BORROWING TO COMPETE OR SURVIVE A PANDEMIC? - NEW DIRECTIONS IN AUSTRALIAN FISCAL FEDERALISM

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To cite this article:
Fenwick, Tracy Beck (2023): Borrowing to compete or survive a pandemic? - New directions in Australian fiscal federalism, Cuadernos Manuel Giménez Abad, Special Issue 9.
DOI: 10.47919/FMGA.CM23.0112

ABSTRACT

This paper shows that Australian net debt by government sector in 2021-22 was at an all-time high, higher than that experienced during the previous GFC crisis. It provides empirical evidence the contribution of the states and territories to all Australian public debt accumulation is currently higher relative to any other point in the history of Australian federalism. The percentage increase of the states' net public sector debt since 2011-12, has considerably outpaced the Commonwealth's. The key question, therefore, is whether these increases in public debt represent a critical juncture in Australian Fiscal Federalism, or, if they are simply pandemic related driven? Australian fiscal arrangements make the states and territories extremely fiscally inflexible during times of crisis. The paper establishes that Australia indeed does have the necessary conditions to pressure increasing state indebtedness in the future. These conditions, however, have not been sufficient to produce high levels of subnational debt accumulation in Australia, relative to other more decentralized federations.

Keywords: Fiscal Federalism, Australia, Subnational Public Debt Accumulation, Soft Budget Constraints.

I. INTRODUCTION

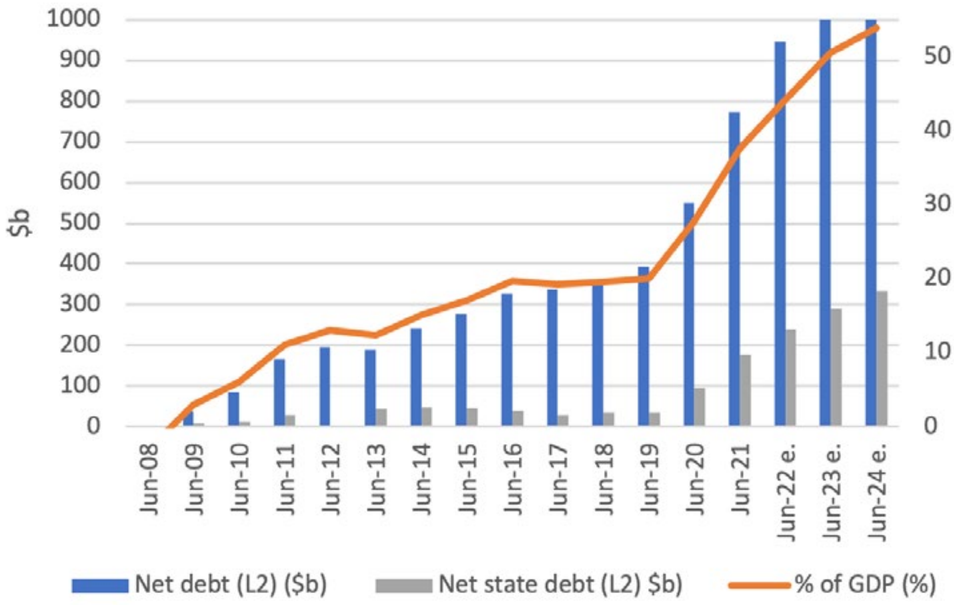
Two deep economic crises have impacted public finances in Australia, the Global Financial Crisis 2008-2009, and the more recent COVID19 Health Pandemic 2019-2022. These events are different, but they are similar in that they each have the potential to expose both the strengths and weaknesses of fiscal arrangements in a federation. In Australia, the most recent COVID19 pandemic, followed by its consequential expenditure shocks, then revenue and supply shocks, have impacted the levels of states and Commonwealth[1] net public sector debts, and thus State-commonwealth fiscal relations. Relative to other federations, Australia historically maintains one of the highest levels of vertical imbalance in the world (VFI).[2] The Commonwealth raises approximately 80 per cent of tax revenues and then redistributes these revenues as both tied and untied grants to the states and territories. As a percentage of GDP, all Australia net public sector debt has risen from a historical low of -6.4% in 2007-2008, to a high of 33.8 % in 2021-22 (ABS, GFS 2021-22). In comparison to other federal countries however, subnational debt remains relatively low, representing only 21% of all Australian public sector debt and 8.6% of total GDP as of June 30, 2021 (see Figure 1). This level of subnational public debt is in stark contrast to more fiscally decentralized federations like Canada, where subnational debt to GDP exceeds 40% (Hanniman, 2020).

In fact, as is clear in figure 1 below, that Australia not only survived the *Global Financial Crisis* (GFC) of 2008-09 but emerged largely unscathed. Throughout the GFC, Australia maintained the lowest debt-to-GDP in the OECD and maintained its AAA credit ratings with global rating agencies—ratings that were extended to the states vis-à-vis the *Commonwealth's Guarantee of State and Territory Borrowing (*Parliament of Australia, 2009). Therefore, vis-à-vis this mechanism during the GFC, the Commonwealth temporarily re-inserted itself as the guarantor of state loans to protect the states from rising global interest rates, protect state-based credit ratings, and ensure their continued access to the foreign debt market. In principle, because of Australia's ability to engage in large countercyclical spending projects such as infrastructure spending to counter the recession and quickly finance federal economic stimulus plans, Australia did not go into economic recession during the GFC.

1. In Australia the "federal" or "central" government is referred to as the "Commonwealth"

2. VBI refers to a situation where subnational units in a federation spend more than they collect, making them dependent on the centre for fiscal resources.

Figure 1: All Australia general and state government sector net debt (L2) as a percentage of GDP



Source: Author elaboration using ABS, National Financial Statistics, Using the GDP annual series as published in Table 36 in the December quarter 2021 issue of Australian National Accounts: National Income, Expenditure and Product. L2 is comparable to government reporting of net debt under Australian accounting standards.

Beyond providing a new analysis of the extent and growth of public debt in Australia, the central goal of this paper is to explore why this most recent crisis (2019-2021), created an increasing need for states and territories to borrow—resulting in them running up their public sector debts to higher than historical levels. Moreover, the key theoretical question is whether this is a critical juncture in Australian fiscal federalism, or simply a short-term pandemic created problem? Empirically, the key question is whether increasing indebtedness is driven by a structural problem, whereby Australian states and territories have limited "fiscal flexibility" because of Australia's high VFI forcing subnational units to borrow in times of crisis? Or, because other political, fiscal, and contingent factors are driving the increased contribution of the states and territories to all Australia net public sector debt since 2019, relative to both the Commonwealth and historical tendencies in Australian federalism?

The paper will proceed as follows: The next section will provide a brief overview of Australia's federal system focusing primarily on its constitutional fiscal arrangements and the politics and impact of fiscal federalism in Australia during crises. Section three frames the key empirical research puzzle to be solved, the article's central research question, followed by two theoretical propositions and an overview of the key determinant in the literature that explains increasing subnational indebtedness. Section four presents an analytical framework to examine the main hypothesis and to uncover if the key conditions to explain increasing subnational public debt are found in the Australian case. Lastly, the paper concludes with some political and policy implications.

