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Australian Loan Council: Arrangements and Experience with Bailouts

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1. Introduction*

In most countries, public borrowing by subnational governments is subjected to some restrictions imposed by the national governments. In a recent study of 53 selected countries, researchers at the International Monetary Fund found that all but six countries imposed such restrictions.[1] Public borrowing by subnational governments was altogether prohibited in 16 countries, while 19 countries did not allow subnational governments to borrow overseas. The controls in the remaining countries vary in detail and have been classified by the authors of the IMF study into the broad categories of administrative controls, rule-based controls and cooperative controls.

A common objective of controls on subnational borrowing appears to be to exercise restraint over the growth of public debt at the subnational level. The reasoning behind the need for administrative controls is that if subnational governments were free to raise public loans, they would borrow excessively, hence the need for externally imposed fiscal discipline in the form of administrative controls. It is now recognized, however, that a regime of administrative controls may perversely contribute to excessive borrowing if subnational governments come to expect that in the event of debt servicing difficulties they would be bailed out by the national government.

Following Kornai, who first argued in 1980 that managers would fail to observe financial discipline if they expected their organization to be bailed out of financial trouble,[2] many studies have explored the effects of organizational structures, including fiscal federalism, on incentives, financial performance and fiscal discipline.[3] Since 1927, the Australian Loan Council has been responsible for determining the overall level of public borrowing in Australia, and state government borrowings could not be undertaken without the approval of the Loan Council. The purpose of this paper is to examine the effect of the Loan Council's restrictions on the fiscal discipline of the states. In particular, the paper examines whether, and to what extent, these restrictions might have resulted in bailouts or otherwise contributed to the growth of soft budget constraints for the states.

The rest of the paper is organized as follows. The background to the establishment of the Loan Council, its composition, rules and procedures are outlined in Section 2. Section 3 traces the experience of the Loan Council through six distinct phases and focuses on four specific episodes that marked turning points in the Loan Council's evolution and which had important implications for budget constraints and incentives facing state governments. A brief summary of the main conclusions is provided in Section 4.

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[1] Ter-Minassian and Craig (1997).

[2] Kornai (1980).

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

2. Australian Loan Council

2.1 Establishment of the Australian Loan Council

Australia became a federation on 1 January 1901, when the six British colonies of Australia adopted the Constitution of the Federal Commonwealth of Australia under which the Commonwealth government was created as the national government of Australia. The Constitution did not provide for coordination of public borrowing, and until 1922 the Commonwealth and the States borrowed individually. A voluntary Loan Council was formed in 1923 to avoid competition among governments for public loans. Four years later, 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 subject to subsequent ratification by their respective Parliaments. The necessary legislation was passed by each of the Parliaments in 1928. As there were doubts about the Constitutional validity of some parts of the Financial Agreement, the preamble to the Agreement acknowledged that it could not be given permanent effect until the Constitution had been appropriately amended. The insertion of a new section, 105A, into the Commonwealth Constitution was approved at a referendum held in November 1928. The referendum was approved in all States and received endorsement from 74 per cent of all voters. According to one source:

> The overwhelming support [for the referendum] undoubtedly resulted from the enthusiastic assurance given to voters that that the amendment would restrict future government borrowing and pay off existing public debt. Most people in the [nineteen] twenties had a phobia about public debt. 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 the public debt per head of population![4]

The Financial Agreement empowered the Commonwealth government to make agreements with the States in respect of their public debt, including (a) the takeover of such debt, (b) the management of such debt, and (c) the borrowing of money by the States or by the Commonwealth for the States. The Australian Loan Council 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 defense purposes and for temporary purposes, though, could still be undertaken without the approval of the Loan Council.[5] Initially, borrowings of local and semi-government authorities were also outside the Loan Council's control. When it became clear, however, that this exception might become a loophole for avoiding the Loan Council's discipline, the exception was removed in 1936 with the passage of the so-called Gentlemen's Agreement, which brought the exempted borrowings under the purview of the Loan Council. During the late 1970s, the Loan Council's control over the borrowings of semi-government authorities was progressively

[4] Mathews and Jay (1972), p. 109.

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

relaxed until the Gentlemen's Agreement was finally terminated in 1985, when the distinction between borrowings of the State governments and their semi-government authorities was removed under the new Global Limit Approach (see Section 3.5 below).

