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Guarantee of State and Territory Borrowing Appropriation Bill 2009

Richard Webb
Economics Section

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Guarantee of State and Territory Borrowing Appropriation Bill 2009

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House: House of Representatives

Portfolio: Treasury

Commencement: On Royal Assent

Links: The relevant links to the Bill, Explanatory Memorandum and second reading speech can be accessed via BillsNet, which is at http://www.aph.gov.au/bills/. When Bills have been passed they can be found at ComLaw, which is at http://www.comlaw.gov.au/.

Purpose

The Guarantee of State and Territory Borrowing Appropriation Bill 2009 (the Bill) has two main purposes. The first is to provide an appropriation enabling the Commonwealth to pay any claim made under the Commonwealth's Guarantee of State and Territory Borrowing (see below). The second purpose is to enable the Commonwealth to borrow funds to meet a Guarantee should there be inadequate funds in the Consolidated Revenue Fund.

Background

As a consequence of the recession, state and territory governments are incurring budget deficits. In addition to incurring operating deficits, the states and territories (hereafter referred to as 'the states') are expanding infrastructure investment to help counter the recession.[1] The states are therefore embarking on substantial borrowing programs.

Much of this investment will be undertaken by government trading enterprises such as water, electricity and port authorities, railways, etc. The states (except the Australian

1. The budget deficit of the general government sector has two elements. The first is the net operating balance, that is, the difference between current revenues and expenses. The second element is the net acquisition of non-financial assets. Technically, infrastructure investment (for example, investment in roads) is the net acquisition of non-financial assets. The budget deficit is the net operating balance less the net acquisition of non-financial assets. Net refers to the difference between acquisitions and disposals of assets.

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Capital Territory) have established central financing authorities, which are responsible for raising funds for all sectors of government including government trading enterprises.[2]

Associated with the recession has been increased caution of the part of lenders generally. They are demanding greater certainty that they will be repaid because the risk of loan default has risen. This increased caution has, amongst other things, put upward pressure on interest rates. For their part, the states wish to maintain their credit ratings because a fall in those ratings would mean having to pay higher interest rates on borrowed funds. The states are therefore trying to balance their desire to increase infrastructure investment, on the one hand, and limit borrowing to avoid jeopardising their credit ratings, on the other hand.

Basis of policy commitment

On 25 March 2009, the Rudd Government announced that it would provide to the states and territories a 'time-limited' guarantee over state borrowing:

> The Rudd Government will take further action to support jobs and protect vital infrastructure plans from the global recession by providing a time-limited, voluntary guarantee over state government borrowing.
>
> This important measure recognises that pulling back on critical nation-building infrastructure investment now would mean ever slower growth and higher unemployment into the future.
>
> Like bond markets around the world, state government bond markets have been hit hard by the global recession.
>
> This has threatened the capacity of state and territory governments to deliver critical infrastructure projects that will support jobs in the face of the global recession, as well as boost productivity and improve living standards in the medium and long-term.
>
> That's why the Rudd Government – in consultation with the state and territory governments – has taken this decisive action to support jobs and protect vital nation-building plans.
>
> **Details of the scheme**
>
> The guarantee will be available for both existing and new issuances of securities, but will not extend to issuances denominated in foreign currencies.
>
> The guarantee will be available over a range of maturities. This will allow states to more readily structure their finance requirements to meet their longer-term

2. The three sectors are general government, public non-financial corporations, and public financial corporations. Public non-financial corporations are often called government trading (business) enterprises. The state central financing authorities are examples of public financial corporations.

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infrastructure plans and prevent the potential crowding which would occur if the maturity of eligible securities was limited to shorter term issuances. States will have the option to determine whether any eligible issuance is subject to the guarantee. The guarantee also extends to the existing stock, should states choose to take up the guarantee for those securities. The option to guarantee existing stock is open to states for 28 days.

The Commonwealth will charge a fee for the use of the guarantee. The fee has been set according to historical experience of borrowing spreads, and at a level that provides an incentive for states to cease utilising the guarantee when market conditions normalise (see below).

Credit Rating	Fee (existing stock)	Fee (new issuance)
AAA	15 basis points	30 basis points
AA+	20 basis points	35 basis points

This approach will provide an appropriate set of incentives for those states which choose to use the guarantee. The guarantee fee needs to provide a balance between facilitating access to the market whilst also providing a disincentive to use the guarantee once market conditions have normalised.

The volatility and significant uncertainty that is evident in the current market environment means that it will be necessary for the guarantee fee arrangements to be reviewed on an ongoing basis and revised if necessary.

A website will be established to transparently display information on guaranteed securities and related scheme details.