II. BRIEF OVERVIEW OF AUSTRALIAN FEDERALISM

Relative to other federal systems, in particular the U.S. and Canada to which Australia is most often compared, Australia has a highly centralised federal system. In theory, such high levels of fiscal centralisation can undermine the goals of federalism by blurring federalism's accountability mechanisms and constraining the ability of the states to diversify their policy options. Federal systems have the dual challenge of having to provide safeguards against the threat of centralized exploitation, as well as decentralized opportunistic behaviour. Australia was federated in 1901, bringing together six (originally five) sovereign states and two territories. In part however, because of Australia's original constitutional design and its high court's subsequent judicial interpretations, fiscal federalism has been a core element of the Commonwealth's growth since federation and its progressive centralization (Galligan, 2012). Fiscal federalism simply refers to how taxing, spending, and regulatory functions are allocated among governments and how intergovernmental transfers are structured.

Under Section 51 of the Australian National Constitution, the Commonwealth has broad taxation powers including personal income tax and the GST tax, customs duties, excises on fuel, alcohol, and tobacco, and petroleum resource rent tax. Currently for example, states and local governments collect less than 20 percent of tax revenue raised in Australia, raising just over half of the revenues they require to fund their expenditures. In 2020-21, the Australian government contributed 46.4 percent of states spending and approximately half of its revenues supplied by the Commonwealth were tied to national goals, priorities, and programs (Commonwealth of Australia, 2022). The size of discretionary transfers relative to non-discretionary transfers thereby provides the Commonwealth ample room to set the direction of policy priorities and policy directions while meanwhile credit-claiming for co-financed policy successes along the way. Moreover, the Commonwealth's power to grant monies to the states *on such terms and conditions as the (national) Parliament thinks fit* is enshrined in Section 96 of the National Constitution. This implies that non-discretionary funding to the states is also *de jure* subject to federal discretion. An extensive discussion of untied transfers to the states which are primarily delivered through *Australia's Horizontal Fiscal Equalization System* (HFE), is outside the goals of this paper.

The key point of this overview section is to underscore that the original Australian Constitution and Fiscal Constitutionalism (referring to subsequent judicial interpretations), makes the states and territories largely fiscally dependent on the centre to fund, to deliver, and to provide public services within their jurisdictional authority—primarily health, education, and infrastructure, among others. As Galligan succinctly asserts (2012, p. 327): "VFI was not precluded; indeed, it was there at the beginning, and only diminished as the states began levying their own income taxes, which they did up until the Commonwealth monopolised that field in 1942." After the imposition of uniform income taxation that was deemed to be a temporary 'crisis measure' related to WWII war measures, but was never returned to the states, the Commonwealth was undisputedly *de jure* and *de facto* considered to be responsible for the state of the National Economy, and the primary borrower in the federation.

There have been some constitutional challenges to federal encroachment of income tax overtime, however, it was not opposed by most states, and when NSW and Victoria did challenge it in 1957, it became judicially clear that a state government could have rejected its federal grants under Section 96, and instead levied their own income tax, but history has shown us that no state was willing to take this decision (Stewart, M., n.d., pg. 13). For example, the idea was floated again in 1976 by Malcolm Fraser's Coalition Government that passed the *States (Personal Income Tax Sharing) Act* (Fenna, 2018), and again in Tony Abbott's short-lived *White Paper on Federation Reform* (2015), but the idea of the states levying their own income tax (on top of the existing Commonwealth income tax), has simply failed to receive much concrete traction or interest at the level of the states for reasons that will become apparent in the following section.

1. The Politics and Impact of Fiscal Federalism in Australia during Crises

Historically and globally, it is well known that crises—war, national disasters, global economic downturns, and more recently health pandemics, necessitate extraordinary fiscal responses. Moreover, although crises are often justified to necessitate moments of national control and leadership while often demanding public sacrifice, they also create unique political opportunities. Mentioned in the previous overview section, this opportunity was first seized upon in Australia by the central government during WWII to impose uniform taxation. As a former Senior member of the Australian parliament commented to the author recently, "the Commonwealth never misses the opportunity of a crisis". The Commonwealth's unlimited expenditure power however (Section 81), even during a crisis, was recently tested during the GFC when Mr. Pape challenged the then Labour government's "Cash Splash", a fiscal stimulus measure during the GFC designed to provide individual payments to families adding up to one per cent of GDP to stimulate the economy (Pape vs. Federal Commissioner of Taxation 2009, 238 CLR 1.). Pape's argument in the High Court was to reject the various judges' claims, that constitutional responsibility for the national economy, especially in times of crisis, might entail or imply extra or special spending powers (see Galligan, 2012, pgs. 334-337). In the end, the High Court allowed the Rudd—Australian Labour Party government (ALP) to make the GFC related stimulus payments as intended to individual taxpayers, but it denied *de jure* that the Commonwealth had unlimited expenditures powers. This federal spending power has been used again during the COVID19 crisis, but it has not been challenged again in the High Court.

The major parties of Australian federal democracy are the Australian Labour Party (ALP)— (currently in 2023, they are holding both the Commonwealth and all but one of the states, Tasmania), and the Liberal-National Party Coalition (that held power during the COVID19 pandemic and was defeated nationally in 2022). Some historical tendencies between Australia's two major political parties' biases regarding their tendencies towards centralisation (anti-federalist), versus decentralisation (pro-federalist) have been documented (Hollander and Patapan, 2007). Both national parties, however, have recently used the commonwealth's expenditure powers under Section 81 of the Constitution, to spend at will during crises on countercyclical fiscal stimulus spending measures. The Labour government did so during the GFC vis-à-vis the *Tax Bonus Act* discussed above, and more recently the Liberal-National Coalition did during the COVID19 crisis vis-a-vis the Commonwealth's *JobKeeper* and *JobSeeker* programs. The extraordinary power of the Australian federal government to both dominate taxation and exercise its expenditure power has meant that whichever national political party governs through a crisis has tended to play a central role in managing its economic consequences—even if this entails exercising expenditure power outside of its jurisdiction. It should be noted however, empirically, that the ability of Australia to provide direct fiscal responses during the acute phases of the COVID19 crisis was related to its lower pre-pandemic debt and a smaller fiscal deficit relative to other countries (Hudson et al., 2021).

Out of the six states and two territories that held elections during the acute and recovery phases of the pandemic, only two of six were defeated that of SA in 2022 and NSW in 2023. No incumbent state government that held elections during the acute phase of the pandemic was defeated. According to the results of the 2022 Australian Election Study (AES), respondents were much more negative about the federal government's handling of the crisis than their own state governments, with just 30 percent saying the federal government had handled the pandemic well (Cameron et al., 2022, p. 32). This potentially indicates that although the Australian voter is cognizant that the federal government is responsible for managing the national economy, good management of the economy alone from 2019 to 2022, was not enough to secure the incumbent government's reelection. According to the authors of the AES, "further analysis of the AES data shows a much stronger relationship between evaluations of the pandemic response and voting behaviour than evaluations of the national economy and voter behaviour (Ibid, p. 33).

Notwithstanding, responsibility for the pandemic measures was assumed almost entirely by the states as it is the states that operate the public hospitals; the government school systems; and the police and emergency services agencies; regulate and licence business; and control the criminal and civil law (Lecours et al., 2021). It was also the decision of each state when to shut and when to reopen its borders. As former Prime Minister Scott Morrison said "We [the Commonwealth] never said there should be borders. That was never the health advice, it was never the agreement. That was something they [the premiers] came up with on their own" (Keen and Payne, 2020). Control by the states over border closure decisions had a tremendous impact on both trade, business, and tourism, resulting in significant lost payroll taxes which is a state-based tax. Although state premiers were re-elected during the pandemic for keeping their territories protected due to what they claimed was the success of their border restrictions, it was in fact precisely because as Fenna describes "the national income tax regime acts as a regional insurance regime" (2018, p. 137). The extent of fiscal centralization and extraordinary federal support offered during the pandemic blurred premiers' accountability for the length of their border closures. Most small businesses that reported revenue declines because of COVID-19 were kept afloat because of the federal government's direct fiscal response of the Commonwealth's Jobkeeper program. Subnational delegation of taxation authority in Australia, during times of crisis, should be considered a marketable asset on behalf of states as it distances them from the direct economic impact of their emergency policy responses at the ballot box.