2.2 Composition and Procedures of the Loan Council

Formally, the Loan Council consists of the Prime Minister (or a Minister nominated by him) and the Premier of each of the six States (or a Minister nominated by each Premier). In practice, the Federal Treasurer represents the Commonwealth and chairs the Loan Council meetings, even though the Prime Minister also attends most of the meetings. Similarly, the State Treasurers represent their respective States at the Loan Council, although some other State Ministers may also attend if required by the agenda of a certain meeting.

The meetings of the Loan Council are always held in camera. No minutes of the meetings are published and only formal resolutions passed at a meeting may be released after the meeting. In principle, a meeting of the Loan Council may be called by the Commonwealth or by any three States at any time. In practice, the Loan Council usually meets at least once a year, at the same time as the Premiers' Conference, due to the common membership of the two bodies and the convenience of considering fiscal issues that are often interrelated. Indeed, it is not uncommon for a meeting of the Premiers' Conference to convert itself into the meeting of the Loan Council for considering a certain issue and convert back into a meeting of the Premiers' Conference to resume an unfinished agenda. In spite of its importance in Australian federalism, there is no specific place or building assigned to the Loan Council and it has no separate secretariat; the Commonwealth Treasury provides the secretarial support for the Loan Council. In recent years, the procedures of the Loan Council have been amended to consider and approve certain resolutions informally through correspondence, which can be noted at a subsequent formal meeting.[6]

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 decisions on the Loan Council.

In understanding the commitment of the States to the discipline of the Loan Council it is important to recognize that the agreement between the States and the Commonwealth in 1927 to establish the Loan Council was not an isolated initiative to impose Commonwealth control over State borrowing. Instead, it was part of a broader agreement that simultaneously addressed a number of outstanding issues of intergovernmental financial relations at the time. Consequently, in complying with the provisions of the Financial Agreement, both levels of government had more at stake than

[6] Commonwealth Budget Paper No. 3, 1996-97, p. 43.

just the coordination of public borrowings.[7] In addition to the establishment of the Loan Council, the Financial Agreement also provided for the following changes to intergovernmental financial arrangements:

- 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.

In the context of potential bailouts and incentives for the States, the following aspects of the new arrangements were particularly important:

- All State loans would now be issued in the name of the Commonwealth;
- The States were only partly responsible for meeting the cost of servicing their debt, as the Commonwealth was also making contributions to the national Sinking fund on their debt;
- The States almost always needed to (at least 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 lower than it would be if the States were borrowing in their own names.

2.3 The Functions of the Loan Council

The main purpose of the Loan Council is to coordinate domestic and overseas borrowings of the States and the Commonwealth. This involves determining the total amount of funds that may be borrowed in a particular year. Such determinations are made in the light of submissions made by the seven governments regarding their respective needs for borrowings, and on the advice of the Commonwealth Treasury and the Reserve Bank of Australia[8] concerning macroeconomic conditions and the likely responses of the capital markets. Generally, the States have sought to borrow more than what the Commonwealth considered to be feasible and what the capital markets were prepared to lend at reasonable rates of interest. Accordingly, the Loan Council has often found it necessary to scale down the original demands made by the States for borrowings.

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[7] According to Mathews and Jay, the Nationalist-Country Party governments at the Commonwealth had been seeking to control the States' borrowings for some time before the Financial Agreement of 1927 (1972, pp. 98-99).

[8] Before the Reserve Bank of Australia was established in 1960, the Commonwealth Bank played the role of the central bank and at times influenced the decisions of the Loan Council (see Section 3 below).

The Loan Council's next function is to allocate the aggregate borrowing for the forthcoming financial year among the States. The procedures dictate that the Loan Council must either approve an allocation unanimously or invoke the formula-based allocation. In the event of the formula-based allocation is invoked, each State's share of the year's total public borrowing would be equal to its share of the net loan expenditure during the previous five years. Although the Loan Council has never invoked the allocation formula, until recently its allocations each year have been aligned with each State's formula entitlements. It is common, however, for a State to voluntarily transfer a part of its allocation to another State in a particular year.