The Loan Council will provide an additional level of transparency and rigour to the operation of the guarantee, as state borrowing requirements will continue to be considered by the Loan Council through the Loan Council Nomination process. In particular, scrutiny via the Loan Council will ensure that the states have to account for their infrastructure spending

The provision of a guarantee will increase the Commonwealth's contingent liabilities, and this will be reflected in the Commonwealth's financial statements. This change in the Commonwealth's circumstances will also be reflected in the disclosure documents which allow banks and states to access foreign debt markets. The existing disclosure documents have been withdrawn and will be replaced as soon as possible with updated versions reflecting the details of the guarantee of state borrowing.

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> The Commonwealth views the likelihood of state default as remote and unquantifiable. Nevertheless, should any payment be required under the guarantee it will be handled in a timely fashion.[3]

Committee consideration

The Bill has been referred to the Senate Economics Legislation Committee for inquiry and report by 16 June 2009. Details of the inquiry are not yet available.

Position of significant interest groups/press commentary

The following is a small sample of reactions to the guarantee. In general, reactions were favourable although questions remain about aspects of the proposal.

Infrastructure Partnerships Australia, the peak body representing private sector infrastructure providers, welcomed the guarantee, saying that it will help state governments to undertake more infrastructure investment.[4]

David Crowe (the Australian Financial Review) noted that the general response to the guarantee was positive and that the announcement of the guarantee resulted in a fall in the cost of state borrowing.[5] However, he also noted questions over the extent of the guarantee.

Laura Tingle (the Australian Financial Review) observed that while most market commentators had argued for a temporary guarantee, the duration of the guarantee is indefinite.[6] The shadow Treasurer, the Hon Joe Hockey, is reportedly critical, among other things, of the absence of a cap on the Commonwealth's potential liability.

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3. W Swan (Treasurer), *Temporary guarantee of state borrowing*, media release, 25 March 2009, viewed 1 June 2009, http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/027.htm&pageID=&min=wms&Year=&DocType=0

4. Infrastructure Partnerships Australia , *Commonwealth guarantee good for infrastructure: says peak body*, media release, 25 March 2009, viewed 1 June 2009, http://www.infrastructure.org.au/Content/COMMONWEALTHGUARANTEEGOODFORINFRASTRUCTURE.aspx

5. D Crowe, 'Swan throws debt lifeline to the states ', *Australian financial review,* 26 March 2009, p. 1, viewed 1 June 2009, http://parlinfo.aph.gov.au/parlInfo/download/media/pressclp/SK4T6/upload_binary/sk4t60.pdf

6. L Tingle, 'Political, financial risks abound', *Australian financial review*, 26 March 2009, p. 8, viewed 1 June 2009, http://parlinfo.aph.gov.au/parlInfo/download/media/pressclp/6L4T6/upload_binary/6l4t60.pdf

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Lenore Taylor (the Australian) quoted the director of Access Economics, Chris Richardson, as saying that the problem with the guarantee is that it puts more pressure on borrowers who do not have the guarantee: "The trouble is we can't guarantee everybody—the more people we include under the guarantee, the more pressure it puts on everybody outside the guarantee".[7]

Key issues

An alternative to guaranteeing state borrowings would be for the Commonwealth to borrow on the states' behalf. Historically, the Commonwealth did this on the grounds that its greater borrowing power and perceived financial stability would enable it to borrow on more favourable terms than if state governments sought to raise funds on their own behalf.[8] However, by 1998-99, the Commonwealth ceased borrowing on the states' behalf as the states increasingly assumed responsibility for fund raising.

As noted, the states have established centralised borrowing authorities. These authorities raise funds for the entire state government sector including government trading enterprises. Arguably the Commonwealth's decision to cease borrowing on the states' behalf has forced the states to be more financially responsible because they now have to raise funds. Having to do so, this argument holds, forces the states to be cautious in their borrowing and use of funds. This is particularly the case given that, historically, some states sought to bypass limits that the Loan Council placed on state borrowings.[9]

A feature of the legislation is that it is open-ended in time and amount. The Minister's media release refers to the guarantee as being 'time-limited'. But there is nothing in the legislation which refers to any such limit. Further, the legislation does not place a limit on the Commonwealth's potential financial liability. Potentially, the Commonwealth government could be called on to pay claims under a Deed of Guarantee or to repay state borrowings. For the moment, the likelihood of this happening seems low given that the states are, so far, limiting borrowing and taking other measures to preserve their credit ratings. The states know that a loan default would be especially damaging for them.