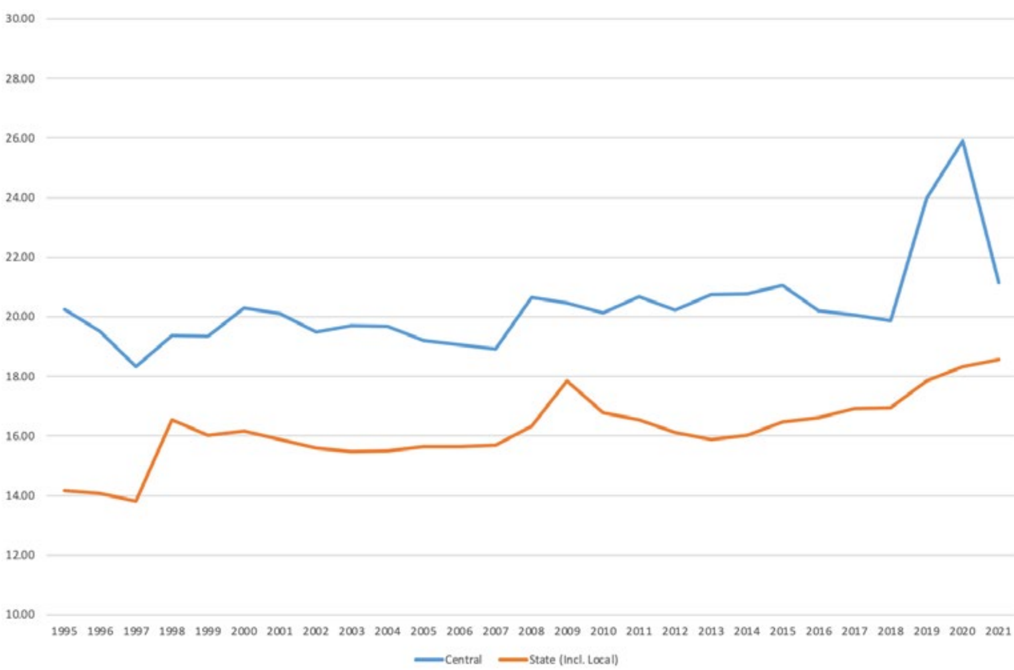
As can be observed with the case of states border closures during the pandemic, the actual distribution of authority does not preclude the fact that the Australian public often cannot discern who is responsible for which policy. Accountability is precisely blurred because of the extent of the VBI. The federal government, for example, supports 50 per cent of the states' health expenditure, and 59 per cent of their education expenditure through *Specific Purpose Payments* designed to provide funds for state and territory governments tied to specific policy goals in areas for which the states have primary responsibility (Commonwealth Government of Australia, 2022). Therefore, as documented theoretically in other federations by Wlezian and Soroka (2011), a combination of federal conditional transfers and subnational policymaking makes it hard for individual survey respondents such as those recorded in the AES data to know which level of government did what. Moreover, unique to the Australian case, the extent of federal fiscal dominance provides a perpetual shirking mechanism for the states to blame their states' policy responses on the lack of federal fiscal support.

Notwithstanding the *status quo* of fiscal federalism in Australia, the continued operating deficits at all levels of government during the recent health pandemic necessitated unprecedented levels of public debt accumulation in Australia. Commonwealth expenses increased considerably during the acute phases of the pandemic from 2019-2021 because of direct fiscal spending stimulus. Net public sector debt in Australia increased by 38% in 2020-21, since 2018-19. Although this was in part related to pandemic-related expenditure increases, net public sector debt in Australia has increased every year from a net lending position in 2007-08, which coincides with the GFC (ABS, 2021). Most interesting from a fiscal federalism perspective, however, is the fact that while Commonwealth net public sector debt increased 21.9 per cent in 2019-20, relative to the previous year, state net public sector debt increased 142.9 per cent in that same year, rising in all states and territories except W.A. (Ibid). Therefore, while the contribution of state debts to all Australia net public sector debt remains considerably low compared to other federations (only 25 per cent of total Australian debt in 2021-22), during the pandemic states contribution tripled from 8.2% in 2018-19. In fact, the Commonwealth sector's share of net public sector debt is at its lowest since 2013-14, while the state sector is at its highest (Ibid.) Does this imply the states were contributing to more of the heavy lifting during the pandemic? Is this evidence of a critical juncture in Australian fiscal federalism?

III. FRAMING THE PUZZLE: INCREASING PUBLIC SECTOR DEBT FROM THE 2008 GFC TO THE COVID19 PANDEMIC

As mentioned at the outset, Australia not only survived the *Global Financial Crisis* (GFC) of 2008-09 but emerged largely unscathed. Throughout the GFC, Australia maintained the lowest debt-to-GDP in the OECD. The GFC did not have a lasting impact on national or subnational finances, primarily for contextual reasons. Although the deterioration of global economic conditions and the need to introduce significant economic stimulus measures increased the net debt position of major OECD economies, Australia's initial position in terms of the strength of its government finances was very different. Its strength relative to other OECD economies was primarily related to its first significant mining boom from 2004 to 2007, successive budget surpluses, and asset sales, all of which resulted in Australia achieving its historical lowest levels of net debt, -3.8% in 2007-08, prior to the onset of the GFC (Di Marco et al., 2009). Thus, even though state expenditure as a percentage of GDP did increase during the GFC (see figure 2), it was easily covered by the Commonwealth's then surpluses and the successful reform of federal-states financial relations that were negotiated in the context of the 2008 crisis. Moreover, given the extent of government surpluses prior to the GFC, increases in government spending began in 2005. Compared to the COVID19 crisis therefore, the GFC did not have a significant impact on central government expenditure. Beyond the federal stimulus spending mentioned in the previous section, the Australian government also did not have to bail out major financial institutions, and its decision to keep interest rates low, further bolstered the economy and enabled it to avoid a recession.

Figure 2: Australia: Consolidated government expenditure as percentage of GDP



Source: OECD Fiscal Federalism Database.