The Loan Council is also responsible for determining the terms and conditions, and the timing of the approved loan raisings. In practice, however, responsibility for monetary policy confers on the Commonwealth government, again acting on the advice of the Reserve Bank of Australia and Commonwealth Treasury, a decisive role in these matters.

The objectives and priorities of the Loan Council have continued to change during the past seventy years, and this has been reflected in the evolution of its rules and procedures over this period. This evolution can be divided into six periods, each of which represents a separate phase in the life of the Loan Council as an institution responsible for the coordination of public sector borrowings in Australia.

3. The Evolution of the Australian Loan Council

3.1. From Competition to Voluntary Coordination: 1901-1927

As noted above, all governments in Australia competed with one another between 1901 and 1922. Some voluntary coordination occurred in 1916 and 1917, when the Commonwealth government raised loans in London on behalf of five States; New South Wales raised its own loans. Competitive borrowing was resumed in 1918 and all governments borrowed heavily in London in the following few years.[9] At the 1923 Premiers' Conference, a voluntary Loan Council was formed, which would seek to coordinate the timing, interest rates and other terms and conditions of public borrowings, but which had no authority for determining the total amount of loan raisings or issuing centralized securities. Both levels of government were under pressure for heavy borrowing during this period: the Commonwealth for repaying its war debt and the States for financing their capital programs, unemployment benefits (a State responsibility at that time) and revenue deficits.[10]

The voluntary arrangement worked reasonably well, although there were occasions when the full support of all members of the voluntary agreement was not

[9] Net indebtedness of the Commonwealth increased from 0.2% of GNP in 1909-10 to 11.0% in 1918-19, while for the States the corresponding figure remained unchanged at 1.9% of GNP. After the First World War, however, the Commonwealth was able to use the high growth in its revenues to reduce its net indebtedness to 0.6% of GNP by 1928-29, whereas indebtedness of the States had increased to 2.9% of GNP.

[10] See Mathews and Jay (1972).

forthcoming. For example, in February 1924, the Commonwealth requested the States to withhold their loan offerings until its own $39 million conversion loan at 6 per cent had been dealt with. While Queensland, Western Australia and Tasmania complied with this request, New South Wales, Victoria and South Australia issued their own securities, interest on which was not only 6 per cent but was also exempt from State income taxes.[11] Agreement was reached in July 1924, however, for the Commonwealth to issue a cash loan for the States in Australia while the States continued to issue their own securities in London. Again, the States kept off the domestic capital market between July and December 1925 so as to allow the Commonwealth loans to be raised as a matter of priority. New South Wales pulled out of the voluntary Loan Council after the Labor Party won an election in July 1925 and J. T. (Jack) Lang became the Premier of that State. The State rejoined the voluntary Loan Council after Labor lost office in December 1927. It will be noted below that Lang returned as Premier of New South Wales in 1930 and became involved in some of the most memorable clashes with the Loan Council in 1931 and 1932.

3.2. Rule-based Coordination: 1928-1950

The first major test for the Loan Council, formally established in 1927, came during the Great Depression of 1930-31. The 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. Advances by banks to Australian governments increased nearly ten-fold between June 1929 and 31 December 1930, from $11 million to $106 million.[12] 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.

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. These measures were part of the prevailing orthodoxy, which favored balanced budgets, high taxes, high interest rates and cuts in wages for increasing the level of economic activity and reducing unemployment.

3.3 New South Wales Defaults in 1931 and 1932

In October 1930, the Labor Party won a sweeping victory in New South Wales on the platform of lower interest rates and credit expansion. 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

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[11] Ibid., p. 106.

[12] Ibid., p. 164.

the other States, particularly Victoria and South Australia, Lang urged the Commonwealth to approach the various Australian banks, including the Commonwealth Bank, to obtain a temporary accommodation for financing the difficult budgetary situation.[13]

After consulting with the other banks, the Chairman of the Commonwealth Bank informed the Loan Council in December 1930 that the banks insisted on all governments keeping their expenditure within the limits of their respective budgetary income. "Not until Australia as a whole is prepared to accept this fundamental principle can the banks see any hope of extricating Australia from her difficulties and eventual disaster," he wrote. He added, however, that the banks would be 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 June 30, 1931.

