

CHAPTER 6: FOREIGN AID AND INCENTIVES TO INSTITUTIONAL CHANGE IN PAPUA NEW GUINEA

6.0 Introduction

It was argued in chapter 3 that development aid is increasingly premised on the hypothesis that it can play an important role in strengthening institutions. Economists are in broad agreement that where institutions and policies are relatively robust, aid can have a positive effect on growth. However, there is less agreement on the effectiveness of aid where institutional failure is high, such as in fragile states. Burnside and Dollar (2004:4) further argue that in weak institutional environments substantial financial aid is unlikely to stimulate reform, and may in fact retard it. Knack (2000) and Dijankov, Montalvo and Reynal-Querol (2005) used cross-country regression analysis to provide empirical support for this view. They further argued that, similar to 'resource curse' effects, large aid flows delivered into countries with high levels of institutional failure can have a negative effect on the quality of political markets and governance, including bureaucratic quality, corruption and the rule of law.

However, it should be noted that these studies are correlational and include conflict-affected countries, which tend to receive high levels of aid during post-conflict and reconstruction phases. Accordingly, they do not conclusively prove that aid actually *caused* the decline in institutional quality. Nevertheless, following these findings, there is a strong evidence-based and conceptual argument that dependence on external finance (including aid), rather than taxation, for the delivery of government services severs the democratic relationship between agent and principals and damages political institutions.

This chapter is concerned with the role of aid in PNG's overall development. It examines whether aid has had a positive, negative or neutral impact on

institutional change at the macro level in PNG, and whether it has acted as a positive incentive to leverage improved governance. Following the analysis in chapter 5, this chapter assesses whether aid has played any role in improving governance. It is organised into six sections.

Section 6.1 provides information on the budget context for aid inflows into PNG, with a focus on the Australian aid program. Section 6.2 summarises the main findings from reviews, evaluations and critiques of aid effectiveness. Section 6.3 is concerned with the links between aid, incentives and institutional change. It explores the relationship between the supply and demand for reform, and the role of aid in influencing developmental outcomes. It also examines how aid affects the principal-agent problem. Section 6.4 draws conclusions on the overall impact of aid in influencing institutional change. Section 6.5 assesses incentive-based approaches against the policy recommendations prescribed by the fragile state paradigm. Section 6.6 concludes this chapter.

6.1 Context and Scope of Aid

6.1.1 Level of Aid

PNG is dependent on foreign aid for delivery of a large majority of its public goods and services. In 2003, per capita aid to PNG was \$US40 (K133), ranking PNG as the 68th most aid-dependent country (World Bank, 2003). Contrary to common perceptions that PNG is one of the most aid-dependent countries in the world, these data rank PNG just above the global median aid level of \$US31 per capita. This establishes that PNG's dependence on foreign aid means it faces similar dependency challenges to a significant number of developing countries, and is not an outlying example. Table 3 below sets out some relevant global comparisons.

Table 3: Aid Levels Per Capita

Country/Region	Aid per capita \$US
Papua New Guinea	40
Sub-Saharan African Region	34
East Asia/Pacific Region	4
Low Income Countries (all)	14
Median Level (all)	31

Source: World Development Indicators, World Bank (2003)

Foreign aid to PNG accounts for 22 percent of the 2005 national budget (PNG Government, 2005). Similar to Sub-Saharan Africa, aid is primarily focused on recurrent expenditure and therefore takes on many core responsibilities for service delivery. It is the primary source of external financing, with commercial loans representing a further 7 percent of total revenues captured in the budget (Hnanguie, 2002:3-4).

Australian government aid accounts for the majority of aid to PNG. Using 2004 data, Australian aid represented 81 percent of international grant aid and comprised 17 percent of the PNG budget (Lepani, Morris and Tuioti, 2004:3). Therefore, given its large size, Australian aid is the primary, but not exclusive, focus of this chapter.

6.1.2 Donor Programs

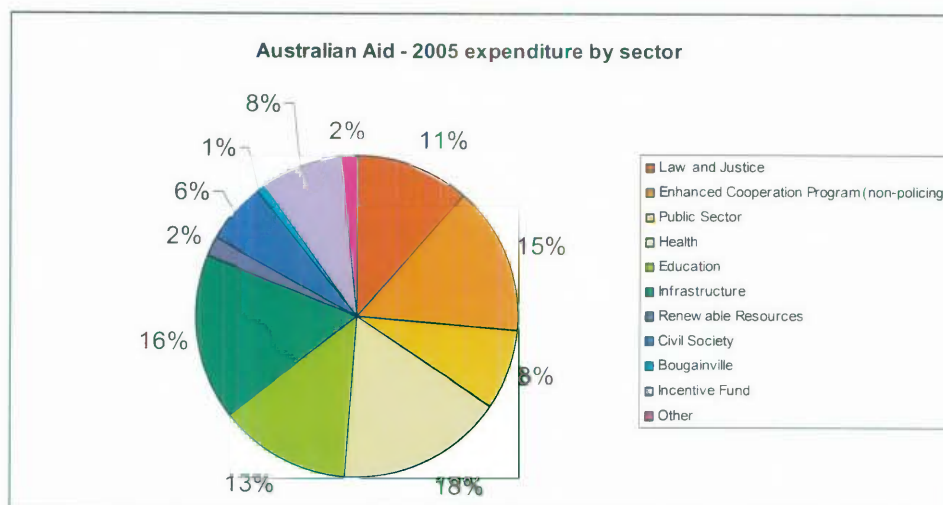
The Australian aid program to PNG is delivered under a Development Cooperation Treaty which stipulates that up to \$300 million (about K700 million) will be delivered each year. PNG is the only country where the Australian aid program is guided by an international treaty. Under this Treaty, Australia currently delivers close to \$300 million per annum through bilateral programs. This amount

represents a 60 percent decline in real terms as a proportion of PNG's budget since PNG gained independence – in 1976 Australian aid provided around \$300 million or 43 percent of the PNG budget which declined to 17 percent of PNG's overall budget by 2004 (Levani, Morris and Tuioti, 2004:4). In addition to the \$300 million bilateral program, Australia also delivers regional and global programs that benefit PNG. For example, between 30 and 80 volunteers are funded by the Australian Government to work in government and non-government agencies across the country.

