DEPARTMENT OF THE PARLIAMENTARY LIBRARY

INFORMATION, ANALYSIS
AND ADVICE FOR THE PARLIAMENT

RESEARCH NOTE

2001–02
No. 43, 18 June 2002

The Australia Loan Council

Australia is unique among federations in that it has a mechanism—the Australian Loan Council—to coordinate borrowing by Federal and State governments. The exercise of this function has, however, changed considerably over time. The purpose of this Research Note is to describe how the Loan Council has evolved and to explain its current role.[1]

Origins

The Loan Council's origins lie in the 1920s when the Commonwealth and States competed for funds on capital markets. The Commonwealth wanted to refinance war debt while the States wanted to fund infrastructure programs. To resolve this and other conflicts, the May 1923 Premiers' Conference agreed to form a voluntary Loan Council. Its prime function was to coordinate the timing of debt issues and deal with other matters such as interest rates on issues of securities.

In 1927, the Commonwealth submitted a draft Financial Agreement to the Loan Council. The draft proposed, among other things, that the Loan Council be made a statutory Commonwealth body and that existing arrangements be formalised. The Loan Council formally came into being in 1927, and the ratified Financial Agreement was incorporated into the *Financial Agreement Act 1928*. This Act, provided among other things for:

- the Loan Council to regulate borrowing by the Commonwealth and States
- the Commonwealth to borrow on the States' behalf
- limits on the States' borrowing powers
- the Commonwealth and the States to contribute to the National Debt Sinking Fund to redeem debt, and
- the Commonwealth to provide grants to the States to help them meet interest payments and Sinking Fund contributions.

The 1928 Financial Agreement has been altered on a number of occasions to take account of new developments.

Gentlemen's Agreement

The 1928 Financial Agreement did not encompass borrowing by Commonwealth and State semi-governmental and local authorities. In 1936, it was resolved under the so-called 'Gentlemen's Agreement' to bring these authorities' borrowings into the Loan Council's ambit to prevent them from circumventing the Council's borrowing limits. This Agreement remained in effect until 1984–85 when the so-called Global Borrowing limits were introduced.

Policy Shift

A major change to the role of the Loan Council took place in the 1950s when the Commonwealth increasingly saw it as an instrument of macroeconomic policy. Early in the 1950s, Australia faced strong inflationary pressures, and the Commonwealth Treasurer advocated reducing Council-approved borrowing to ease these pressures. The Commonwealth's influence over the Loan Council was strengthened by the fact that the Commonwealth undertook to provide funds to the States if the States were unable to raise, through the issue of securities, any borrowing that the Loan Council had approved. In effect, the Commonwealth agreed to underwrite State borrowing.

From a State perspective, this was a mixed blessing. On the one hand, the States were under pressure to acquiesce to the Commonwealth's demands and its increased influence over their fiscal affairs. On the other hand, the Commonwealth's undertaking to underwrite State borrowing gave the States access to guaranteed levels of funding at reasonable interest rates.

Global Borrowing Limits

The Gentlemen's Agreement unravelled when some States used 'unconventional' financing techniques—such as financial leases—to circumvent its restrictions. The States also established borrowing authorities—such as the New South Wales Treasury Corporation—which they used to circumvent Loan Council borrowing limits. In 1984, the Loan Council suspended the Gentlemen's

Agreement and replaced it with Global Borrowing Limits. This 'global approach', among other things, limited the level of all new borrowings—conventional and unconventional—by Commonwealth and State authorities.

1993–94 Arrangements

However, the global approach also broke down. A major reason was the increasing use of sophisticated financing techniques that eroded the Loan Council's effectiveness. The 7 December 1992 Loan Council meeting therefore adopted new arrangements for monitoring and reporting. Under these arrangements which came into effect in 1993–94, each jurisdiction nominated a Loan Council Allocation, which was based on its net borrowings as indicated by its deficit/surplus.[2] The arrangements also changed the way in which borrowings were allocated among the States. Previously, the global limit was allocated by a formula based on State population. But this formula did not take account of a State's particular fiscal circumstances. The Loan Council therefore considered the nominations having regard to each jurisdiction's fiscal position and 'reasonable' infrastructure needs as well as the macroeconomic implications of the total nominations.

The Loan Council Today

The Loan Council is formally a Commonwealth—State Ministerial Council comprising the Commonwealth Treasurer as chairman, and State and Territory Treasurers. It operates under the *Financial Agreement between the Commonwealth, States and Territories*—which is incorporated as a schedule to the *Financial Agreement Act 1994*—and came into effect on 1 July 1995. The Financial Agreement includes changes agreed at the June 1992 Loan Council meeting. The changes:

- removed the requirement for Commonwealth and State borrowings to be approved under the Agreement
- removed the Commonwealth's explicit power to borrow on the States' behalf
- abolished the restriction on State's borrowing through the issue of securities in their own names, and
- included the Australian Capital Territory and Northern Territory as members (they previously had observer status).

It can be seen that these changes—especially the removal of the requirement that borrowings do not have to be approved—constitute a major restructuring of Loan Council powers. Current arrangements seek to emphasise transparency of public sector finances, through financial market scrutiny of proposed borrowing to restrict borrowing to prudent levels.

The mechanism for determining a jurisdiction's allocation is that each jurisdiction nominates a Loan Council Allocation for the forthcoming year. The Loan Council meets once a year to consider the nominations having regard to each jurisdiction's fiscal position.

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ISSN 1328-8016

1. For a fuller description of arrangements until mid-1992, see Denis James, 'The Australian Loan Council (Second Edition)', *Background Paper*, no. 29, Department of the Parliamentary Library, 1993–94. Subsequent developments can be found in Budget Paper No. 3 for various years.
2. Loan Council Allocations comprised the estimated general government deficit/surplus, the public trading enterprise sector net financing requirement, and certain other items. Net borrowings are a more meaningful indicator of a jurisdiction's exposure to financial markets than gross new borrowings used under global limits.