

Submission to the Productivity Commission Review of National Competition Policy Arrangements

Social Market Economy Institute of Australia

NCP Inquiry
Productivity Commission
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Dear Mr Banks

Thank you for the opportunity to provide a submission to the Productivity Commission Review on National Competition Policy Arrangements. The Social Market Economy Institute of Australia (SMEIA) is a new research institute established to promote the ideals of 'ordoliberal' theory in Australian economic and social policy discussion and debates. The chief proponents of ordoliberal theory and applied policy discussions included German scholars such as Walter Eucken, Franz Bohm, Wilhelm Ropke, Alexander Rustow, and Alfred Muller-Armack. These authors were most prolific during the 1930's and 1940's, during the advent and eventual demise of both the German Weimar Republic and Third Reich, and their writings were influential in the development of post-World War II German economic institutions which emphasised the primacy of free markets and limited government intervention. Other eminent scholars, including Friedrich A von Hayek, had also been associated with the ordoliberal school. In more recent times, economists such as Viktor Vanberg and Manfred Streit have made significant contributions to the ordoliberal literature. Over time, ordoliberal theory has successfully incorporated theoretical perspectives from other streams of economic thought, such as Austrian economics, institutional economics, evolutionary economic thought and constitutional political economy.

The meaning of competition

It is appropriate to commence by discussing the purpose and defining features of private sector competition in a modern economy. According to specialists in market process theory, the purpose of competition is to facilitate the discovery, implementation and testing of alternative solutions to a wide range of resource allocation problems. The market is viewed as an arena in which firms engage in conduct, namely price and non-price competition (eg product innovation, advertising, etc), that attempts to attract market share through the production and provision of goods and services that are potentially attractive to consumers.

In other words, the production and provision of commodities reflect the hypotheses and conjectures of producers in relation to consumer preferences, and the prices attached to these outputs transmit knowledge to the consumers in terms of the underlying costs of producing these goods and services. If firms are successful in attracting sufficient consumer demand they may be able to enjoy temporary monopoly positions over their rivals, as well as supernormal profits as the reward for producing products that consumers want and provides incentives for these pioneering firms to further invest. Firms that are unsuccessful in attracting sufficient market share are likely to bear losses, and this in turn provides an opportunity for these organizations to amend their market errors and either replicate the better solutions or modify the existing solutions to generate new products. This in turn sets in train a dynamic, never-ending process where producers strive to produce and provide goods and services to the satisfaction of customers; as described by Potts, 'Entrepreneurs propose, ... markets decide and knowledge grows' (Potts, 2003: 61), and thus creates the foundations for economic growth and prosperity.

The institutional framework of the competitive order: The theory of ordoliberalism, and the role of competition policy

Ordoliberal theory focuses on the importance of a stable and transparent framework of rules for the efficient functioning of a private market economy, as embodied by the notion of 'complete competition' in which no firm can engage in abuses of monopoly positions and other forms of coercion in a given market. Within the ordoliberal framework, the preconditions for the maintenance of a competitive market order include:

- Monetary stability, retaining the value of money and isolating changes in its value from political influence, ensuring that rampant inflation does not distort the allocative and knowledge-transmission functions of the price mechanism.
- Open markets, particularly the absence of public and private market barriers in domestic and international trade.
- Private property and ownership of the means of production, ensuring continued flexibility and incentives to trade and invest within a decentralised market process.
- Freedom of contract between autonomous economic agents. Restrictive contracts and agreements which close off markets and curtail the freedom of others are not permitted.
- Complete liability for one's commitments and actions, ensuring that losses and bankruptcies in the marketplace are not shifted to other agents.
- Consistency of economic policy, where predictable and reliable governmental policies give market agents confidence to invest and make decisions.

Ordoliberals understand that, in order to alleviate the risk that the unencumbered freedom of economic action could lead to private sector restrictions on competition and trade, constitutional government has an important role to play in creating the above foundational conditions through the establishment of appropriate institutions and policies. According to the ordoliberals, the overriding principle of the private market economy is the guarantee of a price system under conditions of free competition. Potential direct government interventions which may distort the functioning of prices, such as price

controls or market protective barriers, are to be strictly avoided¹. In the parlance of a sporting competition, in developing and maintaining the institutional framework of competitive markets, governments effectively play the role of impartial 'referee' providing a rule of order for individual economic agents to 'play the game' of engaging in mutually beneficial market exchange². According to Vanberg (1994), competition is conceived within the ordoliberal paradigm as 'constitutionally constrained competition', or competition with rules that assure its beneficial workings.