With the negotiation of the ECP (currently being renegotiated) in 2003, it was envisaged that an additional \$800 million (or \$160 million a year) for policing would be provided to PNG over 5 years. The non-policing components of the package, which originally included the provision of up to 64 'in-line' (rather than advisory) Australian public servants in economic management, law and justice, border and transport security and immigration, was funded through the existing \$300 million aid program. ECP was a response to the continued weakening of PNG's systems (Potts, 2004:5) and a direct attempt to help curb corruption. Led by the Australian Department of Foreign Affairs and Trade (DFAT), Treasury, and Finance, ECP was also a response to a perception within the broader Australian Government that the existing aid program, delivered through the Australian Agency for International Development (AusAID), had failed.

Figure 12 below shows a break-down of Australian aid by sector (AusAID, 2005d). Funding for activities specifically delivered to target PNG's core institutions responsible for governance is \$100 million of the \$300 million program (or 34 percent). Governance activities account for the majority of expenditure and their proportion of aid has steadily increased since 1995, reflecting Australia's concern for the quality of PNG's institutions. Within all other sector expenditure areas, such as health and education, a significant proportion of the program is focused on improving the governance of these sectors.

Figure 12: Australian Aid Estimates by Sector



Source: Calculated from AusAID (2005d)

The level of expenditure in PNG by the Asian Development Bank (ADB) and World Bank fluctuates around the level of loan agreements. In recent times, with stronger emphasis within the banks on the quality of governance and adherence to LICUS frameworks, the level of agreed loans has reduced in PNG. Both the ADB and WB have cancelled loans in the past two years due to the failure of the PNG Government to deliver on conditionality in the natural resource sector (World Bank, 2005a:3). This has led to more grant-based programs from the banks, primarily in the areas of HIV/AIDS and community development. The European Union (EU), Japan, New Zealand and the United Nations agencies also have grant aid programs in PNG. New Zealand's program of around \$7.2 million (K18m) works closely with Australian aid in the health sector and in the law and justice sector. Japan's \$44 million (K110 million) is mostly targeted to infrastructure programs. The EU contributes around K70 million per annum, and is primarily focused on the agriculture and education sectors, and governance. The UN programs are targeted towards democratic governance and the social sectors, including education, health and HIV/AIDS. Across all its agencies UN expenditure is around \$10 million (K25 million) a year; however, it will be significantly increased once the Global Fund for HIV/AIDS is available to PNG.

6.2 Reviews, Evaluations and Critiques of Aid Effectiveness

This section summarises the main conclusions from reviews undertaken of aid effectiveness in PNG by the development aid sector and some academics. Conclusions are drawn on the usefulness of these reviews in assessing whether aid has acted as an incentive or disincentive for reform.

A number of reviews and evaluations have been undertaken of the Australian aid program to PNG. The most significant of these reviews was the *Joint Review of Australian Aid Program to PNG* (2004) commissioned by the Governments of Australia and PNG, following a break-down in bilateral relations in mid 2003 over the terms of Australian aid. The review, undertaken by an eminent Australian, Papua New Guinean and Pacific Islander, concluded that the Australian aid program had been effective, but there was considerable scope for improving its impact (Lepani, Morris and Tuioti, 2004:iv). The review highlighted the weakness of the existing performance monitoring system for jointly monitoring expenditure of total resources (2004:viii-ix) and the lack of constructive engagement between the two governments (2004:i). It did not make any observations on the role of incentives in influencing institutions.

In 2003, AusAID commissioned an evaluation of Australian aid effectiveness - *The Contribution of Australian Aid to Papua New Guinea's Development 1975-2000*. This evaluation argued that Australian aid had contributed materially to development gains in PNG. It concluded that Australian aid program had:

- (i) been responsive to PNG's own development need and priorities;
- (ii) contributed to sectoral improvements;
- (iii) helped prevent instability; and
- (iv) stemmed the decline in service delivery.

The report was critical of project aid delivered by all donors in PNG, and concluded that project aid had created parallel systems, led to negative institutional impacts in the areas of capacity building and priority setting, and reduced prospects for sustainability (2003:51). Despite these criticisms of past aid delivery mechanisms, the report tended to attribute Australian aid to positive development gains, for example by directly contributing to increasing school enrolment (2003:33-35). However, it assessed the negative development trends relating to declining governance and corruption as being outside the control, and mandate, of the Australian aid program.

The DAC undertook a *Peer Review of Australia* in 2004. The DAC review noted that Australia's aid program was evolving in the right direction, but suggested there were a number of key areas where Australia needed to reassess its approach. First, the review argued that ECP could create tensions in terms of the Australian aid program's approach to ownership, capacity building and partnership (2005c:94). Second, it highlighted the risks of fungibility in service delivery and the need to employ an improved framework for ensuring PNG government funding for service delivery. Third, it criticised the high levels of technical assistance being provided by Australia, which could undermine capacity building and local ownership (2005c:95). The role of aid in institutional development was discussed implicitly and not explicitly.

The WB and the ADB also undertook substantial reviews to evaluate the effectiveness of their aid interventions over the 1990s. The *World Bank Country Assistance Evaluation* (2000:9-11) concluded that its assistance to PNG had been unsatisfactory, the institutional development impact modest, and sustainability uncertain. The WB's evaluation (2003:15) into its activities in extractive industries further concluded that projects in this sector had specific technical-centric sectoral benefits, but had not contributed to overall sustainable development in PNG. The evaluation posited that future programs in the resource

sector will not lead to benefits until there is an improvement in overall public expenditure management. It recommended that future interventions need to be targeted at the management of resource rents and policies to improve governance (2000:18). Similarly, the ADB's *Country Assistance Program Evaluation* assessed its performance as weak in program formulation, with insufficient strategic direction and a resultant lack of coordinated project identification and design (2003b:39). The evaluation concluded that without an increase in PNG government commitment, external assistance would remain ineffective.

Hnanguie (2002:7), a Papua New Guinean ADB economist, pointed out that since 1978 over 60 percent of the WB's and ADB's projects were deemed to have failed. Hnanguie attributes this high failure rate to poor economic management and coordination by the PNG Government. Consistent with the 2003 AusAID commissioned evaluation outlined above, Hnanguie (2002:6-7) argues that foreign aid can be credited with 'what works' in PNG, but concluded it has been less successful at promoting sustained growth across the country. In addition to poor government coordination and implementation, Hnanguie (2002:9-10) views the parallel modality of foreign aid and the limited hand of government in the design, management and evaluation of programs as undermining institutional capacity in PNG.

Thus, in summary the aid community itself has broadly concluded that it has had a limited positive effect on the quality of PNG's institutions.

