market circumstances. And, regardless of where the onus is placed, it is essential that the costs and benefits of different regulatory options are given adequate consideration.

In principle, the NCP makes abundant allowance for this. Firstly, Clause 1(3) provides for a range of economic and social matters to be considered in weighing up the benefits and costs of reforms involving the structure of public monopolies, competitive neutrality, and reviews of legislation (existing and prospective) with anti-competitive effects.

Secondly, the decision-making framework under the NCP recognises that such a weighing-up ultimately requires political judgement. However, it also recognises that to be well informed, such judgement needs to be underpinned by impartial and transparent review processes, in which affected interests can have their say, and in which information relevant to the political tradeoffs can be effectively brought to bear.

Misunderstandings and misuse of NCP

In practice, however, the application of the public interest framework has encountered difficulties. A number of these became evident to the Commission in its inquiry into the impacts of National Competition Policy on rural and regional Australia (PC 1999a). Some of them involve misunderstandings about NCP processes, others are more to do with their implementation.

The most basic difficulty has been lack of knowledge about the public interest provisions themselves. This was particularly evident within local government in regional Australia. For example, the very first submission to the Commission's inquiry, from the Shire of Jerramungup, contained the following (incorrect) statement:

> "Competitive Neutrality does not accept the government's obligations to provide universal access to essential services and provide certain customer service obligations on the basis of equity." (sub 1, p 3)

It would appear that NCP's bad name in rural areas has at least in part been acquired through its inappropriate application by local government – sometimes at the instigation of a State government – including through it being wrongly invoked to pursue cost-cutting budgetary objectives.

Some participants argued that public interest matters were being ignored in the Victorian Government's requirements for compulsory competitive tendering by local councils and for commercialisation of local government services in other jurisdictions. In principle, competitive tendering is not required under the NCP, although it may be used as a way of implementing competitive neutrality. Even so, it allows the wider effects on the local community to be taken into account. The Commission learnt of a number of instances of local governments making decisions not to contract out on that basis – trading off the local employment, skill development or other perceived benefits, against higher charges for ratepayers.

Nevertheless, there does seem to have been considerable confusion about the nature of the public interest test and how to apply it. At face value, this is difficult to reconcile, since all the test is really asking is that governments justify any anti-competitive arrangements by demonstrating that they deliver net benefits to the community. It would be an indictment of our policy-making or regulatory institutions if they found this an entirely novel notion.

Clause 1(3) contains a (non-exhaustive) list of the sorts of economic, social and environmental factors that need to be considered in making a net benefit judgement. They are not unfamiliar or intrinsically difficult to understand. But they can pull in different directions, and not all will be relevant to every case.

Assessing the tradeoffs

The real difficulty therefore is in how the tradeoffs among any competing effects should be made. The National Competition Council has noted that in principle “all public interest considerations intrinsically carry equal weight” (NCC, 1999. See also NCC, 1996). As the Commission has previously observed, this could be misconstrued as them having equal importance in all cases. It may be better to describe the criteria as having equal *status*, which is consistent with a low or high weighting being given to different criteria according to the degree of relevance.

If all the factors were amenable to quantification and valuation, then the various benefits and costs could simply be added up. But even in that situation weighting issues would arise. For example, should a dollar lost by a poor household as a result of a policy change be assigned equal weight to a dollar correspondingly gained by a wealthy household? What if all the costs of a reform that would boost national income are likely to be concentrated on an already struggling region? Answering such questions is clearly not straightforward.

In practice, some factors bearing on the public interest – especially social and environmental impacts – cannot be easily quantified or valued. This brings the danger that only the measurable will be influential in decision-making.

For this reason it is important to do more to evaluate social and environmental impacts in quantitative as well as qualitative terms. For example, in its gambling inquiry, the Commission developed an analytical framework which integrated both the social and economic impacts of gambling. Using survey information and other sources, the Commission was able to impute values for various impacts on families

that had previously not loomed large in policy decisions, but which turned out to be substantial (PC, 1999b).

However, attempts to level the analytical playing field can only go so far. In the gambling report, we were obliged to give a range of high and low estimates for most of the social impacts, which reduced their policy usefulness. And in a report that we did for the ACT Government on battery hen regulation, we provided estimates of the costs of banning battery production, but left it to the Government and ultimately the Assembly to judge whether the community placed a sufficient value on the identified impacts on hen welfare to justify incurring the costs (PC, 1998).

Thus, while it is important that a thorough assessment be conducted of the various community impacts of retaining or removing restrictions on competition, and while there are good reasons for not leaving such a task entirely to the political process, ultimately a judgement call must be made that requires political accountability.

