Did the Australian Loan Council Encourage Excessive Borrowing by the States?

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Abstract

The controls employed by the Australian Loan Council over State governments' borrowings are examined in the context of the recent literature on bailouts and fiscal responsibility. It is found that although some bailout did occur from time to time, there is no evidence of a systemic bias towards bailouts in Australia. Considering that the Australian Loan Council is a unique institution among federal countries, its success in avoiding systemic bailouts may be of more than passing interest in other countries.

1. Introduction

Fiscal decentralisation implies a role for subnational governments in the decision-making processes of a country's finances. The scope of such a role varies from one country to another and is often formally defined in the constitutions of the federal countries. Fiscal decentralisation is not exclusive to federations and local governments in many unitary countries, including Japan, Sweden, and United Kingdom which enjoy a considerable degree of fiscal autonomy where they are responsible for significant shares of public finances. In every country, however, the degree of fiscal autonomy of subnational governments is the highest when measured in terms of their share of national public expenditure, is relatively lower when measured in terms of budgetary revenues and is the lowest when measured in terms of their power over raising loans.

Indeed, as figures in Table 1 show for a selected group of countries, three different aspects of fiscal decentralisation can be clearly distinguished. Subnational governments in most countries in this sample are responsible for 40 per cent or more of public expenditure. None of the countries has a matching degree of decentralisation of budgetary revenues. Only a small number of countries allow unrestricted access to subnational governments to domestic and overseas capital markets for borrowing funds. A recent study of the arrangements for subnational borrowings in 53 countries with federal type constitutions found that borrowing by subnational governments is totally prohibited in 16 countries, and is subjected to varying degrees of control in all but six countries, only one of which, Canada, is a federation (Ter-Minassian and Craig 1977). The other countries were Finland, France, Portugal, Sweden and Russia. Considering the fiscal and financial haemorrhages that Russia has experienced recently, its inclusion in the above list must be considered inconsequential.

Table 1. Three Dimensions of Fiscal Decentralisation

	Percentage share of subnational governments		**Subnational governments' borrowing power**	
	Public expenditure	*Revenue*	*Complete*	*Controlled*
Australia	47.1	20.4		✓
Canada	58.7	49.1	✓	
Germany	41.3	26.6		✓
India	52.5	34.2		✓
Japan	58.8	42.9		✓
Sweden	40.2	21.2	✓	
Switzerland	52.5	na		✓
United Kingdom	27.2	4.0		✓
United States	39.7	34.2		✓

Source: Figures on public expenditure are sourced from Ahmad et al. (1997), figures on revenue are sourced from Norregaard (1997) and figures on controls are based on Ter-Minassian and Craig (1997).

The widespread use of nationally imposed controls over borrowing powers of subnational governments contradicts the widely held belief among the economists in the virtues of fiscal decentralisation. Following Tiebout (1956), economists have believed in the efficiency enhancing properties of fiscal decentralisation. Following Brennan and Buchanan (1980), public choice theorists have considered fiscal decentralisation as an important constraint on the monopoly power of national governments. Against this background, one should expect to find either more examples of fiscal autonomy in public borrowings than is the case or some good reasons for national controls in this field.

A common objective of controls over subnational borrowing appears to be to control the growth of public debt at subnational level. The main premise of these controls is that subnational governments would borrow excessively in the absence of external controls. It is now recognised, however, that external controls often perversely contribute to excessive borrowing, particularly if subnational governments expect to be bailed out by the national government in the event of debt servicing difficulties. Following Kornai's argument (1980), that managers of a firm would fail to observe financial discipline if they expected their organisation to be bailed out of financial trouble, many studies have suggested that an expectation of bailouts would undermine financial performance and fiscal discipline of public sector entities, including subnational governments.[1] Such an expectation may arise due to some features of the regulatory framework itself (for example an encouragement for greater investment in public infrastructure or the strength of national commitment to upholding a fixed exchange rate for the currency). The strategic position of a particular State or city in a national economy may also create an expectation that the jurisdiction is 'too big to fail'.[2] Alternatively, a political affiliation of a State government may create an expectation of a bailout. Insights gained through this literature on bailouts are now exercising an important influence in the reappraisal of existing models of control over subnational borrowings and in the design of new models in developing countries and the emerging market economies.[3]

This paper examines the experience of the Australian Loan Council, which has been responsible for the design and implementation of external controls over subnational borrowings in Australia since 1927. The main purpose of this examination is to assess whether, to what extent, and in which circumstances, Loan Council's restrictions resulted in bailouts or otherwise contributed to the problem of soft budget constraints for the States. The paper focuses on the major turning points in the evolution of the various models and instruments of control employed by the Loan Council during the past seven decades and on specific episodes that provide Australian evidence concerning the bailouts. No discussion of the Australian Loan Council can be complete without comment on the role of the Commonwealth government, which dominated and used the Council's

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[1] See for example, Weingast (1995), Wildasin (1988, 1997), Qian and Weingast (1996, 1997), and Qian and Ronald (1998).

[2] See Wildasin (1997) for this hypothesis.

[3] See in particular, Von Hagen et al. (2000), Borgignon (1999), Dahlberg and Pettersson (1999), Grewal (1999), and Seitz (1999).

decisions throughout this period for enforcing its macroeconomic policies on the States.

The background to the establishment of the Loan Council and its functions is outlined in Section 2. Section 3 traces the experience of the Loan Council through several distinct phases and four specific episodes that marked the turning points in the Loan Council's evolution and which had important implications for budget constraints and incentives facing the State governments. Section 4 provides an assessment of the Loan Council's role in relation to the issues of bailouts and excessive subnational borrowings. Section 5 concludes.