The Commonwealth Bank's reply in effect conveyed a stern warning to the governments to rein in their public expenditure. 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 percent[14] by January 1931 further aggravated the budgetary impact of the economic downturn as the real burden of interest payments on foreign loans increased correspondingly. 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) favored 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, favored 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.[15]

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[13] Shann and Copland (1931, p. 82).

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

[15] Similar disagreements over policies to deal with the depression occurred in other countries. For example, in the United States, President Hoover's State of the Union Address in December 1931 emphasized 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

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 member of the New South Wales Labor Party to resign and form a new Lang Labor Party.[16]

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 previously 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."[17] 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[18] withdrew Lang's commission and dismissed him from the office of the

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confidence, jeopardize the financial system and actually increase unemployment (see De Long, 1998, p. 75).

[16] These developments in 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.

[17] Maclaurin (1937).

[18] 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

Premier of New South Wales on 13 May 1932. In the ensuing State election on 12 June 1932, the Labor Party was badly defeated by the coalition of the United Australia Party and the Country Party. Thus came to an end an episode in the Australian federation's history that cemented the dominant position of the Commonwealth, which was able to impose its decisions on dissenting members of the Loan Council.

This episode also overshadows Jack Lang's considerable contributions 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 the Loan Council 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 interest rates. Similarly, he proposed that in the event that unanimity was not 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.[19]

Lang's proposal that the 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 authorized 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 ofmaterial 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 [$1,014] 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."[20]

Equally importantly, Lang did not favor overspending or overborrowing in the usual meaning of the terms. Instead, he was opposed to the Loan Council's deflationary

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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 (ie. 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.

[19] Mathews and Jay (1972, pp. 113-115).

[20] Maclaurin (1937, pp. 84, 94, 95-96).

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.[21]

3.4 States' Reliance on Commonwealth Lending

The post-war boom in investment in Australia was reflected in private gross fixed capital expenditure increasing 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 1949-50 and 1950-51 and 34 per cent in 1951-52. The States were planning to borrow on an increasing scale but found out during this period that their demand for funds could not be met without additional loans from the Commonwealth, which would gain in consequence greater control over their borrowing programs.

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 a vote, which the Commonwealth was able to win in spite of opposition from four States.[22] 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 in insisting 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 eventually had to 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.[23] Constituting a significant proportion of the States' borrowing programs, special loans became a major source of Commonwealth control over State borrowings during the 1950s and 1960s.

3.5 Loan Council Constraints and the Commonwealth: The Overseas Loans Affair

As noted above, the Commonwealth government's domination of the Loan Council was attributable to both its unequal voting rights in the Council and its financial superiority in comparison to the States. As demonstrated by the overseas loans affair of 1974-75, this

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

[22] 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.

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

did not mean, however, that the Commonwealth government could disregard the constraints and rules of the Loan Council.

In 1974-1975, the government of Prime Minister E. G. (Gough) Whitlam was blamed for failing to observe the rules of the Loan Council, and the overseas loans affair became a contributing factor in Whitlam's dismissal in November 1975. The overseas loans affair started in December 1974, when the Commonwealth Minister for Minerals and Energy, Mr. R. F. X. (Rex) Connor was authorized by the Executive Council to raise large overseas (petro-dollar) loans of up to $4,000 million for what was described at the time as temporary purposes. The authorization was given at a meeting of the Executive Council that was attended by the Prime Minister, the Federal Treasurer, the Federal Attorney-General and Mr Connor, but at which the Governor-General was not present. Neither the Loan Council, the Parliament, nor the Federal Cabinet had been consulted or notified about the loans. The matter became public as a result of a newspaper report in May 1975. The manner of the authorization for the loans attracted strong public criticism of the government for violating the Financial Agreement, under which all member governments were obliged to seek Loan Council approval for the term and conditions of loans, even those for temporary purposes. In any event, Mr. Connor was later reported to have said that the loan monies were to be used to finance an energy crisis program over several years. In the face of strong criticism by the State Premiers at the Loan Council, the Commonwealth government revoked the state's authority for overseas loans in May 1975. The Prime Minister dismissed the Federal Treasurer (Dr. Jim Cairns) in July 1975 for misleading the Parliament. Connor resigned from the ministry in October 1975.