It follows that a defining feature of ordoliberalism is its emphasis on competition policy as a direct means to create and maintain the conditions of 'complete competition'. The key features of the ordoliberal competition policy framework are as follows:

- Establishment of independent 'watch-dog' institutions, such as a 'monopolies office', charged with the prevention of anti-competitive behaviour and conduct, such as cartels, syndicates, mergers, predatory pricing and other forms of price fixing, restraints on trade and other anti-competitive arrangements, by market participants which not only serve to distort free markets and the price mechanism, but which also consolidates private market power in the hands of some firms at the expense of other competitors in the market. The 'monopolies office' is also responsible for the prohibition of entrenched monopolies, including the possible divestiture of monopoly interests where these impinged on the functioning of the competitive order.
- Where the elimination of private sector monopoly positions is not possible (ie natural monopoly scenario), engage in conduct control of monopolies in such a way so that the free market exchange process is emulated in that given market³. This is referred to in the ordoliberal literature as 'as-if' competition, and may include, for example, the enforcement of competitive pricing regimes for the monopolist and measures to enhance contestability within the affected market.

The ordoliberals state that these competition policy initiatives, which establish rules for the conduct of firms throughout the economy, would contribute to the maintenance of the

¹ According to the modern ordoliberal theorist, Ernst-Joachim Mestmacker, 'Holders of economic power jeopardize the economic legitimization of free trade if they make use of the competence of individual planning in order to eliminate the price system; they destroy the basis of private autonomy if they replace freely negotiated contracts with a unilateral act of will; they tamper with the freedom of trade if they coerce by means of open impairment, or drive out of the market, consumers, employees or suppliers who do not give in to the predefined market strategy' (quoted in Moschel, 1989: 151-152).

² As expressed by Eucken in 1950?, 'State planning of forms – Yes; state planning and control of economic process – No! The essential thing is to recognize the difference between form and process, and to act accordingly' (quoted in Riha, 1985: 197).

³ As noted by the ordoliberal economist Leonhard Miksch in 1937, 'Any satisfying management of the monopoly issue and of 'regulated competition' requires the state too practice at least part of the rigor which markets, organized in freedom, would practice themselves' (quoted by Goldschmidt and Berndt, 2003: 4). However, this element of competition policy would be envisaged to apply only in a relatively few cases, if at all, since, as Walter Eucken correctly suggested, the forces of 'complete competition' should break down monopoly positions in economic markets in the first place. In more recent times, economists have also emphasized the potential for the threat of entry by market participants in promoting competitive behaviour by incumbents in the marketplace – this phenomenon is referred to as 'contestability', and is consistent with the competitive economic order precondition of open markets with freedom of entry.

‘open markets’ precondition for the competitive economic order. Other preconditions in the ordoliberal economic constitutional framework provide for other elements of a comprehensive competition policy:

- Application of the competition policy principles is required in equal measure to all interdependent markets. Inherent contradictions between economic markets, especially between those that are regulated and those open to competition, would lead to distortions in price signals and misallocated resources. Therefore, policies to promote and maintain the forces of ‘complete competition’ must be universally applied across all sectors of the economy.
- A commitment to international free trade is also necessary, as this would allow for effective import competition within the economy. This would enhance the freedom of consumers to choose amongst a variety of goods and services, and can thus contribute to constraining the private market power of domestic producers.

Ordoliberal competition policy aims to eliminate the potential for firms to use their market power to impede the performance of their rivals by interfering in the competitive process, and so therefore meeting the conditions for ‘complete competition’ in economic markets⁴. The ordoliberals stress the importance of enshrining competition policy as a central and permanent element of an ‘economic constitution’, as opposed to being a set of discretionary policy decisions which may be subject to frequent changes, and in this sense is a critical component of the institutional economic framework which serves to improve living standards and enhance economic freedoms for the benefit of the community as a whole.

National Competition Policy framework and economic impacts

As referred to in the Issues Paper, in recognition of the need to improve the competitiveness and flexibility of an Australian economy which was consistently underperforming relative to its economic potential, the Australian Government and State and Territory Governments agreed on a program of competition policy reform known as