2. Establishment of the Australian Loan Council

When Australia became a federation on 1 January 1901, the Constitution of the Federal Commonwealth of Australia did not provide for the coordination of public borrowings. The Commonwealth and the States borrowed independently until a voluntary Loan Council was formed in 1923 to avoid competition among governments for public loans. The Australian Loan Council was established formally in December 1927, when the representatives of governments of the six States and the Commonwealth signed the Financial Agreement. As there were doubts about the Constitutional validity of some parts, the Financial Agreement could not be given permanent effect until after the Constitution had been appropriately amended following a referendum held in November 1928. The referendum proposal for amendment of the Constitution to validate the Financial Agreement received overwhelming support from the voters, who were concerned in the 1920s about Australia's high level of public debt. It was expected that the amendment would help to restrict future government borrowing and pay off existing public debt.[4]

The Australian Loan Council thus became the sole Constitutional body with responsibility for determining the amounts, interest rates and other terms and conditions of loan raisings on behalf of the Commonwealth and the six States. Public Borrowings for defence purposes and for temporary purposes could still be undertaken without the approval of the Loan Council.[5]

Borrowings of local and semi-government authorities were initially outside the scope of the Loan Council. However, as it became evident that this exception was likely to become a channel for avoiding the Loan Council's discipline, the exempted borrowings were brought under the purview of the Loan Council in 1936 with the passage of the so-called Gentlemen's Agreement. The Gentlemen's Agreement lasted until 1985 when it was terminated after the distinction between the borrowings of the State governments and their semi-government authorities was removed under the new Global Limit Approach (see below).

[4] Mathews and Jay point out that a recurring newspaper cartoon of the period depicted a newly-born Australian infant with a millstone around his neck on which was inscribed the amount of public debt per head of population (1972, p. 109).

[5] The terms and conditions of loans for temporary purposes also had to be approved by the Loan Council.

In spite of its importance in Australian federalism, the Loan Council does not have its own separate secretariat and has always relied on the Commonwealth Treasury to provide the secretarial support. Each State has one vote at the Loan Council while the Commonwealth has two votes and a casting vote. This means that, if necessary, the Commonwealth can impose its will on the Loan Council with the support of no more than two States whereas five States would need to combine to outvote the Commonwealth. It will be noted below that on certain occasions the Commonwealth had to rely on its unequal voting power to impose its views on the States.

In addition to the establishment of the Loan Council, the Financial Agreement also provided for the following changes to intergovernmental financial arrangements:

- the end of Commonwealth per capita grants to the States (in operation since 1909);
- Commonwealth takeover of the existing debt of the States;
- Commencement of State contributions to the National Debt Sinking Fund;
- Commonwealth grants to the States to enable them to meet a part of their obligations for interest on debt and contributions to the National Debt Sinking Fund; and
- the States' agreement to indemnify the Commonwealth for the difference between the cost of the takeover of State debt and the new Commonwealth grants towards the servicing of State debt.

The principal functions of the Loan Council include the determination of the total amount that may be borrowed in a particular year, the allocation of this total among the States, the determination of the terms and conditions, and the timing of the approved loan raisings. In practice, however, as the Commonwealth government is primarily responsible for macroeconomic policies, it plays a decisive role in these matters.

3. Important Phases of Loan Council Controls

As the specific targets and priorities of the Commonwealth government's macroeconomic policies changed during the past seventy years, the rules and procedures adopted by the Loan Council also evolved accordingly. During this evolution the Loan Council passed through the following important stages.

3.1. Competition and Voluntary Coordination

It was noted above that before the formation of a voluntary Loan Council in 1923, all governments in Australia competed with one another for loans. This fact is remarkable in the context of the current received wisdom in some circles that market forces provide for a better discipline on subnational borrowings than do administrative controls. Australia's experience in the early part of the 20th century shows, however, that the States preferred to cooperate rather than to compete with one another. Voluntary coordination occurred as early as 1916 and 1917, when the Commonwealth government raised loans in London on behalf of the five States other than New South Wales. A voluntary Loan Council was formed at the 1923 Premiers' Conference, which was required to coordinate the timing, interest rates and other terms and conditions of public borrowings, but had no authority for determining total amount of loan raisings or issuing centralised securities.

3.2. The Great Depression and Defaults by New South Wales

The first major test for the controls imposed by the newly formed Loan Council came in the wake of the Great Depression of 1930-31. Economic downturn gathered pace in Australia earlier than in most other countries. Export prices, national production and budgetary revenues fell sharply in 1929-30 while unemployment, government expenditure on unemployment benefits and budgetary deficits rose significantly. The debates over economic policies divided the nation sharply between those who supported immediate imposition on governments of balancing their budgets by cutting expenditure and raising taxes and those who favoured credit expansion and lowering of the interest rates.

Faced with falling tax revenues, several States were relying increasingly on borrowings, and bank advances to Australian governments increased nearly tenfold between June 1929 and December 1930 (Mathews and Jay 1972, p. 164). New South Wales had the largest amount of debt of all jurisdictions in Australia in 1931, nearly 70 per cent of which had been raised in London, and which had an interest payment of $2,686,000 falling due on 1 January 1931.

The Loan Council embraced the prevailing economic orthodoxy, which favoured balanced budgets, high taxes, high interest rates and cuts in wages for increasing the level of economic activity and reducing unemployment. In June 1930, the Loan Council reduced the 1930-31 loan program by 45 per cent in comparison with the previous year and asked all governments to balance their budgets in the following financial year. In the face of declining revenue and increasing unemployment relief expenditure, all governments were asked to impose new taxes.

In contrast, in New South Wales the Labor Party had fought an election in October 1930 on a platform of lower interest rates and credit expansion and had been swept into power. The new State Premier, J. T. Lang, informed the Chairman of the Loan Council (who was also the Acting Commonwealth Treasurer) in November 1930 that it was impossible for his government to balance the State budget without additional taxation and that more time was needed to pass the necessary legislation. Referring to similar budgetary difficulties being faced by some of the other States, particularly Victoria and South Australia, Lang urged the Commonwealth to approach the banks to obtain a temporary accommodation for financing the difficult budgetary situation (Shann and Copeland 1931, p. 82).