Recent academic reviews of aid effectiveness are also highly critical of aid effectiveness in PNG, and the broader Pacific. Hughes (2003) and Hughes & Windybank (2005) argued that aid has failed across the Pacific region because it has not provided an environment for economic growth. Windybank and Manning (2003:12) contended that Australian aid was part of the problem, rather than the solution, because it had enabled successive PNG Governments to "live beyond

their means, encouraging irresponsible policies and postponing the need for reform". They conclude that AusAID risked becoming a surrogate government. Hughes and Windybank (2005:7-8) have criticised the high levels of foreign technical assistance focused on the state. Similarly, Regan (2005:7-9) has questioned the efficacy of additional technical assistance under the ECP on the basis that state-building alone is unlikely to help PNG build a strong nation. Feeney (2005a:29; 2005b:26-30) drawing on econometric analysis, argued that aid to Melanesia has had a limited impact on rural areas (where most Melanesians live) and has had a potentially negative impact on revenue collection efforts because of its fungibility. The Australian Strategic Policy Institute (2003), although not explicitly critical of the evolving directions of the existing Australian aid program, recommended that the program needed to be enhanced by further strengthening the state, economy and the nation, requiring an additional \$500 million a year. This argument is in contrast to Windybank and Manning (2003) who argue that aid is already too high in PNG.

These evaluations and academic critiques paint a fairly consistently negative picture of aid effectiveness in PNG to date. There are three core findings that can be extrapolated from this literature.

- (i) Aid has possibly acted as a disincentive to public sector reform by funding too large a proportion of the PNG Government's core service delivery responsibilities, and has not been linked to an adequate performance monitoring system. This finding assumes that the fungibility of the aid program has decreased the accountability pressure on government.
- (ii) Aid has failed to have a sustained impact on the quality of government institutions in PNG. It has also not shaped the market to provide an environment for economic growth.

- (iii) Aid has been critical to minimising the pace of deterioration in service delivery, and has contributed to stability. This finding assumes that aid funding for service delivery is lubricating PNG enough to prevent its total collapse.

However, these findings all suffer from the inevitable problem of the counterfactual – what would have happened without aid? We thus have to be cautious in drawing firm conclusions. Nevertheless, this literature does suggest that major donors are cognisant of the need to modify their approach to PNG in the future. Given the recent donor focus on ‘institutions’ there is surprisingly limited explicit discussion in these evaluations on the effectiveness of institution building and the role of aid as a possible incentive in this process. A *Review of Incentives in the Australian Aid Program (2003)* sought to examine the role of incentives in leveraging change. Although it included PNG, it only looked at one project in the portfolio, and did not examine aid as an incentive or disincentive across the entirety of the portfolio. This is a major gap in the literature. Incentive structures are further discussed in the remainder of this chapter and in chapter 7.

6.3 Supply and Demand Conditions and Non-market (Aid Sector) Failure

Section 6.3 is concerned with analysing whether foreign aid interventions can modify behaviour in PNG. Sub-section 6.3.1 examines the supply-side elements of past Australian aid and its underlying assumptions about institutional development. Sub-section 6.3.2 then discusses the demand-side conditions for aid interventions in PNG. Sub-section 6.3.3 attempts to situate these supply and demand conditions in a model of non-market failure, incorporating the aid sector for PNG, drawing on earlier analysis in section 4.2. To conclude, sub-section 6.3.4 explores the nature of the principal-agent relationship in the context of PNG, and the role of aid in this matrix.

6.3.1 Supply-Side Elements of Aid

Sub-section 6.3.1 examines each main category of Australian aid interventions and how these deliverables aim to contribute to PNG's development. Both the former *PNG/Australia Country Strategy (2000-2003)* and the new *PNG/Australia Aid Strategy Framework (2006-2010)* establish governance and reform, with a particular focus on service delivery, economic growth and HIV/AIDS response, as the primary development objectives of Australian aid to PNG. The focus on building state capacity as the primary mechanism for influencing development outcomes is a key premise of both strategies. Hence, in 2005, approximately 93 percent of Australian aid to PNG was delivered through the state, predominantly via national agencies (calculated from AusAID, 2005d). A significant proportion of technical assistance and goods procurement was delivered to the state, to positively influence governance and reform through capacity development and policy/planning assistance in key agencies. The PNG Government budget sorts foreign aid into four main categories - technical assistance (personnel) (44 percent), training (13 percent), procurement for goods and services (35 percent) and other (8 percent). The allocation of aid to these categories is determined during the design phase of a program, based on an assessment of state capability gaps.

As a result of the concentration of Australian aid on the state, the dominant area of Australian aid expenditure in PNG is TA. TA was defined and discussed in section 3.1. Using 2005 estimated budget data (AusAID; 2005d)¹, TA makes up about 44 percent of Australian aid to PNG. In order to assess if TA has been effective in PNG it is first useful to examine the assumptions that underpin the relationship between the supply of TA and development outcomes. Aid programs assume that the supply of TA will result in some of the following benefits (Baser and Morgan, 2001; Morgan, 2002):

¹ This excludes police expenditure under the ECP Treaty which was planned for 2005 but not expended due to aspects of the ECP Treaty being ruled unconstitutional by the PNG Supreme Court, and the subsequent

- (i) The transfer of core skills and knowledge from TA to counterparts;
- (ii) Improved overall performance of the organisation work practices in an organisation; and
- (iii) Actual program delivery, where TA is being provided to substitute for capacity.

Does TA achieve these objectives in PNG? In practice, TA is a mixture of capacity building and capacity substitution whereby the core purpose of the latter is to undertake core tasks to ensure the delivery of services and reform outputs. TA will be most effective where the beneficiary organisation has a mandate for reform, and counterparts are selected on the basis of their own performance and potential to act as a champion of reform. There are some cases where Australian TA has increased the skill, knowledge and competency level of individuals at the middle management level and the broader organisation in the PNG public sector. For example, Australian-funded TA to the Ombudsman Commission (OC) in the 1990s, delivered under a strong and independent Ombudsmen, was considered to have been influential in strengthening the OC and its effectiveness in undertaking its core integrity system tasks (PNG Ombudsman Commission Institutional Strengthening Project, 2002). On the other hand, there are examples where TA has taken over core tasks and led to displacement, deskilling and disempowerment of Papua New Guineans. For instance, there is a growing sense that the placement of substantial Australian TA, under the ECP, in PNG's Treasury Department is beginning to have a 'hollowing out' effect on the institution (DNPRD official, 2006). In the absence of political will, supply-driven TA to fill performance gaps cannot shape political will or replace the public sector's role in managing staff performance.

decision by the Australian Government to withdraw police serving under ECP. At the time of submission of this thesis the policing package of ECP was still on hold subject to negotiation between Australia and PNG.