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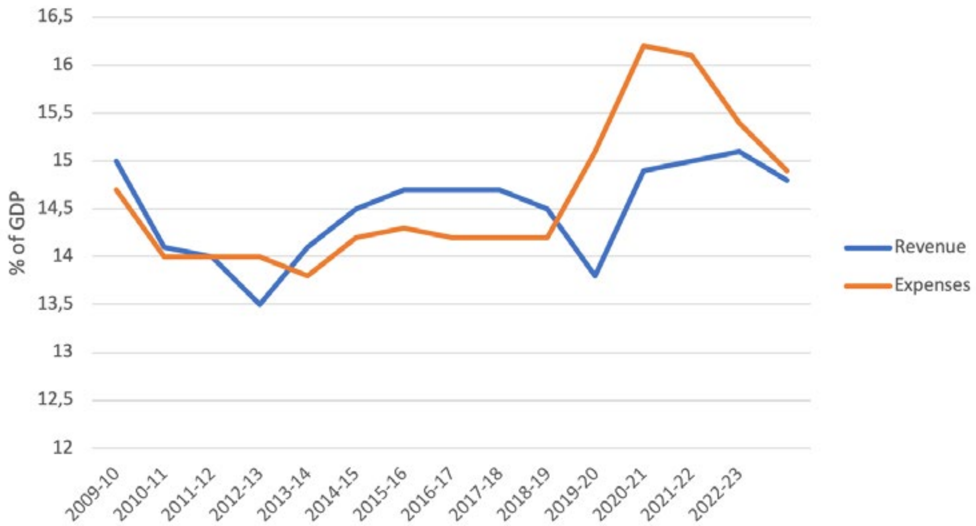
The COVID-19 crisis however, plus other subsequent emergency disasters such as the 2019 bushfires and the 2022 flooding events in Queensland and New South Wales (NSW), have had a severe and lasting impact on national and subnational finances. Taxation revenue fell at most levels, specifically income tax and GST for the commonwealth, and stamp duties and land tax for the states and territories. On the revenue side however, the fall in taxation hurts the Commonwealth and necessitates absolute borrowing more than at the state level because of the VBI, which means the federal government alone collects 80 per cent of total revenues. Ironically decreases in state taxation revenues during the pandemic were partially offset by gambling taxes that are not factored in as a revenue source by the *Commonwealth Grants Commission* (CGC) when calculating state relativities for equalization payments, payments which are paid out of the nationally collected GST tax. On the expenditure side, the *Australian Bureau of Statistics* (ABS) reported in 2022, a 4.6 per cent decrease in total government expenditure from 2021 levels. Notwithstanding, total government expenditure remains higher compared to pre-pandemic levels.

Moreover, at the subnational level, the financial impact has been uneven despite Australia having one of the most egalitarian horizonal equalization systems (HFE) in the world. The larger Eastern States of NSW and Victoria improved upon their net operating balances during the acute phase of the pandemic indicating they are in economic recovery, while the smaller states of Tasmania and Northern Territory with lower revenue raising capacity have had no change, and the mining/resource endowed states of Queensland and Western Australia both recorded positive net operating balances in 2022 (ABS, 2022). In Western Australia (WA) for example, their surplus is the result of having secured a politically negotiated bilateral fiscal deal with the Commonwealth in 2018, that guarantees a minimum revenue floor coupled with strong mineral royalties emanating from its high levels of iron ore production. Taken together, these two factors are the main drivers of a net operating surplus (revenues-expenses) of 8.6 % in WA (2020-21), compared to Victoria's operating deficit of -19.7% (2020-21).[3] Notwithstanding, aggregated state expenses surpassed revenues from 2019 to 2022 in a continuous fashion relative to previous years but are improving (see Figure 3).

Figure 3: Aggregate State Revenue and Expenses



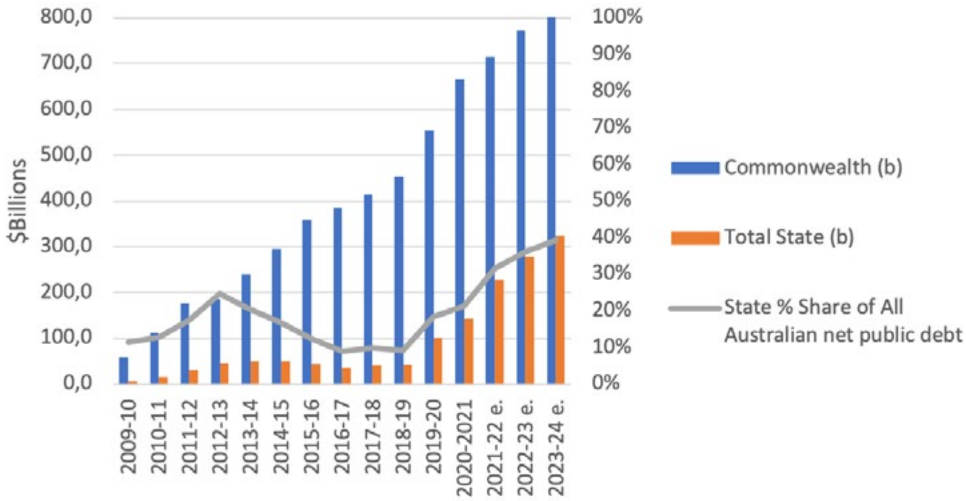
Source: Author Elaborated, ABS, 2022

3. Data sourced from the Australian Parliamentary Office (2022).

1. Why are the States/Territories contributions to All Australia Net Debt Increasing?

Given Australian fiscal federalism arrangements, the Commonwealth continues to be seen as the ultimate provider of subnational revenues and creditor of state debts. Therefore, because of Australia's notoriously high VFI, the Commonwealth has largely absorbed the fiscal shock of COVID19. It remains evident in figure four below that the bulk of Australia's net public sector debt is carried by the Commonwealth. The key point to be noted however, is the proportion of states contribution to total debt is increasing. Since 2018-19, aggregate state net debt relative to the commonwealth's net debt has increased from 9% to 33% in 2021-22, and is expected based on Australian Parliament Office Budget Projections to continue growing to an all-time high of 38% of total national net debt by 2024-25, or stated otherwise, 14.6% of GDP.[4]

Figure 4: Main Contributors to All Australia Net Public Sector Debt



Source: Author Elaborated based on ABS (2021) and Commonwealth of Australia (2022).

The Commonwealth's operating deficit is also considerably higher than those of the states and this will continue necessitating central borrowing and increasing national net debt. However, when calculated as a share of its revenues for example, the state of Victoria's net debt level in 2022 (the highest state debt in the federation), was higher than the Commonwealth's (ABC, 2022). In fact, if we take 2011-12 as the base year to calculate the percentage change in the amount of borrowing undertaken by each level, the Commonwealth is borrowing 236% more than it did in 2011-12, which includes its debt accumulation after the GFC. This is compared to an increase change of 661% that states are now borrowing relative to their 2011-12 level. Therefore, the rate of the states' debt accumulation relative to the Commonwealth's over the past decade in Australia is increasing 2.8 times faster than the Commonwealth's. This is therefore the key puzzle to solved herein: What are the conditions driving the increased contribution of the Australian states and territories to the accumulation of all Australia net public sector debt?

4. Australian Bureau of Statistics (2021).

2. Two Propositions

Theoretically, given that Australian federalism experienced a reinvigoration during the COVID19 pandemic as Premiers took primary leadership roles, it may be possible that new centrifugal forces in the post-pandemic context have increased the public's understanding and expectations regarding the public services and public responses that ought to emanate from the states and territories—especially expectations around making capital investments for future disaster relief and crisis management. Alternatively, from a public finance perspective, the recent pandemic may have simply increased expenditure pressures on the constituent units, while simultaneously decreasing states revenues sources (payroll tax, stamp duties, and property taxes all decreased during 2020-2022). The imbalances in state operating budgets would simply be short-term pandemic related budget deficits.