The Loan Council was informed in December 1930 that the banks insisted on all governments accepting the fundamental principle of keeping their expenditure within the limits of their respective budgetary income. The banks were prepared to meet temporary requirements of a government if they were furnished with an assurance that the assistance provided by the banks could be practically liquidated by 30 June 1931. It has not been possible to find documentary evidence of an assurance provided by the Commonwealth or New South Wales government but the fact that New South Wales was able to meet its interest payment in London in January 1931 suggests that some accommodation must have been provided and a likely default by that State avoided.

This was not, however, the end of financial difficulties for New South Wales. The fact that the Australian currency had depreciated by 30 per cent by January 1931[6] further aggravated the budgetary impact of economic downturn as the real burden of interest payments on foreign loans increased correspondingly. As noted above, expert opinion about the best policy response by governments was sharply divided into three groups at the time: one led by the Commonwealth Bank, a second led by the federal Treasurer E. G. Theodore and the third represented by Lang. An impasse developed in February 1931 when the Loan Council and the Premiers' Conference considered three alternative proposals for future policy direction. The proposal put forward by the Committee of Under-Treasurers (including the Chairman of the Commonwealth Bank Board) favoured deflationary measures but was unacceptable to the Commonwealth government. An alternative proposal supported by the Commonwealth Treasurer involved cuts in government expenditure, expansion of credit and reduction in interest rates but was unacceptable to the Commonwealth Bank. (It should be noted that in April 1930, Theodore had introduced legislation for the establishment of a central bank (which would have made unsecured loans to the government if needed) but the legislation was defeated in the Senate.) The third proposal, favoured by Lang, required conditional repudiation of overseas debt and compulsory reduction of interest rates but was rejected by everyone else, including the other State Premiers.[7]

New South Wales defaulted on the payment of interest on its overseas debt in April 1931. The Commonwealth paid the interest on the following day on behalf of the government of New South Wales and instituted High Court proceedings against the state for violating the Financial Agreement. The Court proceedings were later dropped after the State government reimbursed the Commonwealth, agreed to resume further payments of interest and accepted the Loan Council's decision that balanced budgets must be achieved by June 1934. Lang's action triggered a run on the State Savings Bank of New South Wales, which was forced to close its doors and temporarily freeze deposits of $110 million. The political repercussions of Lang's default were even more serious. The Federal executive of the Labor Party expelled the New South Wales executive, which caused some

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[6] Mathews and Jay note however, that depreciation of the currency indeed assisted the process of economic recovery in Australia during 1931 and 1932 (1972, p. 148).

[7] Similar disagreements over policies to deal with the depression occurred in other countries. For example, in the USA, President Hoover's State of the Union Address in December 1931 emphasised that the first step toward economic recovery was to establish confidence by restoring the financial stability of the United States government and that government borrowing beyond the utmost safe limits would destroy confidence, jeopardise the financial system and actually increase unemployment (see De Long 1998, p. 75).

members of the New South Wales Labor Party to resign and form a new Lang Labor Party.[8]

Later in 1931, Lang returned to the Loan Council requesting leave to borrow additional money from the banks by means of Treasury bills as his deficit was expected to be larger than anticipated. When the request was refused New South Wales defaulted again on overseas interest payments in January 1932. This time the Commonwealth did not pay the interest for ten days. According to one account of the events 'there was a flight of capital to the other States and investment in new South Wales came to a standstill, and the community existed in a state of fear, wondering whether revolution would result' (Maclaurin 1937, p. 101). After finally paying the interest on behalf of New South Wales, the Commonwealth government passed the *Financial Agreements (Commonwealth Liability) Act* 1932, under which it accepted liability to bondholders for payments due on State debts. It also passed the *Financial Agreements Enforcement Acts (Nos 1, 2, 3 and 4)* 1932, which laid down a formal procedure for the Commonwealth to obtain legal authority from the High Court to attach the revenue of a State if that State had violated the Financial Agreement.

Lang challenged the constitutional validity of these Acts in the High Court and was supported in this challenge by Victoria and Tasmania, who both did not support the default by New South Wales but were opposed to the implied attack of the legislation on State sovereignty. By a majority of four to two, the High Court upheld the validity of the Commonwealth legislation under section 105A. Lang nevertheless opposed the execution of the High Court judgment and ordered the State officials to ignore the Commonwealth directive. The Governor of New South Wales requested Lang to withdraw his orders of non-compliance to State officers. When Lang refused to withdraw his directive, the Governor[9] withdrew Lang's commission and dismissed him from the office of the Premier of New South Wales on 13 May 1932. In the ensuing State election on 12 June 1932, Labor Party was badly defeated by the coalition of United Australia Party and the Country Party.

Thus came to an end an episode that cemented the authority of the Australian Loan Council in imposing its discipline over all the member governments. The episode also demonstrates the determination of the Commonwealth government in not allowing a State to damage Australia's financial standing in the overseas capital markets. In spite of the fact that the New South Wales government had legitimate differences with the Loan Council and the Commonwealth government

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[8] These developments in the Labor Party were also linked with the reinstatement of Theodore as federal Treasurer, who had resigned in July 1930 following allegations of corruption. His reappointment followed his vindication in a civil suit.

[9] The government of each State in Australia is headed by a Premier, who is the leader of the political party with a majority in the lower house of the state parliament. Each State also has a formal, unelected head of State, called Governor, who represents the Crown and issues in the name of the Crown the commission for forming the government to a Premier and his Ministers. In normal circumstances, the Governor acts on the advice of the Premier, but in exceptional circumstances, as in the case of Mr. Jack Lang in 1932, a Governor may withdraw the commission of a Premier (i.e. dismiss him) in the interest of peace and stability in the State. Correspondingly, the Federal government is led by the Prime Minister and the representative of the Crown in this case is called the Governor General.

over the most appropriate economic policies at the time, a blatant refusal to honour its financial obligations towards lenders did not succeed. The arrangements that were introduced for dealing with the default did not constitute a bailout. Nor did they create an expectation among the States of a bailout in the future.