The overseas loans affair occurred at a time when the Labor government was facing a hostile Senate, which had already blocked the passage of several bills that had been passed by the House of Representatives. Until October 1975, the Leader of the Opposition, J. M. (Malcolm) Fraser had maintained that the Opposition would not block funding in the Senate "in the absence of extraordinary and reprehensible circumstances." After October 1975, Fraser cited the circumstances leading to Connor's resignation as a justification for refusing to pass the Commonwealth Budget in the Senate. The failure of Mr. Whitlam to assure the passage of the Budget before funds ran out led the Governor-General (Sir John Kerr) to dismiss Whitlam as Prime Minister on 11 November 1975 and to install Fraser as the caretaker Prime Minister. The Labor Party was soundly defeated by the Liberal-Country Party Coalition in the general election held in December 1975, when Malcolm Fraser became the new Prime Minister.

3.6 Relaxation of Loan Council Controls

As noted above, the Financial Agreement did not provide for the coordination of borrowings undertaken by local government authorities and semi-government authorities of the States. In 1936, when it was recognized that the States could avoid Loan Council discipline by setting up such authorities for borrowing on their behalf, a Gentlemen's Agreement was signed by the Commonwealth and the States, which required that

borrowing programs of larger semi-government authorities be approved by the Loan Council.[24]

Borrowings by State and Local government authorities increased sharply between 1977-78 and 1983-84 and were responsible for the strong growth of State and local public sector borrowings as a percentage of GDP (Table 1). Progressive relaxation of the Loan Council restrictions by the Commonwealth government during this period was the main factor behind this growth. In response to the widely shared prospect of a resource-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 the energy and mining sectors. At the 1978 meeting, the Loan Council approved new guidelines and established a separate category for borrowing programs that could 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. In 1982, the Loan Council decided to exempt from its approval domestic borrowings of State electricity authorities. A year later, this exemption was extended to all other larger semi-government authorities.

Overseas borrowing for infrastructure projects was 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 approval. From July 1983, the States were virtually free to allocate their overseas borrowings between their semi-government authorities, and overseas borrowings undertaken by such authorities became merely a sub-component of the overall global total.[25]

The States took full advantage of the new opportunities and borrowed heavily during this period, within Australia and overseas, for infrastructure program. 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 revenues, which were not at the time covered by the Loan Council controls.

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 than that (2.6%) 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

[24] Initially, semi-government authorities borrowing more than $200,000 in a financial year were covered by the provisions of the Gentlemen's Agreement but in subsequent years the threshold amount was adjusted upward several times.

[25] Commonwealth Budget Paper No. 7, 1984-85, p. 36.

sector borrowing had increased to 8.3 per cent of GDP in 1983-84, the highest level in post depression years.

3.7 The Global Borrowing Limits

It was clear by 1983-84 that the Gentlemen's Agreement was no longer an effective instrument for imposing Loan Council discipline on subnational borrowings. At its 1984 meeting, the Loan Council suspended the Gentlemen's Agreement and adopted a new global limit approach, for a one-year trial, for restoring the authority of the Loan Council. The following year, a global limit approach was adopted on an ongoing basis and the Gentlemen's Agreement was terminated. The central feature of the new approach was that the longstanding distinction between the borrowings of the semi-government authorities and of the rest of the government was abandoned. 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.

Table 1
Public Sector Borrowing in Australia
(percent of GDP)

	Commonwealth		**State & 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).

The undertaking given by each government to respect the new global limits covered all semi-government and local authorities, companies and trusts that were effectively controlled by governments. Borrowings by 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 installment purchase by government departments, were progressively added to the list of borrowings covered by the global limit.

Consistent with the Commonwealth government's policy of fiscal restraint during this period, funds approved by the Loan Council under the States' global limit were progressively reduced from 1984-85 onwards. The reductions made were 6.9 percent in real terms in 1985-86, 15.4 percent in 1986-87, 19.5 per cent in 1987-88 and 22 percent 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 (see Table 2), the global limit approach was successful, at least in the initial years of its operation, in halting 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).

3.8 Resistance to the Global Limit Approach

In 1988, Queensland refused to endorse the global limit set by the Commonwealth for that State and refused 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 of $793 million set by the Loan Council for that year.

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 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.