The Commission has previously recommended, in common with the Hawker Parliamentary Committee, that governments produce public guidelines on the nature of the 'public interest' test and how it should be applied. However, as Mulgan (2000) has pointed out, this should not be taken to mean that:

> "with the right principles and the right information correctly weighed, experts will be able to come up with robust and uncontestable assessments of the public interest … such assessments are inherently contestable and should be looked on as political rather than technical judgements." (p. 9)

In this light, it is notable that nearly all of the Hawker Committee's recommendations concerning the application of the public interest test relate to questions of procedure and institutional design, rather than how elements of the test should be interpreted or any tradeoffs resolved. (The main exception is its recognition of the related point that qualitative considerations can be as important to effective analysis as the quantitative.) (Hawker et al, 1997)

That the task of interpreting the public interest is inherently subjective and political is illustrated by McEwin's calculation, in a search of 1167 Commonwealth Acts and 566 Regulations, that the term "public interest" was mentioned 386 times without once being defined (McEwin, 1995).

Are politicians in control?

There is a widespread perception that, in practice, the NCP has allowed political judgements about public interest matters to be circumvented or undermined.

At the time of the Commission's inquiry, for example, some State governments were claiming loss of sovereignty under the NCP – a proposition which, as a matter of principle, would seem inconsistent with them having taken the (sovereign) decision to become signatories in the first place.

In practice, governments have given themselves considerable latitude and discretion under the NCP. Among other things, governments are free to implement their own approaches to prices oversight, competitive neutrality and structural reform for government enterprises; they can determine how competition principles will be applied to local government; they can institute their own (effective) regimes for access to bottleneck infrastructure; they can continue to deliver CSOs; and they can institute their own reviews of legislation that restricts competition.

The fact that each jurisdiction has considerable control over how NCP is implemented has been freely acknowledged by some states. For example, in its submission to the Commission's inquiry, the Tasmanian Government observed:

> "… the NCP agreements do not, in general, compel governments to introduce specific reforms. For example, they do not require privatisation of government business or contracting out and do not expect that deregulation will be the outcome of an independent review. In fact, NCP provides government with flexibility to deal with circumstances where competition might be inconsistent with particular objectives that are valued by the community. For example, under NCP, there is no restriction on governments subsidising social services to rural and regional Australia." (sub. 198, p. 6)

The Western Australian Treasury said that:

> "The impacts of NCP are to a large extent within the hands of Western Australians, since there is considerable flexibility in interpreting the agreements and scope to consider more than purely economic or commercial considerations in choosing to what extent and by what mechanisms to implement the reforms." (Western Australian Treasury, 1998, p. 4)

This doesn't get around the need, of course, for each government under the NCP to justify retaining any anti-competitive arrangements, or failing to implement agreed reforms in such sectors as energy and water. And, under the Competition Principles Agreement, if a government is found wanting in these respects, it risks forfeiting

competition payments from the Commonwealth – which after all are a *dividend* contingent on projected revenue gains flowing from the reforms, not an *entitlement*.

While the sums involved in the competition payments are not large by State budget standards, they do assume significance at the margin. The prospect that the Commonwealth may withhold them, on advice from the National Competition Council (NCC), may well be the true source of concern about loss of sovereignty and helps explain the critical attention directed at the Council and its approach.

This is the flip side of the more constructive political economy function of those fiscal incentives, noted previously. When political pressures are considered too strong to resist, the potential to withhold payments can be portrayed as inappropriate external interference in a jurisdiction's own policy development processes.

The NCC's role

In its submission to the Commission's inquiry, the South Australian Government (sub. 156) alleged:

> "the NCC brings its own ideological position to consideration of policy outcomes and should not seek to dictate those outcomes to Governments, particularly in legislation review where the final decisions on reform outcomes must rest with elected Government."

Similar concerns were raised by the Tasmanian and Queensland Governments, as well as about differences in interpretation of NCP agreements between the NCC and State governments.

While the Commission was not in a position to evaluate all such claims in its inquiry, it considered that the available evidence, particularly for legislation reviews, did not support the contention that the NCC dictated outcomes. It is after all an *advisory* body and, unlike the ACCC, it cannot take regulatory action based on its own interpretation of what is in the public interest. While the NCC clearly does seek to satisfy itself about the integrity of NCP processes, that is what it is required to do.

The Commission raised questions, however, about whether the integrity of the NCC's own role as an impartial adviser had the potential to be compromised by its perceived advocacy activities, including the conducting of legislation reviews (a function that has subsequently been withdrawn). Since then, the NCC has issued a

number of pamphlets targeted at key areas requiring government decisions (such as taxi regulations and the regulation of the medical and legal professions). These took a firm policy line and while they clearly sought to generate debate, they may have served to reinforce earlier concerns about the potential for conflicting roles.

However, it should be noted that, in the absence of greater involvement by governments in selling competition reforms to their electorates, the NCC has had to do more in this area than might otherwise have been necessary (and governments may well have been happy for it to take the lead.)