When it is considered in the context of the underlying fundamental differences over economic policy between the New South Wales government and the dominant view in the Loan Council the episode of Jack Lang's defaults was not about fiscal profligacy but about sharing the burden of the economic depression more fairly between labour and capital. Lang did not favour overspending or over-borrowing in the usual meaning of the terms. Instead, he was opposed to the Loan Council's deflationary policies for dealing with the effects of the depression. Within the Labor Party, the Federal Treasurer E. G. Theodore also shared Lang's opposition to deflationary measures, although Theodore did not approve of Lang's defaults on payments of interest on overseas loans.[10]

Lang's proposal that interest rate be reduced to 3 per cent was based on the view, widely shared at the time in the trade union movement and the Labor Party, that the burden of sacrifice for supporting economic recovery must be shared by bondholders and wage earners. Opposed in the initial stages, that idea eventually became the basis of *The Commonwealth Debt Conversion Agreement Act* 1931, which authorised the Commonwealth on behalf of the Loan Council to convert the existing debts of the Commonwealth and the States into new stock by invitation to the bondholders. The new stock carried interest, which had been reduced by up to 22.5 per cent from original rates. According to a contemporary account:

> While Mr. Lang's stand was most unpopular at the time, it was of material value in persuading the more conservative groups that conversion was necessary…The conversion loan proved a spectacular success… The threat of compulsion was forgotten, and most people willingly turned in their bonds for conversion…The internal debt at the time was [$1014] million. Only 3 per cent of the bondholders dissented…There was no flight of capital following the Plan, as some had forecast. In fact, capital …returned to Australia after the inauguration of the Plan, probably because it laid the ghost of inflation. (Maclaurin 1937, pp. 84, 94-96)

This episode should also not overshadow Jack Lang's considerable contribution to the procedures of the Loan Council and to the policy debates for achieving economic recovery after the Depression. It is worth noting that Lang was responsible for proposing a number of Loan Council's rules in 1927. One of his proposals was that money raised for temporary purposes should remain outside the control of the Loan Council, except for the approval of the interest rates. Similarly, he proposed that in the event of unanimity not being achieved, loan raisings should be allocated among the States in proportion to their net loan expenditure during the previous five years. Lang also proposed that by unanimous approval of the Loan Council a State might borrow overseas and issue its own securities (Mathews and Jay 1972, pp. 113-115).

[10] Theodore was reportedly responsible for shipping over to Australia one of the first copies of Keynes' *General Theory* after its publication in 1936.

3.3. States' Reliance on Commonwealth Lending

Australia's postwar investment boom affected capital expenditure in both the private sector and the public sector. Private gross fixed capital expenditure increased by 30 per cent in 1949-50 over the previous year, 43 per cent in 1950-51 and 22 per cent in 1951-52. Public sector gross fixed capital expenditure increased even more sharply, by 44 per cent in each of 1949-50 and 1950-51 and 34 per cent in 1951-52. The States found that their demand for funds exceeded the supply of funds available to them through the market. Additional loans from the Commonwealth were required to meet the States' needs. Special Commonwealth loans became an important source of capital for the States, and an important source of Commonwealth influence over State budgets, from this period onward.

The size of the borrowing program submitted by the States to the Loan Council in 1951 became embroiled in a bitter division among the members. The States rejected the Commonwealth's suggestion that the program was too large and should be reduced by 25 per cent. As no agreement could be reached the issue was put to vote, which the Commonwealth was able to win in spite of the opposition from four States.[11] Although the Loan Council approved a borrowing program of $454 million, only $148 million could be raised through the public loan. The Commonwealth provided the remaining $306 million in the form of a special loan to the States. When a similar disagreement arose between the Commonwealth and the States at the 1952 meeting of the Loan Council, all States were united insisted on the approval of a borrowing program of $495 million while the Commonwealth supported a smaller program of $360 million. Again, however, as the public loan could only raise $117 million, the Commonwealth provided a special loan of $263 million and the States had to eventually accept total borrowing of $380 million for 1952-53. Special loans (and capital grants in later years) from the Commonwealth became a permanent feature of the States' Loan Council borrowing in the subsequent years.[12]

3.4. Relaxation of Loan Council Controls

In response to the widely shared prospect of a resources-led boom in Australia in the late 1970s, the Commonwealth accepted the States' pleas for higher public sector borrowings for financing large infrastructure projects in energy and mining sectors. The Loan Council approved new guidelines and established a separate category for borrowing programs that could either not be reasonably accommodated within the normal resources available to the States, or had special significance for economic development or required large outlays within a short span of time. Domestic borrowings of State electricity authorities were exempted from Loan Council approval in 1982 and a year later this exemption was extended to all other larger semi-government authorities.

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[11] The Commonwealth has two votes in the Loan Council and was able to exercise its casting vote as it also had the support of the remaining two States.

[12] In most years, special loans were financed by the Commonwealth from its revenue surplus and were advanced to the States at market rate of interest.

Overseas borrowings for infrastructure projects were initially approved after a case by case consideration by the Loan Council but from 1980-81 onward, the Loan Council set indicative ceilings within which overseas borrowings did not require its approval. From 1983 onwards, the States were virtually free to allocate their overseas borrowings between semi-government authorities (Commonwealth of Australia 1984, p. 36).

The States took full advantage of the new opportunities and borrowed heavily during this period for infrastructure programs within Australia and overseas (Table 2). Borrowing by the public trading enterprises of the States (PTEs) increased from 0.8 per cent of GDP in 1976-77 to 2.6 per cent in 1983-84. In the absence of a compensatory reduction in the borrowings of the general government sector, public sector borrowings jumped from 1.3 per cent of GDP in 1976-77 to 3.1 per cent in 1983-84. In their ongoing struggle to by-pass the Loan Council restrictions, the States also developed new ways of raising finance, which were not at the time covered by the Loan Council controls.