From the perspective of fiscal federalism and the politics of federalism however, we know that states and territories are not able to slash publicly provided services, cancel large scale pre-existing infrastructure projects, or raise taxes given their limited ability to utilise this mechanism in Australian federalism. Their most obvious option remaining option, if they can, is to borrow cash. Without increases to federal transfers, states must continue to find revenue to provide the services most Australians believe should be paid for by both levels of government, in particular housing, schooling, and childcare and prisons, plus roads and transport (a major infrastructure expense), which they believe should be paid for by the States/Territories exclusively (Biddle et al., 2019). Does the increased contribution of state public sector debt relative to decreasing Commonwealth contributions therefore, in the post-pandemic context, underscore new directions in Australian Federalism? Or do crises simply further accentuate a well-known structural problem in Australian Fiscal Federalism referred to by international credit risk agencies as the *fiscal inflexibility* of the states and territories?

3. The key Determinant: The Rules Regulating Subnation Finance in Australia

Subnational finances are an integral part of understanding the politics of federalism. Who does what, how, and who pays, basically equates to the distribution of power in a federal democracy. The rules regulating subnational finances can undermine the goals of federalism by limiting the ability of the subnational levels to respond to local demands and/or to respond quickly in times of crisis. Conversely, in more decentralized and robust federations where subnational levels have veto power, the fiscal autonomy of the constituent units can also constrain the ability of the central government to deliver upon national policy objectives and achieve nationally uniform outcomes. Political economists specialising in fiscal federalism have long been concerned with the relationship between federalism and economic outcomes, that is, the consequences for overall macroeconomic performance of a federation of how policies are financed and who finances them (Rodden, 2002). Less attention has been paid to how the rules governing subnational finances affect the political will of subnational levels to both innovate, diversify, and invest in the future. One of the principal debates on issues of fiscal decentralization (decentralization being one the public choice prescribed virtues of federalism), revolves around how to manage/regulate subnational spending and debt.

As observed by Makin and Pearce (2014), "there is a surprising dearth of academic literature examining subnational public debt in Australia". In fact, it is only since the 1991 Premiers' Conference and subsequently updated that the ABS provides disaggregate subnational fiscal data (Makin and Pearce, p. 4). Economists however have long been concerned with the sustainability of public debt. While such analysis is normally focused on the national level, there is an increasing interest in examining the fiscal positions at the sub-national level. In developing federal countries for example, subnational fiscal performance has long been a major area of academic research based on the negative effect subnational units can have on macro-economic stability, particularly following on from times of crisis when countercyclical spending increases for both practical and political reasons.

Moreover, while there may be a dearth of academic interest in examining state level fiscal performance and public debt accumulation in Australia, the recent heightened visibility of the states and Premiers since the 2019 bushfires, and the following onset of the COVID19 pandemic in Australia, ought to result in an increased examination of state policy initiatives and their ability to pay for policy variations that ought to follow on from the leadership roles they are increasingly assuming in the eyes of both the public and the media..

Historically, the Australian states and territories have been subject to both *de jure* and *de facto* hard budget constraints. For federal scholars, a *soft budget constraint*, within the context of the rules regulating subnational finances, refers to the responsibility of the constituent units in a federation to cover their budget expenditure out of their allocated central government transfers and own source revenues. If it fails to cover the expenditure of its budget, it will require external fiscal intervention—this can either be in the form of central government bailouts or directly through borrowing. Beyond economic performance, the *soft budget syndrome* as Kornai et. al (2003) originally coined the concept, affects political behaviour and intergovernmental relations. This is because is well known in federalism studies that political motives often induce a federal government to extend fiscal support to certain states and regions. Kornai et al.'s (2003) theoretical propositions assumes that the supporting institution is hierarchically superior to the supported *budget constraint organization*. In our case the states.

In contrast, *hard budget constraints* refer to a situation where constituent units in a federation will not receive outside support to cover their excessive spending and will thus, be obliged to reduce or terminate an activity if the deficit persists. The threat from a hierarchically superior fiscal organization (i.e., the Commonwealth Government in Australia) is only credible when it is both enforceable (*de jure*), and in the vested interest of that same organization (*de facto*).

Unique to the history of Australian federalism is the fact that the states legally abdicated their right to autonomously borrow monies by inserting section 105(A) through a constitutional amendment in 1927. According to Saunders (1990), the transfer of significant levels of state debts was seen as attractive by the six original states at federation in 1901, however if it required Commonwealth control of future state borrowing, (a *de jure* hard budget constraint), it was considered first, unacceptable by the Premiers, and second, complicated as there were significant differences in the size of pre-federation state debts.

Notwithstanding, the issue created by the imbalance between Commonwealth revenue collections and surplus, and the extent of the states' pre-federation debts plus their ability to pay them with limited revenue sources, remained on the early federation's agenda. This issue was finally resolved in 1927, after several years of economic competition and heavy borrowing on the London market by both levels of government. The Commonwealth would finally take over all state debts in exchange for coordinated future borrowing managed by the *Australian Loan Council* (ALC). All future borrowing would be taken out by the Commonwealth on behalf of the states and their programs for borrowing would have to be approved by the Loan Council—when and if they were allowed to borrow directly, was allowable, however the ALC which was dominated by the power of the Commonwealth would still set the global limits as to how much each state could borrow.

It is beyond the goals of this paper to document the entire history of the ALC (see Saunders 1990). Suffice is to say for the goal herein that several *de facto* modifications occurred so that by the 1990s, the states were borrowing on their own behalf, but within the *global limits* set by the ALC. In response to the GFC in 2008 however, when all Australia net debt was at a record low, -3.1 per cent of GDP (ABS, 2021-22), the government increased these global limits and the then Rudd Labour Party Government issued a time-limited voluntary guarantee over state government borrowing to assist the states who were incurring budget deficits by expanding infrastructure investment to help counter the recession (see Parliament of Australia 2009).

While the ALC has long since served its original purpose *(policy drift*), this author and other federal scholars consulted were surprised to discover during this research that the ALC has formally ceased to be operational and has not met since March 2017. According to Commonwealth of Australia's (2018) Final Budget Outcome:

> "Consistent with the 2018-19 Budget, the Commonwealth's Loan Council Allocation is no longer reported. The ALC unanimously agreed to remove the Australian, State and Territory Governments' reporting requirement form Uniform Presentation Framework (UF), [which previously required reporting and disclosures of net debt] and transfer the administration of the UPF to the Council on Federal Financial Relations [reporting to the National Cabinet formed in 2020]"

Therefore, beyond the *Council of Federal Financial Relations* (CFFR), comprising the Commonwealth Treasurer and all State and Territory Treasurers that is the gatekeeper of the *Federation Funding Agreements* (discretionary funding), Australian state and territories are no longer restricted by any statutory or constitutional rules on borrowing, and they are not required to achieve balanced budgets. This are thus under *de jure*, a soft budget constraint. According to the international credit risk agency *Standard & Poor* (S&P), several states have self-imposed fiscal targets and fiscal principals that call for their net debt to be "stabilized" or "sustainable" in the medium term, but are vague about timeframes for achieving this (S&P, 2022). Therefore, subnational public debt in Australia is currently regulated by the market and state electorates. However, given the high credit ratings enjoyed by Australian states and territories, this means in practice, the only identifiable fiscal constraint on excessive subnational borrowing in the context of recent international bond markets is political.

IV. IS PUBLIC DEBT INCREASING BECAUSE THE STATES CAN BORROW FREELY?

The key answer in the literature as to why subnational debt increases is because they can borrow freely, with limited fiscal, political, or institutional constraints. The following empirical section applies Hanniman's (2020, pp. 279-280), analytical framework he developed to analyse the sources of Canadian provinces growing indebtedness. I have used Hanniman's framework to see if in Australia, similar conditions are present, and if they lead to the same outcome—i.e., high levels of provincial/state indebtedness. As a caveat, the goal herein is not to compare Australian subnational to Canadian subnational debt, but rather to compare Australia across two crises (GFC and COVID19), to see if it is moving in the same direction—towards increasing levels of states/territories indebtedness—for similar reasons.