In many cases, TA is linked to goods and services associated with delivery of projects, and sectorwide approaches. Australia's high proportion of TA is illustrative of the high transaction costs of weak government and the opportunity cost of Australia not being able to provide aid through PNG's system, using its government resources. On the whole, there is little evidence to suggest that expenditure on TA has been successful in shifting the incentive structures within aid beneficiaries. Although the stated aim of TA was capacity building, in many cases TA has in fact compensated for poor state performance and taken on responsibility for some core state functions. For example, through the Commodity Assistance Support Project Australia funded and delivered almost 100 percent of state supplied school materials for elementary and primary schools across PNG.

The second category of aid is the delivery of training, comprising about 13 percent of Australian aid flows in 2005 (AusAID, 2005d). Training programs assume that these individuals will act as change agents within their organisations and communities by enhancing the knowledge and skill set of individuals. Similar to the above discussion about TA, training as a catalyst for change relies on a critical mass of trained individuals to occupy positions where they can influence change, and to have a willingness to do so. It also relies on training recipients operating within an institutional environment where they can exercise these skills, and management demands higher performance as a result of the training. This is broadly not the case in PNG. To date, there is some evidence that Papua New Guineans who have taken tertiary studies overseas have often been agents of change. For example, the PNG Treasurer, a scholarship beneficiary, is considered to be a significant reform agent and the *Kumul Foundation*, a network association that emanated from PNG students in Australia, is undertaking important work on leadership and ethics. However, the Director of the *Kumul Foundation* estimates that less than 5 percent of scholarship holders have returned to PNG and sought to undertake a catalytic leadership role (Smare, 2006). Anecdotal evidence suggests this development activity is just as much

about exposure to outside ideas and systems as the skills and knowledge acquired through training.

The third category of aid is financial support for core service delivery. From 2005 data, this expenditure category makes up about 35 percent of Australia aid (AusAID, 2005d). The assumption underpinning aid funding for service delivery in health, education, transport infrastructure and law and justice is to complement government to improve the livelihoods of Papua New Guineans throughout the country. Funding for services can only shift incentives in key service delivery agencies to the extent that aid resources are performance-based. Australian aid has sought to support service delivery in the health sector, and for road maintenance using sectoral approaches, with PNG agency performance elements. However, on the whole, Australian aid has often been fungible, and had not been positioned in the 1980s and 1990s to influence PNG's allocation of resources. Funding for service delivery will only act as an incentive at the macroeconomic level if it is provided on a performance basis, i.e. Australian aid is provided on the basis of a formulae related to PNG expenditure on goods and services, excluding salaries. Under the revised aid arrangements currently being renegotiated between PNG and Australia, a tighter performance management system incorporating some of these features has been agreed in-principle (Governments of PNG and Australia, 2005: 4-5).

The remaining 8 percent of Australian aid covers expenditures that do not clearly fit into one of the above outlined categories (AusAID, 2005d). A significant amount of this funding is for community-level development.

Drawing on Table 2 in chapter 3, Australian aid in PNG primarily follows a *functional-push approach*, whereby interventions are directed at strengthening formal organisational structures, systems and skills transfer. In reality only a small amount of Australian aid interventions seek to employ *political-push* and *pull* approaches by adopting incentive-based approaches. Bolger et al (2005: 24)

studied the PNG health sector and suggested that if aid interventions aim to provide an impetus for endogenous change then interventions need to be practical, and linked to what matters to the everyday lives of Papua New Guineans. Furthermore, this study found that formal approaches to capacity development, which have dominated Australia's approach as outlined above, do not sufficiently consider the need for the development of 'soft capacities' (e.g. attitudes, values, motivations) that influence behaviour.

Drawing on Wolf's theory of non-market failure initially explored in sections 2.3.1 and 4.2, the supply conditions of Australian aid in PNG contribute to its lack of effectiveness. First, it is difficult to define and measure outputs, including negative incentive effects. Second, Australian aid interventions are determined by a single supplier – predominantly AusAID, although recently challenged by other Departments under the ECP. Third, despite attempts to measure its effectiveness as set up in section 6.2 there is no 'bottom-line' to determine performance of aid in PNG.

In sum, it could be concluded that it is almost impossible for aid to induce change where it has been premised on a *functional-push* approach, with insufficient attention to *political-push* and *pull* strategies that explicitly aim to incrementally shift incentive structures. It is recognised that Australia is seeking to shift this imbalance by refocusing its aid interventions at the sub-national level of government and through increasing its attention on capacity development of non-state actors, and the relationship between the state and civil society (AusAID, 2005f; Fox et al, 2005). The new aid arrangements under the *PNG/Australia Country Strategy Framework*, also provide for a \$30 million performance grant, which may increase over time subject to good performance. Until now, the Australian aid program has been fixed at \$300 million per annum and delivered in PNG regardless of the PNG Government's performance. These changes are moves in the right direction.

6.3.2 Demand-Side Conditions of Aid Interventions

Sub-section 6.3.2 discusses the demand conditions *within PNG* that provide the context for Australian aid interventions in PNG. Drawing on chapter 5, there is limited effective pressure on the state to minimise government failure. This stems from the underdevelopment of the economy, formal political markets and the transition of PNG society from traditional to modern systems, and a resultant confused understanding of the role of the PNG state. Rather, most civil society pressure arises from demand for localised services and projects (e.g. water supply) and is directed at MPs. There is weak effective civil society demand for improving state capacity through broader economic and institutional reforms.

According to the *Topology of State Capacity and Willingness* set out in Figure 2, chapter 3, PNG would be characterised as weak on both accounts. This translates to an environment that is not yet conducive to undertaking the institutional change being supported by *functional-push* aid interventions. For example, in 2005 Australia budgeted to spend \$50 million in the PNG health sector on TA and goods/services funding premised on the need for continued reform and rationalisation. This mandate has been set by the donor program, and is not premised on domestic political and civil society pressure to improve health outcomes. Because of these domestic demand conditions, aid interventions - particularly where *functional-push* approaches are employed - are subject to high rates of non-market failure.

Foreign aid can help to shape domestic demand by increasing information and power asymmetries by the provision of aid to support the media sector, community participation in sector program, participatory community development projects, and economic interventions (e.g. microfinance, road maintenance). Performance-based aid that seeks to influence institutional incentives may also generate internal reform if appropriately implemented and enforced.