Table 2. Public Sector Borrowing in Australia (per cent of GDP)

	Commonwealth		**State and Local**		**Total**
	General government	*Public trading enterprises*	*General government*	*Public trading enterprises*	*Public sector*
1972-73	2.0	0.0	0.4	0.8	3.2
1973-74	1.3	1.0	0.4	0.6	3.3
1974-75	2.0	-0.1	0.4	0.6	3.0
1975-76	4.8	0.0	0.5	0.8	6.1
1976-77	3.1	0.3	0.5	0.8	4.7
1977-78	2.6	0.1	0.4	0.9	4.0
1978-79	3.5	1.2	0.4	1.2	6.3
1979-80	0.6	0.4	0.4	1.4	2.7
1980-81	1.8	-0.1	0.4	1.5	3.5
1981-82	0.3	0.5	0.3	2.3	3.5
1982-83	3.1	0.0	0.3	2.8	6.1
1983-84	4.4	0.7	0.5	2.6	8.3
1984-85	3.2	0.6	1.1	1.7	6.5
1985-86	2.3	0.3	0.8	1.6	5.0
1986-87	1.6	1.0	1.4	1.1	5.1
1987-88	-1.3	0.1	1.2	0.7	0.7
1088-89	-1.6	0.4	0.8	0.4	0.0
1989-90	-2.2	0.9	0.8	0.3	-0.4
1990-91	0.1	0.9	1.8	0.1	2.9
1991-92	2.5	0.0	2.9	0.1	5.5
1992-93	4.0	0.2	2.0	-0.4	5.9
1993-94	3.4	-0.3	1.1	-0.5	3.7
1994-95	2.9	-0.3	0.1	-0.4	2.3

Source: Foster (1996).

By 1983-84, the State public sector had borrowed more than $2.3 billion under the infrastructure guidelines, more than 60 per cent of which was borrowed overseas. The Loan Council was on the verge of losing control over semi-government authority borrowings. In 1979-80, for example, the Loan Council had approved 95 per cent of the States' semi-government authority borrowings. By 1983-84, the corresponding figure had fallen to 25 per cent. Whereas borrowings by these authorities in 1979-80 constituted 1.4 per cent of GDP, the corresponding figure had doubled in 1982-83 and was only slightly lower (2.6 per cent) than that in 1983-84. As the general government sector also borrowed heavily in 1982-83 and 1983-84 to cover recession-driven budgetary deficits, total public sector borrowing had increased to 8.3 per cent of GDP in 1983-84, the highest level in post depression years.

3.5. Global Borrowing Limits

It had become clear by 1983-84 that the Gentlemen's Agreement was no longer an effective instrument for imposing Loan Council discipline on subnational borrowings. The Gentlemen's Agreement was suspended in 1984 when the Loan Council adopted a new global limit approach, for a one-year trial. The following year, the global limit approach was implemented on an on-going basis and the Gentlemen's Agreement was terminated. Thus, the long-standing distinction between the borrowings of the semi-government authorities and of the rest of the government was abandoned under the new approach. Instead, the Loan Council approved each year an aggregate amount – the global limit – for new money borrowings (i.e. excluding loans for re-financing purposes) of each State and the Commonwealth, within which the governments were free to allocate borrowed funds between their respective authorities and the general government sector.

Each State agreed that the new global limits extended to all semi-government and local authorities, companies and trusts that were effectively controlled by governments. Borrowings of public financial institutions (such as State Banks and insurance offices) were exempt from the global limit, except when such borrowings were on-lent to, or used by, governments or authorities that were themselves subject to the global limit. In addition to conventional domestic and overseas loan raisings, deferred payments, trade credits, leasing arrangements of all kinds, except operating leases (which were included from 1993-94) and instalment purchase by government departments were progressively added to the list of borrowings covered by the global limit.

Consistent with the Commonwealth government's policies of fiscal restraint during this period, funds approved by the Loan Council under the States' global limit were progressively and sharply reduced from 1984-85 onwards. The reductions made were 6.9 per cent in real terms in 1985-86, 15.4 per cent in 1986-87, 19.5 per cent in 1987-88 and 22 per cent in 1989-90. By 1989-90, the States' aggregate global limit had been reduced to less than 60 per cent of its 1984-85 level in nominal terms. In real terms the reduction was far greater. Although actual borrowings by the States generally exceeded the approved amounts, the global limit approach was successful, at least in the initial years of its operation, in constraining the growth of subnational borrowings. Indeed, total borrowings of the State and local sector had been reduced to 1.1 per cent of GDP by 1989-90 from the earlier peak of 3.1 per cent in 1983-84 (Table 1).

The imposition of the new framework did, however, generate dissent. In 1988, Queensland refused to endorse the global limit set by the Commonwealth and to comply with the Loan council requirement of furnishing information of borrowings by its authorities. The Commonwealth forced Queensland to comply, however, after threatening to deduct from that State's financial assistance grants any excess of borrowings by Queensland over the global limit set by the Loan Council for it, for that year at $793 million.

The background to Queensland's opposition to the global limit approach in 1988 was partly economic and partly political. As noted above, from 1985-86 onwards, the Commonwealth Labor government had imposed on the States measures of unprecedented fiscal restraint. Net Commonwealth payments to the States and the Northern Territory had been reduced in real terms by 0.5 per cent in 1985-86, 1.1 per cent in 1986-87, and 4.4 per cent in 1987-88. At the 1988 Premiers' Conference and Loan Council meeting, the Commonwealth proposed a further cut of 7.0 per cent in real terms to these payments (Government of Victoria 1990). These cuts would reduce Commonwealth net payments in 1989-90 to the lowest percentage of GDP (6.8 per cent) since 1961-62. The States had unsuccessfully resisted the cuts at each Premiers' Conference. At the 1988 meeting of the Loan Council the Commonwealth had asked for a further reduction in global limit borrowings of the order of 22 per cent in real terms.[13] For individual States, however, the reductions were distributed unevenly, with the largest cut of 32 per cent proposed for Queensland.