⁴ Franz Boehm (1966) provides detailed remarks outlining the importance of protecting the competitive economic order from private and public predation as follows: ‘it is possible for any participant or any group of participants to obtain benefits by violating the rules. This occurs at the expense of other participants or groups of participants. In the market economy, also, it is possible to make a source of income out of cheating. For example, participants or groups of participants may try to cheat even in the sphere of the private law society. They do so on their own initiative, that is by deliberately abusing their private autonomy, whether in the disreputable form of unfair competition, usury and fraud or in the more honest but more harmful form of attempting to monopolise markets, for instance, by forming cartels. Much more effective, however, is the attempt by groups of participants to recall the fact that their members are indeed voters with a share in the sovereignty of the people and to bring these qualities of their contributors to bear in the sphere of the state and politics. In this case, the individual does not expose himself to the odium of cheating but demands are made of the legislator or the government to elevate cheating to a legislative or governmental programme’ (Boehm, in Peacock and Willgerodt, 1989: 64). It is important to note that the writings of Boehm and other early ordoliberal theorists served as a precursor for the analysis by public choice theorists since the late 1960’s of ‘rent-seeking’ behaviours by various interest groups in the political realm, and the need for governments to be impervious to these pressures in the interests of protecting the free market system.

the National Competition Policy (NCP). In broad terms the elements of the NCP reforms, which were formalised by a series of intergovernmental agreements in 1995, include:

- Extension of the *Trade Practices Act 1974* (TPA) to sections of the economy that were previously exempt from its anti-competitive conduct provisions, including government business enterprises (GBEs), professional and occupational services, agricultural marketing authorities, and various other sectors predominantly in the non-traded segment of the Australian economy.
- Structural reform of public monopolies to facilitate competition, including restructuring which separates the regulatory functions of a GBE from its commercial functions.
- Legislation review and, where appropriate, reforms of laws which have the effect of restricting competition in markets, such as professional services, statutory marketing, fishing and forestry, retail trading, transport, communications, insurance and superannuation, social services, education, child care, gambling, and planning and development services.
- Prices oversight to assist in the restraint of monopoly pricing behaviour, including the establishment of independent authorities at a State/Territory level to set, administer or oversee prices for services remaining under monopoly control.
- Fostering ‘competitive neutrality’ between government businesses and private sector competitors when they compete, such as ensuring that GBEs pay taxes in the same way as private enterprises.
- Introducing access rights by third parties for infrastructure services and other essential facilities to promote competition in related markets.
- Continuation of earlier reform commitments for gas, electricity, water and road transport, as previously agreed by the Council of Australian Governments (COAG).

The institutional framework ensuring that the NCP reform initiatives are progressed is derived from three intergovernmental agreements between the Australian, State and Territory Governments:

- Competition Principles Agreement (CPA) establishes common principles agreed by governments in relation to NCP reform elements.
- Conduct Code Agreement sets out the processes for amendments to the competition laws of all jurisdictions to extend the anti-competitive conduct provisions of the TPA to previously exempt businesses.
- The Agreement to Implement the National Competition Policy and Related Reforms (the Agreement) recommits governments to earlier agreed reforms in electricity and gas, water and road transport, and provides for National Competition Payments to the States and Territories.

The NCP framework is complemented by two independent statutory bodies, the Australian Competition and Consumer Commission (ACCC), which was formed to administer the TPA provisions across the economy, and the National Competition Council (NCC) which is involved in the implementation, monitoring and enforcement of

the NCP initiatives. This includes making recommendations to the Commonwealth on the distribution of National Competition Payments, totaling around \$16 billion over nine years, to the States and Territories on the basis of satisfactory progress against the NCP commitments.

The advent of National Competition Policy represented a watershed in Australian economic history. Many segments of the Australian economy were exposed to the winds of competition for the first time, and the unanimous adoption of the 1995 NCP Agreements illustrates a commonality of purpose rarely seen in the context of intergovernmental relations in Australia. In spite of the various calls of rent-seeking interests to 'roll-back' various provisions of the NCP in their favour, the adoption of this momentous reform package has been vindicated by economic studies which illustrates its continued benefits to the Australian economy and consumers. For example, according to the Productivity Commission, selected NCP initiatives have been estimated to increase long-run output in the order of 2.5 per cent over and above what would be otherwise expected to occur in the absence of reforms. This translates to an average increase in the incomes of Australian households by around \$7,000 per annum. In a 1995 modelling study of the effects of the NCP reforms, the Industry Commission concluded that selected reforms would lead to the creation of an additional 30,000 jobs nationally. A host of other studies have estimated that NCP reforms have led to real price reductions in a wide range of industries affected by the reform process, including electricity, gas and water, rail freight, and telecommunications.