It is also relevant that while the NCC formally has only an advisory role, as an independent national body its advice clearly carries considerable weight, particularly at the Commonwealth level. Thus, although its advice has on occasion been rejected by State Ministers (on infrastructural access matters), it has always been accepted by the Commonwealth. (This includes advice to the Industry Minister on coverage of the Eastern Gas Pipeline under the National Access Regime – a decision which was subsequently overturned on appeal to the Australian Competition Tribunal.)

In its report, the Commission considered that the way in which the NCC and the States "worked together and/or communicated" could benefit from a re-examination in the COAG review of the National Competition Policy. In the event, COAG agreed at its November 2000 meeting on a number of changes, including enhancing the opportunity for States to make their case, where the NCC recommends a penalty, before the Commonwealth's final decision on competition payments.

With respect to Legislation Reviews, the following (obscurely worded) amendment was made to the Competition Principles Agreement to guide the NCC's assessment of compliance.

> "In assessing whether the threshold requirement of Clause 5 has been achieved, the NCC should consider whether the conclusion reached in the report is within a range of outcomes that could reasonably be reached based on the information available to a properly constituted review process. Within the range of outcomes that could reasonably be reached, it is a matter for Government to determine what policy is in the public interest." (COAG, 2000, Attachment B)

This appears to suggest that a government need not comply with the recommendation of a review, provided that its decision is within a range of outcomes that a "properly constituted review" might consider reasonable. On this point, the President of the NCC has recently stated:

> "… I would take issue with suggestions that the November amendments give the States more autonomy in determining what policies are in the public interest. The amendments show that the States are prepared to set rigorous disciplines on themselves in applying the public interest test." (Samuel, 2001, p. 6)

One important discipline is the requirement for governments to provide more transparent reasons for any decisions to retain any anti-competitive arrangements. Governments agreed that they

> "should document the public interest reasons supporting a decision or assessment and make them available to interested parties and the public" (COAG, 2000, Attachment B).

This would seem fundamental to the integrity of the process. Among other examples, such an approach would have assisted public understanding of the Commonwealth's rejection of the Irving Committee's (relatively mild) recommendations to partially free up the single export desk for wheat.

Well informed political decisions

There also seems to be general acceptance that a 'properly constituted review process' is the key to achieving appropriate outcomes. This applies to most elements of the NCP, but it is particularly relevant to assessments under the Legislation Review Program and for new regulations, including national standard setting by Ministerial Councils.

Processes which systematically review the objectives and rationales for regulatory arrangements, and the relative merits of different options for meeting them, are critical to informed political decision-making. They can also play a pivotal role in promoting public awareness of the tradeoffs in different policy approaches, thereby facilitating broader acceptance of change. Reforms to longstanding arrangements are always politically difficult, particularly those that involve losses by particular groups. Bringing the wider community along – at least some of the way – is often the key to achieving durable reform. For this reason, as well as for its informational value, public consultation needs to be a central feature of any review process.

For similar reasons, it is also important that the NCP's placing of the onus of proof on defenders of anti-competitive arrangements does not preclude an adequate case being made for the *removal* of such arrangements. In its own assessments, the NCC appears to permit 'short cuts' to be taken when jurisdictions are removing restrictions (NCC, 2001, pp 5.8-5.9). While this clearly accords with the underlying

logic of the NCP, to the extent that governments do so, it could add to perceptions that the process is a loaded one, in which the interests of parties benefiting from existing arrangements cannot get a ‘fair hearing’.

By the same token, it is important that review processes are conducted at arm’s length from those who may be affected by regulation, as well as those responsible for administering it. Input from all interests is important to an understanding of the issues, but that input should be transparently offered in submissions or public evidence, not by compromising the capacity of a review group to make (and be seen to make) an impartial assessment.

That said, the time and resource requirements of best-practice reviews can be substantial. Given the demanding schedule of the Legislation Review Program alone – involving some 1700 reviews across all jurisdictions, within an initial timeframe of just five years – it was inevitable that some corners would be cut. That may not matter much for insignificant or uncontentious matters, but many restrictions on competition are almost by definition not of that character. Poorly structured or hurried reviews neither assist the public image of National Competition Policy, nor enhance the prospects of achieving beneficial change.

It might be noted, as a footnote to this discussion, that the scheduled five year review of the NCP was essentially conducted by governments as an ‘in-house’ exercise, although explicitly drawing on the Commission’s public inquiry on regional aspects, as well as two Parliamentary inquiries.

The fact that governments have once again signed off on what is only a slightly modified National Competition Policy is nevertheless of great significance. The Council of Australian Governments, in its own words,

> “affirmed the importance of the National Competition Policy in sustaining the competitiveness and flexibility of the Australian economy and contributing to higher standards of living.” (COAG, 2000, p4)

As a renewed commitment in support of competition, made at the highest political level in Australia, this should itself be seen as a clear expression of the public interest.

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