The Commonwealth's logic apparently was that Queensland could afford such a large reduction. Queensland had always prided itself for being a State with low levels of borrowings and public debt. At the end of June 1988, Queensland was the only State in Australia whose general government sector became a net lender, after wiping out a small net debt during the previous year. Regardless of its low borrowing requirement, however, the State had been 'entitled' to substantial amounts of borrowings under the arrangements applied at the time for the distribution of aggregate global limit between the States (refer to Table 3). The disproportionate cut in Queensland's 1988-89 global limit reflected the Commonwealth desire to move towards a need-based allocation of the proposed cuts to be applied to the total borrowings.

The following political background might have also played a role in Queensland's non-cooperation with the Loan Council. Mr (later Sir) Joh Bjelke-Petersen, who had been the Premier of Queensland since 1968 had been forced by the National Party caucus to resign in December 1987 and was succeeded as Premier by Mr M. J. (Mike) Ahern, a former minister of health. Mr Ahern was the Premier and Treasurer of Queensland when the State government refused to endorse the global limit. Mr Ahern was attending his first Premiers' Conference and Loan Council meeting in May 1988 as the State leader. Although Ahern had been a minister in Queensland for some time, he was relatively new to these two principal forums of intergovernmental negotiations. In the past, his predecessor had successfully practised the art of 'Canberra bashing' to win popular support in his own State. New to the game of political brinkmanship, Ahern perhaps got carried away by the theatrical atmosphere of the public session of the meeting. As the next election

[13] In the event, however, actual borrowings by the States in 1988-89 were $135 million below the approved amount.

in Queensland was to be held within the following 18 months, he might also have been seeking to project an image of a strong leader who refused to allow Canberra to override the interests of Queensland. In the end, his refusal amounted to little more than a symbolic protest.

The Commonwealth proceeded with the global limit approved by the Loan Council and used the 1988-89 figure for approving Queensland's global limit borrowings in subsequent years without any amendments. Mr T. R. (Russell) Cooper replaced Mr Ahern as Premier of Queensland in September 1989, less than three months before the following State election that was held on 2 December 1989. Mr Wayne Goss became the next Premier of Queensland after the Labor Party won the election and formed the new government in Queensland after a period of 21 years.

Queensland's episode focussed attention on at least one of the shortcomings of the global limit approach – that global limits approved by the Loan Council for individual jurisdictions were not related to their respective needs but were driven solely by macroeconomic targets of the Commonwealth government. The changes introduced by the Loan Council soon after the Queensland episode, including the replacement of the global limit approach by a new system of Loan Council Allocations in 1994 (discussed below), attempted to address this problem as well as the other shortcomings of the previous approach.

3.6. Towards Greater Accountability for States

The Commonwealth ceased to borrow on behalf of the States from 1989-90 onwards. The Commonwealth remained responsible for the debt which it had issued on behalf of the States in the past but the States now became responsible for financing and managing their own debt. The new borrowing arrangements exposed the States and their central borrowing authorities to financial scrutiny from credit rating agencies. Depending upon their respective credit ratings (see Table 3), different States now faced different interest costs for their borrowings, whereas previously all States were charged the same rate of interest by the Commonwealth government.

The Loan Council decided to phase-in equal per capita shares for the allocation of global borrowings to individual jurisdictions over a period of five years from 1991-92. Agreement was also reached in 1990 for the States to progressively redeem the debt that the Commonwealth government had issued on their behalf so that by 2005-06 this debt would be fully taken over by the States. The Financial Agreement was amended in 1992 to give formal recognition to the new arrangements for State borrowings. A new Financial Agreement was signed in 1994 and became operative from 1 July 1995.

Table 3. Credit Ratings of Australian States: 1989-1998

Date	NSW	VIC	QLD	WA	SA	TAS
May 1989		AAA				
June 1990	AAA	AA+	AAA	AAA	AAA	
August 1990						AA-
March 1991					AA+	
May 1991		AA				
October 1991				AA+	AA	
September 1996		AA+				
April 1998		AAA				
December 1998				AAA		

Source: Information supplied by Standard and Poor's (May 1999).

3.7. Retrospective Bailout of Victoria

Victoria's budgetary position had deteriorated sharply from 1989-90 onwards due to several adverse developments. First, in common with the other States, Victoria's revenues had been adversely affected by the share market crash of October 1987 and the recession of 1990-91. Additionally, however, Victoria had major problems of its own. A number of private sector companies to whom Victorian Economic Development Corporation (VEDC) had financial exposure by way of loans or share of equity had performed poorly. A merchant bank – Tricontinental Bank, which was a subsidiary of the government-owned State Bank of Victoria, had also collapsed, leaving the Victorian government with an exposure of $2.7 billion to fund its guarantee and eventually to the sale of the State Bank of Victoria. The failure of a group of building societies – the Farrow Group – had also added to the financial liabilities of the State government of Victoria. The interest cost on Victoria's debt had increased with the rise in interest rates in the late 1980s and in 1990 and 1991. In addition to a capital account deficit, Victoria's current revenue account had also turned into a deficit in 1989-90.

The State Treasurer Mr R. A. Jolly resigned in April 1990 followed by the Premier Mr John Cain who resigned in August 1990, and was replaced by Mrs Joan Kirner as the new Labor Premier. Between 1989-90 and 1991-92, the State government borrowed heavily from its non-budget sector financial entity Victorian Development Fund (VDF). The Loan Council's approval had not been obtained for these borrowings, presumably because the State regarded these as short-term advances. In May 1992, a few weeks before the end of the financial year on 30 June, Victoria refinanced these advances as medium-term loans from Victorian Public Authorities Finance Agency (VicFin). However, this refinancing put Victoria in breach of the Loan Council conditions, as the medium-term borrowings fell within the definition of global limit borrowing. However, as compliance with these conditions was voluntary, there was no formal action required or taken by the Loan Council.