The background to the Queensland episode of 1988 was partly economic and partly political. As noted above, from 1985-86 onwards, the Commonwealth government had imposed on the States a policy of unprecedented fiscal restraint. Net Commonwealth payments to the States and the Northern Territory had been reduced in real terms by 0.5 percent in 1985-86, 1.1 percent in 1986-87, and 4.4 percent in 1987-88. At the 1988 Premiers' Conference and Loan Council meeting, the Commonwealth proposed a further

cut of 7.0 percent in real terms to these payments.[26] These cuts would reduce Commonwealth net payments in 1989-90 to 6.8 percent of GDP, the lowest level since 1961-62. The States had unsuccessfully resisted the cuts at each Premiers' Conference. As noted above, the Loan Council had applied even greater cuts to the States' borrowings since the introduction in 1984-85 of the new global limit. 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.[27] 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 among the States (see Table 3). The disproportionate cut in Queensland's 1988-89 global limit reflected the Commonwealth's 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 Ahern's refusal to accept the Loan Council's decision. Ahern was attending his first Premiers' Conference and Loan Council meeting in May 1988 as Premier and Treasurer of Queensland, having replaced Bjelke-Petersen the previous December. 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 practiced 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 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. T. R. (Russell) Cooper replaced 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 in opposition.

[26] Government of Victoria, *Commonwealth-State Financial Relations in the 1980s*, Victorian Treasury Discussion Paper No. 1, Department of the Treasury, Melbourne, June 1990.

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

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.

The Loan Council decided in 1990 that the allocation of global borrowings to individual jurisdictions would be moved progressively to equal per capita shares. The Commonwealth also 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, different States now faced different interest costs for their borrowings (see Table 2), whereas previously all States were charged the same rate of interest by the Commonwealth government.

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. In 1992, it was agreed to amend the Financial Agreement 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 2
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.

3.9 Retrospective Bailout of Victoria

At its May 1991 meeting, the Loan Council approved a basic global borrowing limit of $3,750 million for all States. This figure represented zero nominal increase over the previous year's approved global limit but was a reduction of nearly $400 million on the actual borrowings in 1990-91, which had exceeded the approved limit. Special temporary additions of $818 million were added, however, to the 1991-92 basic global limit, of which $300 million was for Victoria. Actual borrowings in 1991-92, however, far exceeded these figures, with Victoria's borrowings increasing from $1,137 million in 1990-91 to $ 2661 million in 1991-92.

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 stock 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.

State Treasurer R. A. Jolly resigned in April 1990, followed by Premier John Cain, who resigned in August 1990 and was replaced by 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, the 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 the 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 Jeff Kennett replaced Kirner as Premier of Victoria.

At the December 1992 meeting, the Loan Council retrospectively approved additional borrowings totalling $2,981.5 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 strengthen its reporting requirements and to shift its focus to prospective budgetary situation and strategy of each jurisdiction.

3.10 The End of the Global Limit Approach

At its meeting on 7 December 1992, the Loan Council 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."[28] It was also recognised that neither the aggregate global limit nor its allocation was directly related to a jurisdiction's fiscal circumstances. From 1 July 1993, global borrowing limits were replaced by the new Loan Council Allocations (LCAs). The new approach was designed to signal a change in the philosophy of the Loan Council from insisting on a rigid regime of compliance to one based on a framework that was both credible and transparent. Together with the Loan Council's scrutiny, market exposure of State finances is expected to provide greater fiscal discipline.

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 upon with the jurisdictions to allow flexibility in the event that economic forecasts are not realized. Each jurisdiction is obliged to report to the Loan Council on an annual and quarterly basis regarding its budgetary situation, and 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.[29]

The new Loan Council Allocations system is intended to:

- Facilitate financial market scrutiny of public sector finances via better reporting and so make jurisdictions more accountable to markets;

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[28] Australian Loan Council, *Future Arrangements for Loan Council Monitoring and Reporting*, Loan Council 5 July 1993, p. 1.

[29] 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.

- Enhance the role of the 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.[30]

4. Summary and Conclusions

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."[31] On the other hand, the foregoing discussion in this paper reveals that the Loan Council's decisions concerning subnational borrowings have been virtually dictated by the Commonwealth government, which has exercised its dominant position in Australia's revenue raising system to override any opposition by the States.