6.3.3 *A Model of Non-Market (Aid Sector) Failure in PNG*

Sub-section 6.3.3 seeks to derive a model of non-market failure for the aid sector in PNG, drawing heavily on an initial analysis in section 4.2. Accordingly, the scale of non-market failure in PNG is caused by both the supply and demand conditions of Australian aid interventions as outlined in Sub-sections 6.3.1 and 6.3.2. Given around 93 percent of Australia aid interventions are directed through the PNG state, or delivered in parallel, this analysis of aid sector failure is closely associated with government failures described in chapter 5. Thus, based on Australian aid's current direction, government and aid sector failure in PNG are closely intertwined given aid interventions are highly dependent on PNG government capacity and willingness to improve its effectiveness. Aid sector failure in PNG can be further analysed using Wolf's taxonomy of non-market failure.

Internalities: There are significant inconsistencies between the stated objective of aid program interventions (usually reform and improved performance) and the willingness and capacity of the individual PNG beneficiaries (usually state agencies) to implement these reforms. In PNG, incoherence comes about in two ways. First, many aid beneficiary agencies are pursuing primordial goals through the formal sector, for instance through the employment of *wantoks* on the basis of obligation rather than performance, and the distribution of funds for private consumption. These goals are inconsistent with the aid intervention goals that aim to change the status quo. Second, aid program implementers are often primarily concerned with achieving project outputs to meet their terms of reference, or to meet the demand of the PNG agency that has become dependent on TA. Under this scenario, the process of skills transfer is by-passed in order to meet these outputs.

Disjuncture between costs and revenues: There is a high level of disjuncture between the price of aid and its outputs, in particular where the supply condition

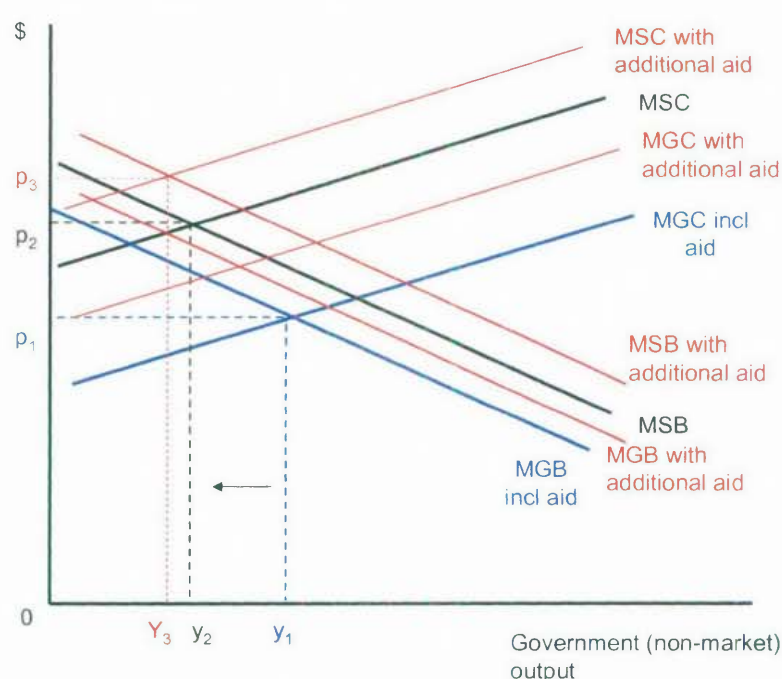
assumptions about aid effectiveness are flawed. Accordingly, it is difficult to measure how much benefit \$250,000 of TA brings in terms of capacity development and reform. Similarly, where TA results in 'hollowing out' the bureaucracy by taking over its core functions rather than capacity building it imposes social costs over the long-term and ongoing aid dependency to fulfill core functions. Aid in PNG is often perceived by organisational beneficiaries to be a 'free good' and thus subject to rent-seeking and rising but redundant prices (i.e. the marginal benefit of each aid dollar is declining). By way of a trivial example, many of the PNG agencies that have been regular aid beneficiaries have become accustomed to workshops in expensive city conference centres and will no longer accept standard work planning in their own workplace.

Derived externalities: Derived externalities are the unintended institutional consequences of aid interventions on PNG. Often these effects may be evident over the medium to longer term. They include the fungibility of aid flows for service delivery, TA undermining staff and not addressing 'soft capacities' and the extent to which aid substitutes for government effort to raise revenues. Furthermore, where there is constrained domestic political demand for reform, the transaction cost of supplying governance focused aid is high in terms of the limited supply of bureaucratic time and political capital. For example, the drawn-out negotiation of immunity for Australian in-line officers under the ECP since 2003 has expended considerable political capital of reformist PNG Ministers and capable staff in the bureaucracy.

Distributional inequity: In PNG, where the state is patrimonial, both government and aid sector resources controlled by the state are likely to be distributed unevenly, and/or be captured by those in power. For example, only a small percentage of aid resources directly benefit capacity development at the grass-roots level and within institutions outside the state.

Thus, as a result of these existing sources of aid sector failure in PNG, additional *functional-push* aid expenditure delivered through the state (for example, ECP) will likely create further negative internalities illustrated by a large outward shift of the MSC, and a small increase in MSB. The effect of increasing the supply of aid from p_2 to p_3 reduces output from y_2 to y_3 over the long-run. This effect is diagrammatically represented in Figure 13 below.

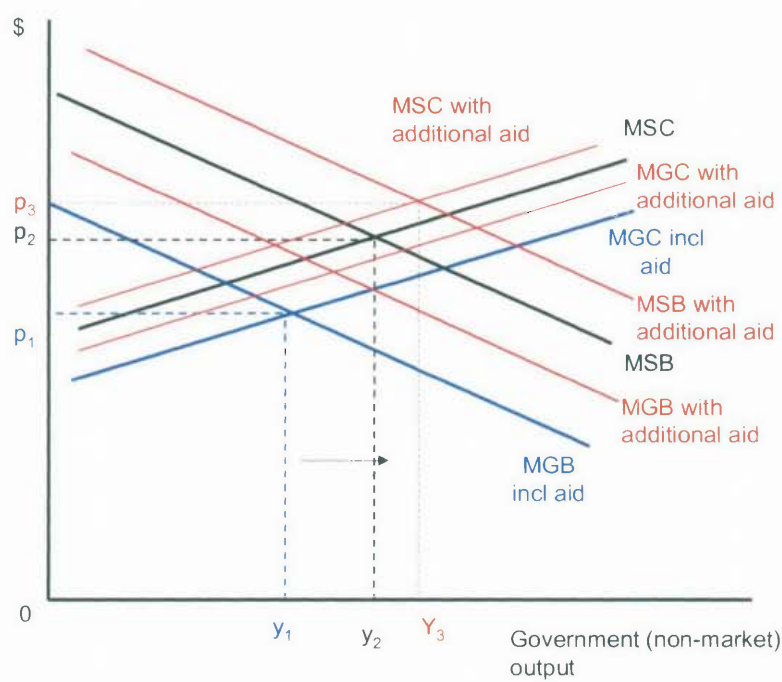
Figure 13: Effect of Additional Aid where Aid Sector Failure is High