7. L Taylor, 'Swan's $150 bn lifeline to states', *The Australian,* 26 March 2009, viewed 1 June 2009, http://parlinfo.aph.gov.au/parlInfo/download/media/pressclp/9M4T6/upload_binary/9m4t62.pdf

8. D James, *Federal-State Financial Relations: The Deakin Prophecy*, Research Paper, no. 17, 1999-2000, p. 33, Parliamentary Library, Canberra, 2000, viewed 2 June 2009, http://www.aph.gov.au/library/pubs/rp/1999-2000/2000rp17.pdf

9. For an overview of the role of the Loan Council, see R Webb, *The Australian Loan Council*, Research Note, no. 43, 2001-02, Parliamentary Library, Canberra, 2002, viewed 1 June 2009, http://www.aph.gov.au/library/pubs/rn/2001-02/02rn43.pdf

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While the risk to the Commonwealth's coffers may seem low now, much will depend on developments in the world and Australian economies. Should the recession get worse and the states seek to borrow more, the greater the likelihood that the Commonwealth will be called on to meet its undertakings, that is, assume greater risk of having to meet its undertakings.

Much will also depend on how contracts are written between state governments and infrastructure providers, particularly as to which party assumes various risks in the event that projects fail. Providers will be keen to ensure that state governments assume as many financial and other risks as possible. The Commonwealth will therefore have a strong interest in ensuring that state governments do not unnecessarily assume risks and thereby be in a position to 'pass the buck' to the Commonwealth. This will require careful oversight of state activities. Arguably, given that the Commonwealth is assuming risk under the guarantee, the Commonwealth should have some oversight of how contracts are written and, more generally, how the states spend funds. In short, the guarantee could lead to greater centralisation of economic policy making.

A question that arises is the future of the Loan Council in limiting state borrowing.[10] In particular, the Commonwealth may have to be more forceful in the Loan Council to restrict state borrowing in order to limit its own potential exposure under the guarantee.

The passage of the Bill may encourage some additional lending or lending on more favourable terms to the state central financing authorities. However, it is impossible to quantify these potential effects.

Standing appropriations

The Bill provides a standing appropriation to enable the Commonwealth to pay claims to under a guarantee, and repay borrowings (including interest), if required.

Main provisions

Clause 3 contains two definitions. The definition of a ***Deed of Guarantee*** has two elements:

- it must be executed on behalf of the Commonwealth in 2009 [**paragraph 3(a)**],

10. On 25 March 2009, the Loan Council approved an additional $13 billion in new issues for 2009-10 and $13 billion for 2008-09. See W Swan (Treasurer), A Fraser (Queensland Treasurer) and T Buswell (Treasurer of Western Australia), joint press conference, 25 March 2009, viewed 1 June 2009, http://www.treasurer.gov.au/DisplayDocs.aspx?doc=transcripts/2009/045.htm&pageID=004&min=wms&Year=&DocType

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- it must be entitled “Deed of Guarantee in respect of the Australian Government Guarantee of State and Territory Borrowing” [**paragraph 3(b)**],

as that deed is in force from time to time.

The second definition is of ***Scheme Rules***. They are those identified in the Deed of Guarantee as those Rules are in force from time to time.

Clause 4 – Application within and outside Australia states that the proposed *Guarantee of State and Territory Borrowing Appropriation Act 2009* applies within and outside Australia. Presumably this allows the Commonwealth to issue guarantees to overseas lenders. It also allows the Commonwealth to borrow overseas, should it be required to borrow money under **clause 6** (see below).

Clause 5 – Appropriation is a standing appropriation, and provides that the Consolidated Revenue Fund is appropriated to:

- pay claims under the Deed of Guarantee in accordance with the Scheme Rules [**paragraph 5(a)**]
- repay a borrowing, and interest on a borrowing, made under section 6 [**paragraph 5(b)**]

Clause 6 – Borrowing provides that the Minister may borrow money for the purposes of paying claims under the Deed of Guarantee [**subclause 6(1)**]. However, the period of the borrowing must not be for a period longer than 24 months [**subclause 6(2)**]. **Subclause 6(3)** defines ***borrow***, for the purpose of clause 6, as including raising money or obtaining credit, whether by dealing in securities or otherwise, but specifically does not include obtaining credit in a transaction forming part of the day-to-day operations of the Commonwealth. This definition ensures that money borrowed under this clause will be quarantined from being used to finance day-to-day government operations.

Concluding comments

From the Commonwealth’s perspective, the nature of the guarantee is that it assumes a contingent liability. This liability is unquantifiable. It may be the case that the Commonwealth will never have to meet its undertakings under the guarantee but that is not certain. A more immediate test of the success or otherwise of the guarantee is the extent to which the guarantee succeeds in freeing up funds for borrowing by the states that might not otherwise have been available.

The Commonwealth may receive some revenue if the states pay fees. At this stage, the amount, if any, is unquantifiable because the states have to determine what course of action they will pursue.

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