The High Court of Australia has interpreted the Constitutional restrictions (section 90 in particular) to virtually exclude the States from the field of taxation on the sales or consumption of goods.[32] Since 1942, when the Commonwealth gained a monopoly over income taxation in Australia, the States have been extremely constrained in respect of their revenue raising powers.[33] The combined effect of these decisions is that the States collect less than 17 per cent of national taxation revenue while they are responsible for nearly one-half of public sector outlays. Thus, the States have become critically and permanently dependent on financial assistance from the Commonwealth. This financial assistance comes in a variety of ways, including general revenue grants, general purpose capital grants and advances, and specific purpose grants and advances. Although some formula-based funding arrangements have always existed to reduce the degree of arbitrariness, 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 impose its decision on Queensland solely because of the threat that, if necessary, it could reduce that State'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 admission made by P. J. Keating (who was Federal Treasurer between 1983-1990 and Prime Minister from 1991-1996) sums up the controlling position of the Commonwealth extremely well:

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[30] Commonwealth Budget Paper No. 3, pp. 67-68.
[31] Minassian and Craig (1997, pp. 158-159).
[32] See Grewal (1998).
[33] See Mathews and Grewal (1997) for a detailed discussion and references on this topic.

> The national perspective dominates Australian political life because the national government dominates revenue raising, and only because the national government dominates revenue raising.[34]

The establishment of the Loan Council in the 1920s provided a rule-based mechanism for the coordination of public loans at a time when the market-based competitive system of public borrowing had proved to be counterproductive. As noted above, from 1951 onwards the Commonwealth government became more influential in the determinations of the Loan Council, thanks to its ability to provide special loans to the States. Commonwealth support, however, proved to be a double-edged sword for the States. On the one hand, it enabled them to borrow on a larger scale than they could have borrowed on their own at reasonable rates of interest. On the other hand, the special loans also made it possible for the Commonwealth to dominate the Loan Council and, through it, national policy on capital outlays and public investment.

The Commonwealth government lost its way, however, towards the end of the 1970s, when it relaxed Loan Council controls on borrowings for infrastructure programs, which resulted in a blow-out of subnational borrowings in the 1980s. In the mid-1980s, concerns over Australia's current account deficit and foreign debt led the Commonwealth into enforcing a strategy of severe fiscal contraction, which culminated in the recession of 1990-91. During this period, the Loan Council again served as an important vehicle for enforcing Commonwealth policy on the States.

Throughout this period, however, the Loan Council's approach targeted public borrowing by the States indiscriminately, with little attention to the different needs of individual States. After the financial deregulation introduced in Australia during the mid-1980s, the Loan Council's discipline over the States became increasingly ineffective. The Council was generally a step behind the States and was often engaged in closing loopholes that had been exploited by some of the States through new and innovative schemes for avoiding accountability.

Although the Loan Council did not bail out the States explicitly, it did contribute to softening their budget constraints implicitly through special additions to the borrowing programs and global limits from time to time. Supplementations of this kind did not, however, always distort the States' fiscal choices. When the supplementations were provided *ex post*, as in the case of the defaults by New South Wales in the 1930s and the retrospective bailout of Victoria in 1992, they did not become a part of the States' expectations and are unlikely to have distorted their decisions. But whenever the supplementations were provided *ex ante,* as was the case under the borrowing arrangements for infrastructure projects, or under the global limit approach, they distorted the incentives facing the States and resulted in sharp increases in the level of borrowings. Following this reasoning, the arrangements of the Loan Council can be considered to have been successful and non-distorting, except for the period between 1978-89 and 1992-93.

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[34] Keating (1991).

It is clear from the above discussion that the Commonwealth government's domination of Australia's public finances is extremely important in understanding the Loan Council's role in the coordination of subnational borrowings. It has been argued above that the Commonwealth government was able to use the Loan Council as an instrument of its own 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.

Another consequence of the Loan Council arrangements, not often recognized, was that the smaller States benefited from the formula based allocations of the Loan Council. These allocations provided implicit financial equalization that undoubtedly helped the less populous States, which otherwise would not have been able to raise the same amount of capital resources in the market. Indeed, it is possible to argue that the present Loan Council arrangements may well contribute to widening economic disparities between the States by removing this form of financial equalization and by increasing the exposure of the States' capital programs to market forces.

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