Financial mismanagement by Labor governments of Cain and Kirner became a key issue in the State election that was held in October 1992. The Liberal-National Party Coalition ran its election campaign by concentrating on the theme of labelling Labor as the ‘Guilty Party’. The Labor Party was soundly defeated in the election and Mr. Jeff Kennett replaced Mrs Kirner as Premier of Victoria.

At the December 1992 meeting, the Loan Council retrospectively approved additional borrowings totalling $2981.5 million for Victoria in respect of its excess borrowings in 1991-92 and 1992-93. The Loan Council approved further special additions for Victoria of $700 million in March 1993.

Occurring retrospectively after the change of government in Victoria, these approvals effectively set the record straight and cleared the deck for the new State government’s dealings with the Loan Council. The Victorian episode also led the Loan Council to abandon the global limit approach and to shift its focus to prospective budgetary situation and strategy of each jurisdiction.

3.8. Replacement of Global Limits by Loan Council Allocations

The global borrowing limits were replaced by the new Loan Council Allocations (LCAs) in July 1993. In December 1992, the Loan Council had admitted that the global limit arrangement of the previous nine years had ‘become less effective over time and by the end of 1992 [was] at the point of breakdown’ (Australian Loan Council 1993, p. 1). It was also recognised that neither the aggregate global limit nor its allocation was directly related to a jurisdiction’s fiscal circumstances.

The new LCA approach signalled a change in the philosophy of the Loan Council from a rigid regime of compliance to a framework that is both credible and transparent. Under the new arrangement, each jurisdiction is required to nominate a Loan Council allocation, which is anchored in its own estimated budget balance for the forthcoming year and its strategy to achieve a balance, if the budget is in deficit. If the sum total of the nominated LCAs is inconsistent with the Commonwealth government’s macroeconomic policy objectives, appropriate adjustments are negotiated with the States. Tolerance limits are agreed with the jurisdictions to allow flexibility in the case of economic forecasts not being realised. Each jurisdiction is obliged to report to the Loan Council on an annual and quarterly basis about its budgetary situation. Uniform and comprehensive reporting arrangements have been established for such reporting. The LCAs are based on estimated budget balance plus certain memorandum items, which are akin to borrowing even though they might not be strictly classified as such.[14]

[14] These items include the impact of operating leases, recourse asset sales, private sector involvement in public sector infrastructure projects, public sector superannuation funds, local government, statutory marketing authorities, and central borrowing authorities.

The objectives of the new Loan Council allocations are to:

- facilitate financial market scrutiny of public sector finances via better reporting and so make jurisdictions more accountable to markets;
- enhance the role of Loan Council as a forum for coordinating public sector borrowings in the light of the national fiscal situation and the fiscal policy imperatives confronting individual governments;
- promote greater public and financial market understanding of budgetary processes; and
- provide the basis for States assuming greater freedom and responsibility in determining their financing requirements consistent with their fiscal and debt position and overall macroeconomic constraints. (Commonwealth of Australia 1997b, pp. 67-68)

4. Assessments

4.1. Back to the Markets

The Australian Loan Council was established to provide a mechanism for the coordination of public sector borrowings at a time when the States were experiencing difficulties in raising funds in the domestic and overseas markets. The newly introduced rule-based coordination was considered an improvement over the previous market-based competition for loans that prevailed during the first two decades after Federation. From 1990 onwards, a shift has been made in the Loan Council arrangements to increase the exposure of the States' borrowings to market forces. This shift reflects in part a realisation that Loan Council controls had not been fully effective from around 1977-78, and in part an ideological shift, embraced by Australian governments in common with many other developed countries, in favour of the efficiency enhancing market-based solutions. The long-term effects of the new arrangements, which also encourage, *inter alia*, privatisation of public sector assets, are uncertain.

Admittedly, there has been an improvement in Australia's public sector debt position in recent years, particularly in the net debt position of the State and local government sector. A variety of developments are responsible for this improvement, including improvements in the efficiency of public trading enterprises (PTEs) in most States, and fiscal consolidation and privatisation of public assets (see Commonwealth of Australia 1997a, Statement 7). The full implications of fiscal consolidation and privatisation on the economy will take more time to materialise. According to some observers, the effects on employment, and inequalities within the Australian economy and society are unlikely to be beneficial (see Mathews and Grewal 1997).

4.2. Commonwealth Domination

It is possible to interpret the operations of the Australian Loan Council in different ways. For example, the nature of Australia's borrowing controls may be described, as Ter-Minassian and Craig have done, as 'cooperative controls' (1997, pp. 158-159). On the other hand, the discussion in this paper reveals that the Commonwealth government heavily influenced the Loan Council's decisions concerning subnational borrowings and used the Council as an instrument of its macroeconomic policies. Changes in the operations and procedures of the Loan Council over the years followed closely the dictates of Commonwealth policy. The success or failure of the Loan Council indeed reflected the success or failure of the Commonwealth policy in a particular period. Commonwealth government's domination of Australia's public finances is, therefore, extremely important in understanding the Loan Council's role in Australia.

The key to the Commonwealth government's domination lies in the high degree of centralisation of the revenue raising system in Australia, where the States are able to raise less than 16 percent and local governments four percent of national taxation revenues. This situation has been perpetuated by the monopoly of the Commonwealth over income taxation in Australia since 1942 (see Mathews and Jay 1972) and by the High Court of Australia, which has interpreted the Constitutional restrictions on sales taxation (section 90 in particular) to virtually exclude the States from taxation on goods (see Grewal 1998). The States are critically and permanently dependent on financial assistance from the Commonwealth. This financial assistance comes in a variety of ways, including general-purpose grants and specific purpose grants. Although formula-based funding arrangements help to reduce the discretion available to the Commonwealth over many of these payments, in the ultimate analysis virtually all Commonwealth assistance is susceptible to changes in Commonwealth policy.