However, if the development context in PNG improved, providing a better environment for aid interventions, additional aid (assuming well designed) could result in MSB moving outwards further than MSC. Using the example of ENB Province, which is broadly considered to be the best governed province in PNG with a reasonably well functioning political system, appropriate aid interventions are considered to be more effective. Australian aid interventions through the Sub-National Initiative (SNI), which provides a small amount of financial support to the ENB Provincial Government on a performance basis, is more likely to result in a

sustained increase in development outputs from y_2 to y_3 as set out in Figure 14 below.

Figure 14: Effect of Additional Aid with Strong Capacity and Willingness



This series of MSB-MSC diagrams illustrates two key points relevant for future aid frameworks in PNG. First, donors in PNG have to shift their focus away from the supply of *functional-push* aid targeted at state capacity building when there is not an effective domestic constituency for reform and limited political ownership. Donors can, and should, continue to improve the quality of *functional-push* aid interventions, but understand it may have zero effect on long-term development outcomes unless aid is actively helping to address non-market failures, in particular through helping to shape the demand conditions discussed in sub-section 6.3.2. Drawing on comparative institutionalism, this means pursuing aid interventions that enhance social cohesion and collective action, to help civil society ‘rebalance’ its power relations with those that capture the resources of the state. For example, at the national level it might mean providing core funding for

groups to evaluate and publish PNG Government expenditure. At the provincial level it might be greater expenditure on rural roads to increase economic activity and information-based interventions around local service delivery. An example is encouraging parents associations to form, on a voluntary basis, around schools to promote the transparent use of school resources. This latter type of aid program interventions are overtly political because they challenge and monitor political and bureaucratic resource allocation decisions.

Secondly, this analysis raises questions about the assumptions the PNG aid literature reviews have made about the relationship between aid and state fragility. The fragile state paradigm and reviews of PNG aid effectiveness (discussed in section 6.2) made strong claims that aid is necessary to improve sectoral outcomes, and to prevent the collapse of services. An alternative view is that Papua New Guineans will begin to mobilise themselves to demand better governance when services collapse completely. Following this line of argument, we could therefore assume, where supply of aid for both reform and service delivery is low, demand is assumed to be more elastic because the situation triggers some collective action for change. Perhaps, a reduced supply of foreign aid may precipitate this scenario. However, this hypothesis does not hold true for many areas in PNG where governance has deteriorated to the point that the state is delivering few goods and services. For example, the absence of the state has not led to effective pressure on government in remote parts of Southern Highlands and Gulf provinces. In part, the fact that other organisations, such as NGOs, the Australian-funded Community Development Scheme, the churches and resource companies, have filled the gap has alleviated public pressure on the government to deliver services in these areas (Kini, 2005).

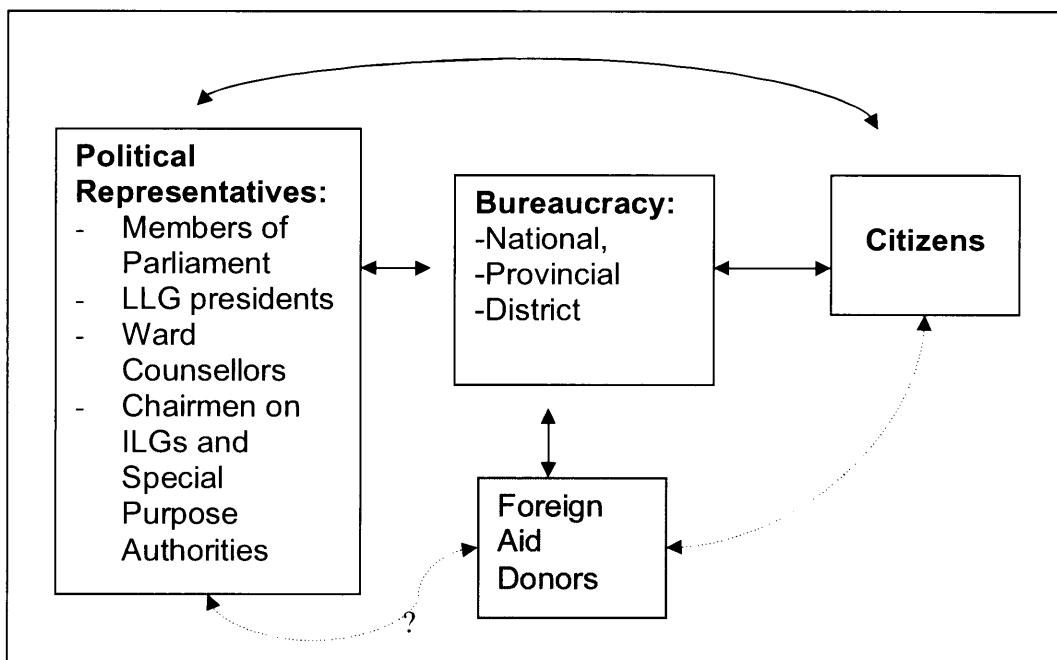
6.3.4 Accountability

Sub-section 6.3.4 explores the role aid plays in shaping the incentive structures between agents and principals. It is recognised that incentive structures only

change where there is pressure for a transformation in the power relations between principals and agents.

In PNG, the principal–agent problem encapsulated in the formal system lies at the core of political market dysfunctionality. That is, political representatives who make decisions about resource distribution are generally not making these decisions in the interests of the electorate they purport to represent. This occurs at the national level and all the way down to the clan level, as discussed in section 5.1. Figure 15 below illustrates a number of accountability relations that exist in the formal system.

Figure 15: Principal-Agent Relationships in Formal System



Where external interventions, such as Australian aid, make up a considerable component of government expenditure, it raises questions about where donors find themselves in the accountability function. Donors are both principals and agents. They are accountable to the PNG Government in terms of delivery of aid within agreed PNG Government policies and priorities, and can demand certain governance requirements to be met as a condition of continued aid and as a

safeguard against moral hazard. Global studies have found that ownership of reform is weakest where the reform package has been donor initiated, lacking in domestic demand and designed with limited local input. If aid programs have these characteristics, cross-country analysis has shown that implementation is weak and likely to fail (Killick, 1998:87-100).