Proposals to reform the National Competition Policy framework

Unfinished business and extending existing NCP reform

While the NCP reforms implemented to date have delivered significant benefits in favour of consumers and competitive enterprises, a range of reforms under the original package are yet to be fully implemented. These have been identified by the NCC and include:

- Introduction of a contestable national electricity market. To date, only New South Wales, Victoria, Queensland, South Australia and the Australian Capital Territory are part of an interconnected electricity market. Factors contributing to this relate to issues concerning the adequacy of transmission investments, locational pricing structures, cost-reflective network pricing, the extent of competition in the generation sector of the market, and inefficient governance arrangements.
- Reform of the rural water supply sector. Key reforms in this area are yet to be finalized, including the specification, enforcement and trading of property rights, and institutional settings allowing for national consistency in outcomes.
- Contestability in the gas market. Queensland has previously announced that it does not intend to introduce full retail contestability in this sector of the economy.
- Retention of prescribed shop trading hours, particularly in Western Australia, and the retention of liquor licensing laws which induce barriers to entry, discrimination between sellers, and maintain market conduct regulations.
- Retention of statutory marketing arrangements for a variety of agricultural products.

- Regulations affecting professional services and occupations, including health practitioners (eg pharmacies, dental and optometry services), building-related trades such as architects, and legal practitioners.
- No jurisdiction managed to complete their pre-announced legislation review and reform activities by the (extended) deadline of 30 June 2003. Around 30 per cent of scheduled reviews were incomplete at this time.

As pointed out above in the discussion of an appropriate economic institutional framework in line with ordoliberal principles, competition policies should be framed to promote a competitive economic order and be universally applied across all economic activities. However, in reality, some of the NCP reforms are being advanced slowly due to a combination of resistance from special interest groups which benefit from the restrictions on competition, an element of 'reform fatigue' on the part of some governments, and the significant delays associated with formalising intergovernmental arrangements to facilitate specific NCP initiatives. For instance, while not subject to the regime of National Competition Payments, the NCC notes that the Commonwealth has set a poor example to the States in terms of its own progress in legislation review and reform. *It is imperative that all parties responsible for implementation of the reform process act decisively to implement the remaining components of the current NCP program in the interests of consumers and innovative businesses within their respective jurisdictions, with a focus on the benefits associated with extending the scope of the competitive market order as the guarantor of economic prosperity and rising living standards.*

Related to these issues is the question of processes governing the NCP arrangements. As mentioned beforehand, the ordoliberal framework specifies that rule-frameworks that shape the economic constitution should be applied universally, and hence not discriminates between segments of the economy. It follows therefore that competition policy will not work to the fullest extent possible if there are loopholes in its provisions, such as the 'public interest' test, which allow for the persistence of anti-competitive arrangements in the Australian economy. This lack of consistency in the application of the test between jurisdictions, sectors, industries and firms is highly likely to distort investment and other commercial decisions and thereby give rise to the deterioration of the competitive market order.

While the November 2000 COAG decision requiring governments to publicly document the 'public interest' reasons supporting a given assessment is welcome on transparency grounds, the design of the current 'public interest' test seems to be based on the perception that competitive market dynamics is antagonistic to the objectives of social cohesion and environmental amenity. Instead, ordoliberals understand that 'complete competition' promotes social cohesion through breaking down entrenched market concentration, lowering prices for the benefit of customers, including those on low incomes, and promoting product choices for consumers. Further, the economic growth that accrues from a competitive market order provides society with additional resources with which to tackle environmental problems, and a free price mechanism provides signals to the market encouraging the appropriate usage of scarce resources. *SMEIA*

therefore considers that progress in implementing the competitive economic order through the NCP institutional framework would be greatly facilitated by removing the current 'public interest' test from the Competition Principles Agreement (CPA) and other provisions of the NCP, thereby acknowledging the promotion of competition as being the sole objective of NCP.

We note the complementarities and interaction between a comprehensive NCP platform and potential measures to strengthen the provisions of the TPA. The TPA has represented Australia's premier institution for promoting the objectives of a competitive economic order since 1965, with the current Act outlawing private sector anti-competitive restrictions such as price fixing, anti-competitive exclusive dealings, the misuse of market power, resale price maintenance, mergers resulting in market dominance, and other agreements and restraints against competition. *In the context of a dynamic and changing market economy, it is imperative that the Trade Practices provisions continue to be upgraded in order to effectively restrain the consolidation of private economic power.* It is noted that current public discussions on reforms to the TPA include reforming Section 46 (abuse of market power) of the Act to outlaw predatory pricing, introducing criminal sanctions for those found to cartelise markets, introduction of new powers to put into effect immediate 'cease and desist' orders against anti-competitive conduct, and measures to order the divestiture of corporate assets in extreme cases of market abuse. SMEIA submits that such reforms to the TPA are broadly consistent with the ordoliberal philosophy of a strong competition law, and would ensure that the NCP more effectively eliminates the various forms of anti-competitive conduct that may arise in markets.