The episode of Queensland's resistance to global limits illustrates this aspect of the States' fiscal vulnerability. In that episode, the Commonwealth government was able to threaten that, if necessary, it would reduce Queensland's general revenue grants, in spite of the fact that those grants were formula-based payments and were widely regarded as totally unencumbered by any discretionary conditions. Indeed, the following candid statement made by P. J. Keating (1991) (who was Federal Treasurer between 1983-1990 and Prime Minister from 1991-1996) sums up extremely well the critical importance of revenue centralisation in putting the Commonwealth in the controlling position in Australia:

> The national perspective dominates Australian political life because the national government dominates revenue raising, and only because the national government dominates revenue raising. (Keating 1991)

As noted above, from 1951 onwards the Commonwealth government through its special loans to the States became more influential in the determinations of the Loan Council. The support provided by the Commonwealth proved to be a double-edged sword for the States. On the one hand, it enabled them to borrow more than they could have borrowed on their own at reasonable rates of interest. On the other hand, special loans also made it possible for the Commonwealth to dominate the Loan Council and through it the national policy on capital outlays and public investment.

The Commonwealth lost its way towards the end of the 1970s, when it relaxed the Loan Council controls over borrowings for infrastructure programs, which resulted in a blow out of subnational borrowings. In the mid 1980s, the concerns over Australia’s current account deficit and foreign debt led the Commonwealth into enforcing a strategy of severe fiscal contraction through the Loan Council, which culminated in the recession of 1990-91.

Throughout this period, the Loan Council’s approach targeted public borrowing by the States indiscriminately, with little attention to differential needs of individual States. The Loan Council’s discipline, however, was never fully effective and the Council was often a step behind in closing the loopholes exploited by one State or another for avoiding accountability. The formula-based allocations by the Loan Council obviously did not reflect the needs of individual States but provided implicit financial equalisation that undoubtedly helped the less populous States, which in the absence of the Loan Council might not have been able to raise the same amount of capital. Indeed, it is possible that economic disparities between the States might increase in future as a consequence of the greater exposure of the States’ capital programs to market-based outcomes.

4.3. Bailouts

The literature on bailouts is concerned with factors that are likely to create systemic failure of fiscal discipline at subnational government level (see Von Hagen et al. 2000). A key consideration for such a failure is the expectation that the national government would rescue the jurisdiction in financial trouble. This expectation may be due to some feature of the regulatory framework itself (for example an encouragement for greater investment in public infrastructure) or may be attributed to the strategic position of a jurisdiction. A subnational jurisdiction may consider that it is ‘too big to fail’.[15] Alternatively, a political affiliation of a State government may create an expectation of a bailout.

In principle, some of the Loan Council’s arrangements could have been conducive to bailouts and to the development of soft budget constraints. The following aspects of the coordination arrangements introduced in the wake of the establishment of the Loan Council, and which remained operative from 1928 to 1990, are particularly noteworthy in this context:

- all loans for the States were issued in the name of the Commonwealth;
- the States were only partly responsible for meeting the cost of servicing their debt, as the Commonwealth also made contributions to the National Sinking Fund on the States’ debt;
- the States almost always sought to borrow more than was on offer in the capital markets at the price offered by the States; and
- as the Commonwealth government was the borrower under the Loan Council arrangements, the interest cost of borrowings was the same for every State and

[15] See Wildasin (1997) for this hypothesis.

was lower than it would have been if the States were borrowing in their own names.

It is clear, however, from the discussion in this paper that although there were some sporadic bailouts in Australia, the Loan Council arrangements did not create a systemic environment of bailouts.

The main reason for the success of the Loan Council in avoiding bailouts was that its rules and actions did not create an expectation of future bailouts. When assistance was provided *ex post*, as for example in the case of the defaults by New South Wales in the 1930s and the retrospective bailout of Victoria in 1992, Loan Council's decisions did not become a part of the States' expectations and did not distort their incentives. But when assistance was provided on an *ex ante* basis, as for example under the borrowing arrangements for infrastructure projects, or under the global limit approach, incentives facing the States were indeed distorted and this led to sharp increases in the level of State borrowings. From this perspective, the arrangements of the Loan Council can be considered to be successful, except for the period between 1978-89 and 1992-93.

The treatment of New South Wales in the 1931-32 episode also shows that in Australia, the 'too big to loose' expectation did not win. Similarly, political affiliations were not the important factor in the retrospective bailout of Victoria in 1992, the Labor Party had lost the State election and had been replaced by a coalition government before the bailout was approved by the Loan Council.

4.4. Excessive State Borrowing?

Borrowings by State and local governments in Australia generally remained responsive to Commonwealth government's policy. For example, during the six years to 1977-78, annual borrowings of the State and local governments averaged at 0.75 per cent of GDP. Under the impetus of infrastructure funding encouraged by the Loan Council after 1978, the borrowings in the subsequent six years rose to 1.97 per cent of GDP per year on average, an increase of 162.7 per cent within such a short time (Table 2). The only time the Commonwealth lost control over the volume of State borrowings was during the 1984-92 period when the States enthusiastically exploited the new freedom under the global borrowing limits. Eventually, however, the Commonwealth was able to regain control over State borrowings under the new Loan Council Allocations.

5. Conclusion

In conclusion, Australia's system of controls over subnational borrowings appears to have served the country well, even though Loan Council's discipline failed for a decade and half from 1978. However, the Loan Council's success derived mainly from the acute degree of vertical fiscal imbalance in Australia, which put the Commonwealth government in a commanding fiscal position. The Commonwealth government also retained a strategic position in the Loan Council by virtue of its two votes and a casting vote, in contrast to one vote for each State, which meant that it could control the majority decisions with the support of only two States. The fact that the Loan Council also relies on Commonwealth Treasury for its secretarial services as well as technical advice on macroeconomic conditions gave further power to the Commonwealth in dealing with the States as members of the Loan Council.

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