Based on my observations and data obtained from the ABS, I suggest the three key drivers of increasing indebtedness at the state level in Australia case are indeed, like the Canadian case, present, albeit at significantly lower levels because of the extent of fiscal centralization in Australia. As explained in the overview, the VFI is primarily a product of the Commonwealth's taxation power. In contrast with Canadian provinces, the centralized nature of fiscal federalism in Australia means that the states do not have large open-ended expenditures, they are however rigid. Most of the policy sectors the states in Australia are responsible for are funded in partnership with the Commonwealth through closed National and Federation Funding Agreements. The degree of indebtedness of the states, therefore, is driven by their fiscal inflexibility in periods of falling revenues sources and rising expenditure needs (Condition 1). It is however quantitatively less than in Canada, but it equates nevertheless in Australia as a driver of Australian states increasing indebtedness.

Second, Australian states revenue streams are also cyclical (Condition 2), specifically during crises. In Australia, because of the 3-year time lag that is built into Australia's HFE, plus the vulnerability of stamp duty and property taxes on the local property market, and the reliance of payroll taxes on levels of employment including fluctuating resources royalties—makes the states and territories untied, and own-source revenue streams, cyclical. States untied revenue streams in Australia, however, are predominantly used to sustain high levels of infrastructure spending, which is a product of countercyclical spending in times of crisis or during natural disasters. And third, like Canada, the final driver of states increasing indebtedness is their ability to borrow without federal restrictions at low interest rates to cover revenue gaps when needed (Condition 3). According to international credit risk agencies, there are no real constraints to the size of subnational deficits in Australia, "despite what politicians can tolerate and what the bond market can digest" (S&P 2022). Moreover, the three largest states, NSW, Victoria, and Queensland, have borrowed considerably since 2018-19.

Condition 1 and 2 therefore, puts pressure on the states to borrow during times of crisis, including natural disasters such as flooding and bushfires. Most Australian States in the post-pandemic context have had substantially higher borrowing needs occurring because of revenue losses coupled by increased spending needs that has resulted in negative net operating balances (see Table 1). Australian state and territories generally rely on receipts from payroll taxes, transfer duties, gambling taxes, stamp duty, and property tax. Payroll taxes took a significant blow during the COVID19 lock downs. Moreover, the states deliver most high-cost public services such as health and education, which are funded out of tied and untied commonwealth grants that have not been reviewed since 2019-20. States and territories relied on the Commonwealth to fund 46.4% of their operating budget in 2020-21. Additionally, however during the COVID19 pandemic, exceptional powers were also granted to state ministers and premiers with little oversight.

State treasures for example were given power to spend money on a needs basis to meet the "exigencies of government" and Treasurer's advances were increased to cover this emergency spending without the usual parliamentary oversight (S&P September 7th, 2020). According to S&P risk analysis, lifting advance limits plus health and stimulus expenditures coupled by revenue losses does not always imply a debt facility, but does often imply more borrowing to cover operating costs over capital expenditure. Such spending however would be pandemic created and not likely to indicate new longer-term trends in Australian fiscal federalism.

Table 1: Net Operating Balance, State and Local General Government, 2020-22
(% of GDP).

States	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
2020-21	-0.4	-0.8	-0.2	0.3	-0.1	0.0	0.0	0.0
2021-22	-0.4	-0.5	-0.2	0.1	-0.1	0.0	-0.1	0.0

Source: ABS (2022).

Condition 2 however appears to be a larger determinant to increasing indebtedness, specifically in the Eastern States (NSW and Victoria) who had already committed to large infrastructure projects in the pre-pandemic period. Economic stimulus normally equals more borrowing, and the Commonwealth Government has been encouraging state leaders to spend more on higher infrastructure spending. This would signal higher medium to longer-term spending at the level of the states. Former Prime Minister Scott Morrison for example said the federal government's direct economic support of around $251 billion is one of the "most significant COVID responses in the world" (Sky News, 2021). Mr Morrison said the states and territories have also made a valuable contribution to the economic response, committing an additional $122 billion. "But I think even they would say it's fair to say the heavy lifting has been done by the Commonwealth over this past year," he said.

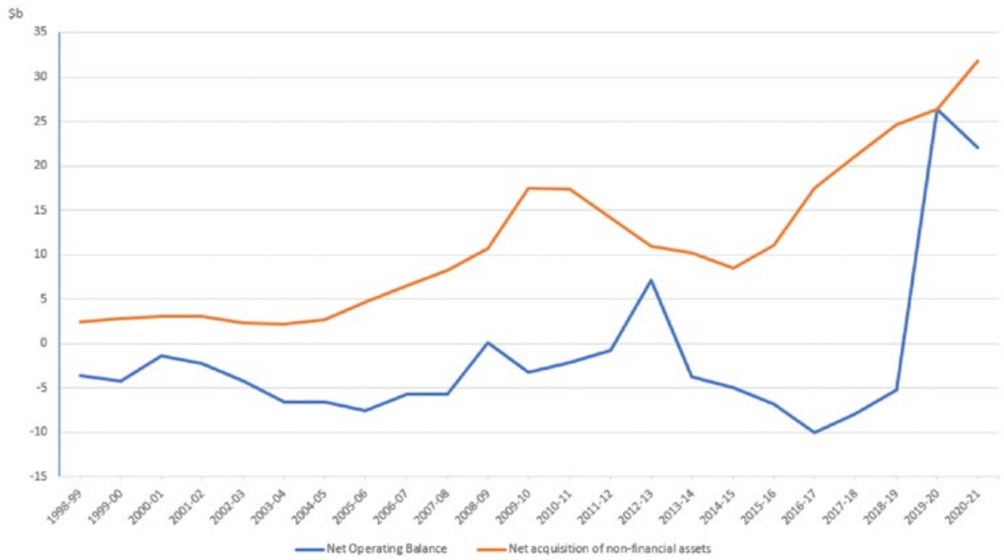
According to my calculations in absolute terms the Prime Minister was correct, but he was not correct when comparing like with like. In 2018-19 the Commonwealth's net debt represented 19.2 per cent of GDP. By 2021-22, this represented a 38-percentage change, equating to 22.5 per cent of GDP. In contrast with the states, in 2018-19 their net debt represented 1.8 per cent of GDP. By 2021-22, their levels of debt had increased by 510 per cent using the pre-pandemic year as a base, equating to a historical high of 8.3 per cent of GDP (ABS, GFS, 2021-22).

Commonwealth pressure on states and territory governments did not begin with the COVID19 pandemic. States/Territories began to expand infrastructure spending as a countercyclical measure following the 2008-2009 GFC recession. During this economic downturn however, the largest constraint to subnational borrowing was what the bond markets could digest. Therefore, the Rudd Government announced in 2009, that it would provide to the states and territories a time-limited guarantee over state borrowing to support jobs and protect vital nation-building plans that were dependent on state infrastructure investment. During the GFC however, the ALC as discussed previously placed *de jure* global limits on state borrowing. Moreover, in contrast with the GFC, international bond market conditions during the acute phase of the COVID19 pandemic were more favourable to subnational borrowing. Bond market conditions are therefore a permissive condition to subnational borrowing under a soft-budget constraint (Condition 3), with the latter being a necessary condition to increasing indebtedness at the level of the states/territories.