Competition-related reforms outside the current NCP

In addition to further progress in outstanding areas of reform under the current NCP framework, and the potential for extending the current institutional framework, *the realisation of 'complete competition' would be greatly enhanced by expanding the scope of NCP rules to areas of the economy which have remained relatively untouched by market-based reform.* These include the various 'merit good' sectors such as health, welfare, community services and education where private sector alternatives have effectively been 'crowded out' by government provision in these areas. Other public sector funding policies, such as industry policies including subsidies, rebates and other incentives to selected firms, create imbalances in the competitive economic order and distort competition. It is suggested that these imbalances in the competitive order be rectified by *extending the competitive neutrality condition so that (a) all government entities do not enjoy competitive advantages over private sector competitors in the same market by virtue of government ownership and public sector funding levels, and (b) private companies do not enjoy any competitive advantages over other private operators as a result of the provision of public sector funding and other incentives that are made available on a selective and discretionary basis.* This would in turn promote generality in public sector treatment of industries, and thus create an institutional environment .

In addition to further progress in outstanding areas of reform under the current NCP framework, and extensions to aspects of existing reforms on the NCP agenda, the Issues Paper refers to a variety of reform measures outside the NCP umbrella which have sought to improve the cost-effectiveness of funding as well as enhance delivery arrangements. Whilst these reform measures to introduce pro-competition arrangements in regulated sectors of the economy outside the direct scope of the NCP framework is welcome, the extent of effective competition in these sectors varies significantly and further reforms are necessary to promote 'complete competition'. To assist in the progress towards further reform in this area, *it is suggested that the Productivity Commission provide an annual statement of competition-related reforms outside the NCP process* outlining:

- Initiatives undertaken by jurisdictions in promoting microeconomic reform outside the scope of the NCP agenda;
- The effects of continued regulatory inconsistencies affecting various sectors on competition and the competitive market order more generally;
- Information on the potential for, and the extent of, consistency across jurisdictions in undertaking these reforms; and
- Suggested further reforms to take place within each sector as described by the Australian Bureau of Statistics (ABS) ANZSIC industry classification (Divisional level) code, and the economic and other benefits associated with these additional reforms.

This report would serve to raise public awareness of issues relating to extending the scope of competition through the Australian economy, providing information with which citizen-taxpayers can compare the commitment by jurisdictions towards implementing a comprehensive competitive market order, and thus assist in driving reforms in this area.

Notwithstanding these commendable reform efforts, there a number of facets associated with public sector operations which can have a deleterious impact on the long-term prospects for private sector competition in selected markets. For example, a number of commentators have studied the potential for large-scale public sector regulatory and funding interventions in 'merit goods' sectors such as health, welfare and community services and education to displace (or 'crowd out') private sector alternatives, with clear implications for the potential for competitive forces to operate. On another level, governments to varying degrees continue to implement policy interventions that distort the capacity of private sector firms to compete against each other on an equal footing. A clear example of this is industry policies, such as subsidies, rebates and other incentives provided to selected firms but not available to others. *It is recommended that governments more closely consider the consequences of all policy and program interventions on the private sector*, including corporations and non-profit organizations, and more broadly on the competitive market order. This may be achieved, for example, by the introduction of Competition Impact Statements for all legislation and associated regulatory instruments, which expand on the Regulatory Impact Statements currently adopted by a number of jurisdictions by considering the impact of public sector interventions on competitive markets.

Concluding remarks

In summary, Australia has enjoyed over a decade of strong economic growth, which has been highlighted by low inflation and interest rates, rising incomes, strong productivity growth, increasing investment, and a sustained reduction in unemployment. In explanations of the underlying causes for these trends, a number of influential commentators, including the Productivity Commission, OECD and IMF, have found cause to suggest that NCP represents one of the key enabling conditions facilitating the historically significant improvement in Australia's economic circumstances. SMEIA concurs with these assessments, and considers that the NCP framework is broadly consistent with the ordoliberal program of securing a universal competitive free market order which is the basis for securing an adaptive growth economy combined with extensive economic freedoms. In this sense, economic competition is a virtue in itself and which should be protected and encouraged by governments, at all levels, which are impervious to the privilege-seeking agendas of special interest groups which seek to restrain 'complete competition' in order to secure benefits to themselves, at the expense of the general community and taxpayers. However, there is a concern that NCP signatory governments, to varying degrees, have succumbed to a variety of 'rent-seeking' pressures and 'reform fatigue' complacency which has tended to halt the progress of significant ongoing work to alleviate anti-competition restrictions throughout the Australian economy. In addition, as with all other products of constructivist policy design, the NCP program can be subjected to further improvements and renovations to ensure that the full gains from a comprehensive framework of competition policy can be realised for the benefit of all Australians.

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