In most cases, donors have choices about whether they provide aid to a state. However, in the case of PNG, due to former colonial ties and Australia's strategic interests in a stable PNG state, Australia has little choice about providing aid. The PNG government is aware that the provision of Australian aid to ensure the stability of the state will continue, because it is firmly in Australia's interests. In this sense accountability of the PNG state to Australia is extremely weak, due to the confidence of the political elite that Australia will continue to provide high levels of aid to PNG, regardless of its performance. To date, in nominal terms aid flows have remained the same in nominal terms regardless of good or bad performance, but has declined in real terms. Therefore, at the macro level Australian aid does not provide an incentive for the political leadership to improve its governance. The failure of aid to act as a lever of change because of non-enforcement of the contract between the principal (donor) and the agent (recipient government) is well documented on a global basis (see Killick, 1998).

Under the recently negotiated *PNG/Australia Country Strategy Framework*, Australia is seeking greater engagement with PNG on expenditure of their revenues as a condition of financial support. In this sense, Australia is asking for greater accountability from the PNG Government to compensate for the weakness of state and the lack of collective action for accountability from citizens. This may have some impact in shifting incentives at the macro level, but only if the performance framework is appropriately structured, and has ownership within PNG. By ownership, it is implied that there is an awareness, participation and political commitment to the package. Australia must have the conviction to enforce the performance framework and secure the agreement of the PNG

government to close the large information asymmetries about how PNG actually expends resources to have any hope in Australian aid acting as a lever for change.

It is not clear what role Australian aid plays in either enhancing or severing accountability links between political representatives and citizens. It could be argued that Australian aid is contributing to weakening organic institutional development by seeking to take on responsibility for holding the PNG Government to account, and reducing the need for Papua New Guineans to take action. In developing the new arrangements it is critical that the transparency of aid resource allocations, linked to the PNG budget, are well understood by civil society. If domestic information asymmetries about the distribution of PNG's revenues, including aid, remain weak then there is little scope for reducing principal-agent problems.

6.4 Assessment of Aid as an Influencer

Section 6.4 draws conclusions on where Australian aid has effectively acted as a positive and negative influence for change. Four main conclusions are drawn in turn.

(I) Aid Focus and Approach: Australian aid has assumed that PNG's governance problems will be eased by targeting assistance at the state. Accordingly, its first major limitation is that aid has been overly state-focused, at the expense of broader societal development. With about 93 percent of Australian aid delivered through the state, there is limited effective competition for funds because aid has been distributed on the basis of supporting the necessary core functions of government, such as health, education, transport infrastructure, macroeconomic stability, and law and justice. As there has been a strong expectation on Australia to support core functions, there has been no effective competition between agencies on the basis of demonstrated reform. This reliable

level of aid funding for service delivery has reduced the pressure to undertake public sector reform and exercise fiscal discipline. For example, following expenditure 'blowouts' related to the 2002 national election, as the PNG Government had run out of funds to meet its core commitments.

Second, aid has operated on the assumption of trickle-down, with an estimate that 89 percent of Australian aid directly supports national expenditure responsibilities (NEFC, 2005) and is primarily delivered through national institutions. Often national institutions, which are the primary negotiators of aid have targeted assistance to their own needs. For example, in the education sector, about 94 percent of funding has supported national functions (NEFC, 2005d). Provincial and local level governments have historically only benefited through goods and services flowing from the national level. Aid benefits to the sub-national level have mostly been delivered in the form of training courses and materials outside of their own budget (i.e. not equivalent or fungible for cash or other priorities). Australia's new SNI which directs a small percentage of aid expenditure to directly support reform through province's own budget framework in three pilot provinces is a move in the right direction.

Third, aid has followed a *functional-push* approach. This issue has already been explored in section 6.3. It is, however, worth further discussing the Australia Government decision in 2003 to deliver additional TA to PNG through ECP. Although the ECP was supported by a number of key reformers in PNG, it has generally been conceived of as an Australian and not PNG owned and designed initiative (Sugden, 2004:61). It appears to have been developed as a response to an Australian fear of continuing deterioration in PNG's governance (Dinnen, 2004), rather than in response to a PNG domestic push. Mekere Morauta (2004:4), former Prime Minister of PNG, made the comment that "the glue cannot be manufactured by Dick Smith; it must be Made in Waigani". Craig Sugden (2004:62-63) points out that ECP is technical in nature, similar to many past aid interventions, and does not ultimately shift the institutional environment. Sugden

concludes that ECP offers a temporary relief to symptoms within key state institutions, but does not tackle the root of governance problems in PNG (2004:55). The success or otherwise of ECP, and other TA, can only really be assessed over the medium to long-term. Only if ECP can make a difference in minimising corruption on a systemic basis and helping the state to successfully prosecute leaders, which eventually acts as a disincentive for leaders to undertake corrupt practices, is it likely to be judged a success (see Morauta quoted in APSI, 2004:54).

Fourth, the majority of the 7 percent of Australian funding delivered through non-state actors, such as the church and non-government organisations, has primarily been focused on delivering services in place of government. Only a small percentage of total aid flows have been used to influence domestic demand by strengthening the capacity of civil society to advocate for a more effective government. Direct capacity focused and core funding assistance to civil society organisations in 2004 and 2005 totaled about K5.2 million (Community Development Scheme II, 2005).

Fifth, all aid to PNG has raised the costs of government and the expectations of public servants that benefit from aid. For example, in the 1990s the PNG Government adopted the UN rates of \$US300 a day for overseas travel that they had experienced through aid funded overseas trips. It has also contributed to the rent-seeking culture of government by providing new cars and materials alongside projects that should ordinarily be a lower priority for government expenditure. Where aid activities have delivered 'cargo', such as courses and travel, aid activities can divert the state's resources away from their core business. As an example, the senior planning officer in a Provincial Government spent from six to twelve months of 2004 on various funded short-term missions and courses funded by the Japanese Government and the UN.