Net capital investments are a key driver of subnational public debt levels because the states were already gearing up for an infrastructure boom with several projects already approved by state parliaments, reflecting state-level commitments to large capital infrastructure spending that began in the post-2009 context. Moreover, during the pandemic, Premiers were under considerable pressure from federal policymakers to spend more on infrastructure investment as a fiscal response measure. In contrast with during the GFC however, instead of the Commonwealth guaranteeing state borrowing to ensure favourable contracts, the bond market was able to continue digesting state bond issuances.

This was also enabled because of the Royal Bank of Australia's quantitative easing program that from 2020-2022, purchased A$56 billions of state governments securities on the secondary market, to keep subnational borrowing costs low and bond markets functioning (S&P, Ma2022). It would appear therefore that the biggest determinant of state borrowing is sustained infrastructure investment, that for reasons already discussed, Premiers had to keep financing but could only do so through borrowing because they are fiscally inflexible because of cyclical and limited revenue sources—in particular, during a crisis. As evident in figure five below, during crises both the net operating balances and net capital investments contributed to state-level borrowing, but outside of the crisis/disaster recovery phase, net capital spending appears to be a larger determinant to borrowing than to cover operating costs.

Figure 5: Total State Contribution to GFS Net Lending/Borrowing



Source: ABS, Customised Report, 2022.

To summarize, condition 1 makes state budgets in Australia vulnerable to shocks because of their fiscal inflexibility, and conditions 2 and 3, encourages steady upwards spending, but condition 2 is supported by greater national support during times of crisis and natural disasters because of Australia's institutional arrangements. Condition 3 allows the states to borrow because they can, most recently at historically low interest rates. Credit risk ratings were downgraded during the COVID19 pandemic, one notch in NSW and two notches in Victoria. They remain however two of the highest rated sub sovereign government debt issuers in the world. Government experts also relate this to the "halo effect" whereby Australian states creditworthiness continues to be among the highest on a global scale because of Australia's diversified economy, its strong access to bond markets, and its excellent (federal) institutional settings (S&P, 2020). Even though Australia has no formal bailout procedures (a key enabling condition of the soft-budget syndrome), the VFI in Australia means the public's expectation is that the federal government is responsible for economic performance, and, for providing extraordinary support during crises. For example, during the COVID19 pandemic, the newly formed National Cabinet quickly agreed to a 50/50 shared health funding deal to cover increased health services. And, during natural disasters, this extraordinary support is extended vis-à-vis the *Disaster Recover Funding Arrangements*, whereby the Commonwealth meets 50-75% of assistance costs to individuals and to maintain public services.

Condition 3, therefore, appears to be the one that makes Canada and Australia most alike in contrast to the United States. As Hanniman (2020) highlights, in contrast U.S. states cannot borrow to the same degree, because of widespread balanced-budget legislation. This is like other federations in the Americas such as Brazil and Mexico, where a rules-based hard budget approach to manage subnational debt accumulation is followed—but often at great social costs as was seen in Brazil during COVID19 crisis. The causal mechanism to condition three however, is evidently shown in this research to be fiscal necessity. This is the mechanism that varies most across federations and across crises as it is dependent on unique institutional arrangements and a country's constitutionalism. Even though Australian states are fiscally inflexible, and this makes them vulnerable to shocks—they only collect 20 per cent of Australia's revenues. They have a built-in shirking-mechanism therefore, that blurs lines of government accountability and enables them to continue, in times of need, go knocking on the Treasurer's door.

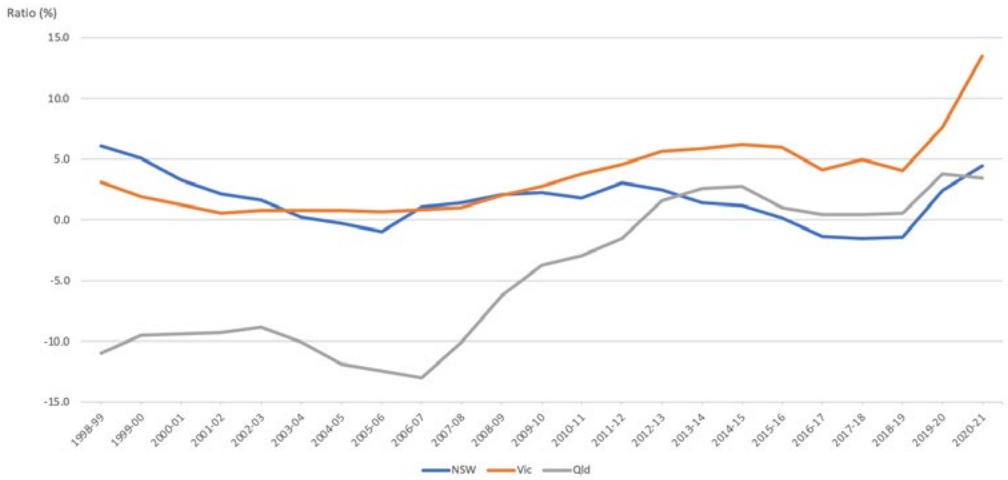
1 Are Australian States Public Debt Fiscally Sustainable?

In the international fiscal federalism literature, one of the greatest concerns are questions around the sustainability of public debt accumulated at the subnational levels. This is because subnational public debt, represents a significant credit risk to macroeconomic stability if it is not monitored. Therefore, if for example, politically speaking, health and education is electorally rewarded in state-level elections, there is a built-in political incentive to spend more. The mechanisms however (legal, political, and fiscal) that incentivise and constrain subnational debt accumulation, as mentioned above, vary considerably across federal systems.

State-level public sector debt in Australia is currently fiscally sustainable. Even with increased global interest rates in 2022, debt interest payments remain historically low. Aggregate state public debt interest payments in 2021-22 were 0.4% of GDP, the same percentage of GDP as in 2011-2012, despite a 661-percentage change to state public sector debt from that same year. Beyond low debt interest payments, the ratio of state net public sector to GSP in Australia is also low. This ratio is frequently used as an indicator of the ability of SNGs to make future payments on their debt.

It remains however, territorially uneven. The Territorial Northern territory has the highest ratio of state net debt to GSP of 20.4%, followed by Victoria at 13.5%, and South Australia at 10.5% (ABS, 2020-21 Consultancy Data). These figures have increased from the previous year, representing approximately five percentage point increases from 2019-20. The Australian Capital Territory continues to have the lowest ratio of public sector debt to GSP of -3.8%, followed by Tasmania with a ratio of 1.1%. Ratio of state net debt to GSP however, has been steadily increasing in the post-2009 context, when the states began to take on a new role in promoting countercyclical spending to boost their economies (see Figure 6).

Figure 6: Ratio (%) of state net debt (L2) (a) to gross state product (GSP) (b), selected states.



