

CHAPTER 7: THE USE OF INCENTIVES TO INFLUENCE INSTITUTIONAL CHANGE: SUCCESS OR FAILURE?

7.0 Introduction

This chapter explores the effectiveness of aid interventions as instruments for inducing institutional change, through the use of incentives, at the program level in Papua New Guinea. The purpose of this chapter is to build upon the analysis in chapter 6 through illustrating in more detail the complexities of donor attempts to influence institutional change. To do this, two major Australian aid programs are examined. These programs have been selected on the basis of their explicit attempt to use incentives to influence institutional behaviour. Intended and unintended institutional effects of these aid programs are also explored. Health Sector interventions and the PNG Incentive Fund (PNGIF) are briefly explained in turn.

Health Sector: Major donor interventions in the health sector have been primarily delivered through the Health Sector Improvement Program (HSIP) and Health Services Support Program (HSSP). These programs operate in partnership with the National Department of Health (NDoH). The ADB, Australia and New Zealand provided funding through HSIP to assist GoPNG to implement the National Health Plan. Australia funded 100 percent of HSSP which supported implementation of the plan, with the provision of TA being a major component. The Health Sector is discussed in section 7.1.

PNG Incentive Fund: The PNGIF provides large grants to PNG organisations of excellence - both government and non-government - to support their key priorities. It is 100 percent funded by Australia and operates outside the PNG government system. The PNGIF is discussed in section 7.2.

The following questions are addressed in sections 7.1 and 7.2:

- **Incentive-based Aid:** How does the program intend to use incentive-based aid as a method to induce institutional change, and to what extent were incentive-based principles effective?
- **Ownership:** Is the program owned by the PNG Government (and implementing PNG agency)? To what extent are performance criteria jointly owned?
- **Fungibility:** To what extent does the program replace (i.e. substitute for) GoPNG expenditure, or leverage additional PNG Government resources?
- **Impact:** How successful has the program been at inducing or influencing incremental institutional change (a) within the implementing institution; (b) in the broader community for whom the program is being implemented; and (c) at the macro level?
- **Performance:** Were performance systems in place, relevant, enforceable and actually enforced when appropriate?

These criteria are assessed through program review and evaluation reports, interviews with key stakeholders and the author's own observations working on the Australian aid program in PNG from 2001 until 2006. Section 7.3 concludes the chapter by drawing out some lessons from the use of incentive-based aid.

7.1 Health Sector

7.1.1 Sector Overview

A multi-donor approach to supporting the health sector in PNG began to evolve in 1999 through an ADB loan, and led by NDoH. This \$US60 million (K200 million) loan over five years was intended to support the PNG Government to implement the National Health Plan (1996-2000) and was a conscious move towards a multi-donor sectorwide approach (SWAp). A SWAp is a public expenditure approach to donor assistance that seeks to leverage partner government resources. The approach usually aims to achieve the following principles in its delivery design (ADB, 2002a:1):

- All significant donor funding to the sector supports a single policy and expenditure program.
- Government provides leadership for the program.
- Common implementation and management approaches are applied across the sector by all partners.

The main contributing donor partners to the PNG Health SWAp, through the Health Services Improvement Program (HSIP), include the ADB, Australia and New Zealand. In 2004, the PNG Government signed a partnering agreement with Australia, New Zealand, United Nations Family Planning Agency (UNFPA), United Nations International Children's Education Fund (UNICEF) and the World Health Organisation (WHO) which committed these partners to work consistently with the principles of the SWAp. The SWAp is continuing to evolve. To date, a single policy and Medium Term Expenditure Framework (MTEF) is in place to guide all expenditure within the health sector; however, a number of donors are still implementing programs outside the common funding pool. This is partly a

reflection of NDoH capacity and accountability systems, and the requirement for some donor organisations to brand name programs. Pooled funding arrangements are expected to evolve over the next few years.

In 2005, Australia's support for the health sector was \$50 million (K125 m), of which \$15 million (K37m) was specific to HIV/AIDS programs, and \$25 million (K62m) was directly supporting the SWAp. In 1999, Australia commenced HSSP - a six-year \$100 million (K250m) program which was intended to complement the evolution towards the implementation of the SWAp. HSSP had a significant focus on capacity building through TA.