(II) Aid Coherence: Australia, and other donors to PNG, have been unsuccessful at positioning aid inflows to influence performance within central agencies. In recent years there were attempts by AusAID, the ADB and the WB to reposition aid collectively through a Joint Country Strategy process. However, the PNG Government perceived this process as donors 'ganging up' and requested it to be halted. At the central level, aid has lacked coherence and potential for leverage. The absence of a jointly agreed strategy and procedures also means all donor programs operate under different systems and philosophies. Some donors, such as Australia and New Zealand, provide program-based funding where priorities for funding are mainly set with government. Others, like Japan, deliver all aid in kind. The EU delivers most of its funding through government contracts. These different systems create confusion in government and in communities. There is an urgent need for better coordination and harmonisation of donor approaches and procedures. Some progress to address poor coordination is now being made at the sector level. The health sector is the best example where this approach has been reasonably successful (see chapter 7). The education sector stands at the opposite end, where there are over twenty separate donor-funded projects, and where in some cases donor project's policy objectives pull in opposite directions. For example, Australia is pursuing an 'affordable' approach to education and UNICEF is pushing 'free education'.

In the late 1990s, Australia sought to link the program, at the macro level, to 'benchmarks' in the Treaty to attempt to leverage Australian aid at the central government level. However, many of the benchmarks were inappropriate (for example, some of the benchmarks were unaffordable), and non-compliance was not backed up by aid reduction. In essence, although intentions were good the benchmarks were toothless in effecting change within the public sector.

(III) Aid and Demand: Australian aid to date has not had sufficient focus on influencing the effectiveness of the political system- from the national level down

to the grass-roots. Coupled with economic development, it is possible over the long-term that donors can work with reform agents to reduce public expenditure information asymmetries about public expenditure, thereby contributing to effective demand for improved government performance. Australian support to PNG's NEFC to undertake analysis and dissemination of information about resource distribution may help shape demand if it is accessible and meaningful to enough people. Australia's recently formed partnerships with the Media Council and the National Broadcasting Commission, aim to increase public information flows and debate. They may also contribute to shaping demand over the longer term. The new aid arrangements, which will require the PNG Government to be more transparent about its expenditure, may help shape demand for better political decision making if sufficient public awareness exists to ensure Papua New Guineans outside government understand the terms and conditions of aid. However, under a tighter performance framework, it seems likely that aid will only be effective in leveraging resource allocation decisions within agencies where aid funding is significant relative to other possible sources of rents (such as resource rents).

This fairly damning assessment of aid at the macro level does not suggest that individual programs have not provided a foundation for change at the level they have operated. There are some positive examples of how aid has leveraged reform within sectors, provinces, or individual organisations. These programs are further discussed in chapter 7.

6.5 How do Incentive-Based Approaches Fit with a Fragile State Approach?

Assessed purely against the broader fragile state framework outlined in section 3.2, Australia's existing aid to PNG meets many of the basic criteria for good aid, or is at least moving in this direction. Three examples suffice to establish these observations.

Informed by relevant country-based analysis: Management of the Australian aid program has been devolved from Canberra to PNG (i.e. from headquarters to the field office). As a result, the analysis underpinning programs and decisions has been better informed by local knowledge than in the past. Activities are now managed by locally employed Papua New Guineans. Some AusAID policy staff and programs have been physically moved to government departments. However, major policies and directions, for example, the ECP, continue to be developed and directed in Canberra

Strategic incrementalism: Australian aid is focused on a few core aspects of public administration in the central agencies, and has not sought to broaden the reforms beyond these core aspects. In the infrastructure sector, Australia was successful at linking the funding of retrenchments costs to increased PNG Government for road maintenance. Australia has also begun to work at the provincial level using a performance framework as the basis of support.

New partnerships: Australia has commenced the process of working in longer term partnership with functioning institutions outside the state such as civil society organisations, churches and the private sector.

However, given the preceding analysis in this chapter, there is a problem with these findings that Australian aid to PNG seems broadly consistent with the basic principles of good aid to fragile states. This analysis suggests that *political-pull* approaches and the fragile state approach are at odds and highlights the inherent tensions for Australia in positioning its aid program in PNG to influence change. On the one hand, Australia acknowledges that a long-term incremental approach to building stronger institutions is crucial, and that its aid program should at a minimum not inflict harm (AusAID, 2002). However, pure implementation of this agenda means increased recognition of the perverse incentives that large aid inflows can have on the evolution of local institutions.

To the contrary, Australia is applying a number of hard end state-building fragile states strategies in PNG. This includes maintaining service delivery to prevent collapse, even if it means establishing parallel structures and capacity substitution through large amounts of TA (AusAID, 2005f:19, 39). One of the main tensions between using aid as an incentive, and positioning an aid program to be focused on the causes of fragility is time inconsistency. Institution building is long-term and based on the idea of shifting incentive structures incrementally. Moreover, although the policies associated with the fragile states paradigm promote long-term approaches, in practice, the focus on a state's fragility has tended to elicit short-term state-building responses.

The fragile state paradigm is also limited in providing guidance on assessing the overall institutional effects of aid. For example, it assumes that this approach will strengthen the functionality of the state by providing parallel services that are in excess of its own capabilities. There is evidence that this might hold true in post-conflict transition countries where a broadly accepted peace agreement provides the basis for reform and generally start from a low base (i.e. easy gains). Conversely, the paradigm is unable to provide guidance on countries categorised as 'governance deteriorating' countries such as PNG, where it seems clear that aid to the state through TA and service delivery, is acting as a disincentive to reform at the macro level. To the contrary, large levels of aid should not be directed outside government. If substantially more aid was delivered outside the state through non-government organisations, churches, and the private sector, there are serious questions about the unintended consequences of this support for the legitimacy of the state. The non-state service delivery agents' ability to fill the gap left by deteriorating government services reduces the pressure on government to undertake its core functions, and ultimately reduces the legitimacy of the state. To this end, reducing the pressure on the state to perform its core functions should not be one of the objectives of the fragile state paradigm. Again, to the extent that the paradigm promotes parallel service delivery to prevent

collapse, it highlights the internal inconsistencies within policy directions prescribed by the fragile state literature.

6.6 Conclusion

The Australian aid program has had limited impact at a macro level in positively influencing incentive structures, and therefore the robustness of state institutions in PNG. The analysis in this chapter argues that because Australian aid has predominantly sought to supply reforms through the state, where limited will and capacity exist, aid has not been able to leverage reforms at the aggregate level. Therefore, its focus on strengthening state institutions has been a considerable constraint to aid acting as a lever for change, and has probably acted as a disincentive to, or negative influence on, reform. To date, attempts to direct aid interventions to shift power relations between state and society have been limited.

This conclusion should not detract from the many success stories of Australian aid, some of which are outlined in chapter 7. Nor should it give the impression that other donor's aid programs in PNG have been more effective. Indeed, all donors' programs in PNG are likely to be open to a similar or in some cases an even more scathing critique.