Source: Australian Bureau of Statistics.[5]

Australian states, despite unconstrained fiscal conditions and their favourable credit-worthiness, don't borrow that much in terms of the ratio of state net debt to gross state product (GSP). Moreover, because of Australia's pronounced VFI and how the GST is distributed vis-à-vis the HFE system, they don't have a comparable "need" to borrow to deliver baseline state services. For example, in 2021-22, Commonwealth) Government financial assistance to states represented 46.4% of states' expenditures (Commonwealth Government, 2022). Therefore, in contrast with more fiscally decentralized federations, subnational debt is unlikely to threaten critical service delivery. Nevertheless, states in Australia have increased their levels of public sector debt since the onset of the COVID19 crisis and they appear to have decided to prioritize financing their ongoing infrastructure projects before balancing their budget deficits. This decision has also critically paid off at the polls. Somewhat counterintuitively, centre-right governments in NSW, South Australia, and Tasmania, spent more liberally in health and economic support packages, based on GDP/GSP, than the centre-left governments of Victoria, WA, Queensland, and the two territories (S&P analysis, 2022).Two of those right-of-centre high spending pandemic state governments have since been replaced by centre-left State Labour Parties who have promised to increase public sector wages, alongside maintaining the state's major-projects. Both promises will contribute to rising debt in both NSW and Victoria under the current governments.

V. CONCLUSIONS AND IMPLICATIONS

This paper has provided evidence that Australian net debt by government sector in 2021-22 was at an all-time high, and higher than that experienced during the previous GFC crisis, which did not have long-term effects on Australia's public debt accumulation. The paper has importantly shown that the contribution of the states to all Australian public debt accumulation, is currently higher relative to any other point in the history

5. Footnotes: (a) The L2 measure of debt is the measure most comparable to government reporting of net debt under the UPF. It comprises debt securities, loans, Special Drawing Rights and currency and deposits. No state holds SDRs, the zeros included here are for completeness with the definition.

(b) Based on Gross State Product (GSP), current prices, as published in the annual release of Australian National Accounts: State Accounts, Table 1 Gross State Product, Current Prices, 2020-21 release. https://www.abs.gov.au/statistics/economy/national-accounts/australian-national-accounts-state-accounts/2020-21 of Australian federalism. The percentage increase of the states' net public sector debt since 2011-12, has considerably outpaced the Commonwealth's. The key question at the outset of the paper was whether these increases represent a critical juncture in Australian Fiscal Federalism, or, if they were simply pandemic related?

Several qualitative answers can be suggested that have both political and policy implications. The paper has established that Australia indeed does have the necessary conditions to pressure increasing state indebtedness in the future. In particular, there are no *de jure* restrictions to the amount the states can borrow, apart from what the bond market can absorb and voters can tolerate. These conditions, however, have not been sufficient to produce high levels of subnational debt accumulation in Australia, relative to other more decentralized federations. Why?

Australian states do not have a comparable fiscal necessity to borrow given both the extent of the VFI and the HFE distribution system. They are however fiscally inflexible, during times of crisis because their limited revenue streams are vulnerable to economic shocks, and the HFE distribution system has a 3-year time lag. The HFE was updated in 2022, to assess changes to state circumstances from July 2018 to July 2021 (CGC, 2022). Therefore, the uneven impacts of the pandemic on the states in terms of those that had been hit hardest on both the revenue and expenditure side, will not be reflected in the actual GST distributions until 2022 and beyond. This partly explains why it is evident across the two crises, the GFC and the COVID19 crisis, that states' operating, and fiscal balances are impacted upon negatively as expenses indeed outpace revenues, however, in more normal economic times, quick recovery is evident, except for NSW and Victoria. Net operating surpluses for 2024-25 are forecast for most of the states.

Moreover, the fiscal flexibility of the states has moderately increased since 2018 vis-à-vis the HFE update and increases to the size of the overall GST pool. The Commonwealth is offering a "no worse off" guarantee during the transition period up to 2026-27, that protects states from any falling GST revenues arising from the 2018 update that set a revenue floor of 0.7 and 0.75 thereafter. The Commonwealth has also perpetually topped-up the size of the actual GST pool to be distributed. Third, several states have recently funded large infrastructure projects through asset recycling, although this practice does not seem at the present time to be politically sustainable going forwards. Therefore, upward pressure on the states to borrow will remain elevated after the crisis, predominantly because the premiers in recent elections have vowed to continue playing a more significant role in the provision of infrastructure and capital investment expenditure. The HFE however does take a state's net borrowing into account when calculating its assessments that determine the amount of GST to be distributed to that state. The HFE therefore, is according to this research's findings a *de facto* hard budget constraint in Australia fiscal federalism. Any material increase to a state's revenues or expenditures, has a negative relationship to the proportion of GST they will receive, relative to other states.

Politically, since the 1990s, political tolerance for high public spending at all levels of government in Australia has been low. In fact, in the 1990s, high spending at the state level became an electoral liability, with several state elections being lost to incumbent labour governments who were perceived as being fiscally irresponsible (Robinson 2001, p. 713). All jurisdictions' reactions to what was publicly perceived as a debt crisis in the 1990s was to adopt rules requiring budget surpluses with a goal of reducing/eliminating public debts. NSW adopted a rule in 1995 that "the budget should be least balanced" with a medium-term objective of achieving zero net debt by 2020 (Robinson 2021: 715). Ironically, NSW's net debt has done nothing since, but rise to a decade high ratio of state net debt to gross state product of 4.5% in 2020-21 (Based on ABS data, Customised Report 2022).

During recent state elections, politicians have tried to distinguish borrowing cash and privatising key state-owned asses to fund critical state projects, versus using debt to fund public services. This has led to less political aversion to debt related to large infrastructure projects. During the COVID19 pandemic, Premiers from both political parties were receiving political and fiscal support from the Commonwealth Government, the RBA, Business, and Economic commentators, all who were encouraging state governments to keep spending. Hence while states net operating balances have improved since 2021, capital investment on large public infrastructure projects continue to elevate state public sector debt and necessitate borrowing. This is not enough evidence however to suggest that crisis budgets will become electoral budgets.

Interstate budget variations, however, have never been so evident in Australia. As some states are wealthier than others in terms of revenues (in particular, those with mining royalties), their capital budgets are smaller relative to gross state product. Those with lower GSP such as Victoria relative to WA, are pressured to borrow to fund their capital budgets. They must borrow to compete in the reinvigorated infrastructure playbook. In Tasmania for example, major spending has been allocated to roads and bridges development, human services and housing development, and health and education infrastructure. Current budget on infrastructure spending in the states, however, has been overbudgeted due to capacity constraints, labour shortages, and supply shortages. Moreover, the Australian public continues to support cutting expenses to reduce deficits. In a recent survey taken before the October 2022 midterm budget, only 28% of those survey respondents polled supported maintaining current spending levels and living with government debt and deficits for now (SMH, October 11th, 2022).

Therefore, the political tensions over the HFE 2018 updates will continue to be salient, if the 'no worse off guarantees' are not perpetually maintained. The intention of the minimum revenue floors was to provide greater fiscal flexibility to resource-dependent states by reducing their volatility on fluctuating commodity prices, however as the HFE distribution remains a zero-sum game, if it is seen to necessitate rising public debt in the larger eastern state to cover capital investment in hospitals, schools, and infrastructure, the 'fair go' federal culture the underpins Australian fiscal federalism may become unhinged.

From a policy perspective, the fiscal need to pay for things that are seen as investments in future generations may lead to the increasing political willingness for the states to spend on capital infrastructure spending, including climate change and disaster preparedness such as bushfire response capabilities. This ought to lead to less public aversion for subnational debt accumulation.

It was clear during the COVID19 pandemic, that premiers with the highest perceived performance at managing the crisis in their territories, were electorally rewarded, regardless of the effect of those measures on national economic performance. This ought to create an electoral incentive to borrow in times of crisis, and the occurrence of such crises related to climate events (floods and bushfires), may no longer be just rare events that lead to short-term changes in Australian fiscal federalism.

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