7.1.2 Incentive-based Aid

Assistance to the health sector, through HSIP and HSSP, was primarily designed to be an institutional strengthening program. Interventions in the sector were in the form of TA for capacity building at the systems and skills level, although significant levels of financing were also available to fund core services and maintenance. Hence, it adopted a *functional-push*, or supply approach, to institutional change that focused on improving planning, budgeting and technical aspects of health delivery. The original design of these interventions did not explicitly seek to change internal dynamics by internal competitive pressures or by offering incentives that changed the systems through performance-based benefits (Bolger, Mandie-Filer and Hauck, 2005:15). The programs relied on the trickle-down effect on systems, capacity and service delivery at the sub-national level.

Based on stakeholders' evolving understanding of the nature of the political constraints in the health system, the health sector began to introduce an explicit incentive-based framework to guide expenditure flows to provincial governments. In 2003, NDoH and donors introduced a condition that required provincial governments to allocate six percent of their goods and services budget to the

health sector to qualify for HSIP funding. In 2005, the incentive system was broadened by linking small capital works funds to demonstrated good provincial performance. The donors' approach to institutional change in the health sector, and more recently its experimentation with incentive-based frameworks, has had mixed results. Three practical aspects of these programs are now discussed in turn.

First, HSSP has predominantly adopted a *functional-push* strategy centered on training and organisational change processes as a means of achieving institutional change (Bolger, Mandie-Filer and Hauck, 2005:10). The sector relied on high levels of TA (AusAID, 2006:12-13), which had overwhelmed the absorptive capacity of NDoH. For example, in 2001-02, Australia AusAID provided 264 TA positions including 222 expatriates (148 were short-term inputs of which 60 provided direct health care) (DAC, 2005: 95). A recent independent review of HSSP found that TA tended to fill any potential systems flaws and demotivate staff because highly competent advisers tended to 'set the bar' too high (AusAID, 2006:12-13). A 2005 review of the PNG Health Sector (Bolger, Mandie-Filer and Hauck, 2005:23-24) also questioned its approach to capacity building which tended to be focused on report writing and planning at the national level, rather than practical matters linked to service delivery. It concluded that this type of skills transfer was not likely to change behaviour and learning in the PNG context. Bolger, Mandie-Filer and Hauck (2005) also pointed out that the technical capacity building approach articulated by donor partners was high risk because of insufficient attention in the program design to "issues of power, competing interests and the informal dynamics of stakeholder relationships". To address these issues, more focus is needed on attitudes, motivations and traditional values that can influence behaviour. Consistent with these recommendations, the independent review at the completion of HSSP (AusAID, 2006:2-4) concluded that leadership and management of staff performance at all levels in the system were the major constraints to improvements in health outcomes that the program had not been able to influence.

The second issue to consider is the effectiveness of incentive-based approaches where they were applied. The six percent HSIP funding requirement for provinces has been effective in increasing provincial resources to health (see sub-section 7.1.4 below). Most critically, this approach to funds provision has introduced a culture of performance-based funding into the health system. Although this incentive-based element of the program is deemed to have been broadly successful because it increased the overall level of spending in the health sector, it has not yet translated to an improvement in the quality of health outputs. Analysis of the expenditure data by the NEFC (2005b) also revealed material discrepancies between appropriations and expenditure on health services, highlighting the perverse incentive for provinces to miscode expenditure in order to meet the six percent HSIP requirement. In a weak governance environment where monitoring by Treasury and key accountability agencies is weak, incentive-based approaches are difficult to implement and enforce without a substantial amount of high cost external auditing.

Third, in designing the program there was a lack of appreciation of the decentralised system of government and of the broader governance environment. Under the OLPGLLG substantial responsibility for service delivery rests with provincial and district level governments over which NDoH – the main partner in HSIP and HSSP – has little effective control. Therefore, to influence institutional change at the point of service delivery, HSIP and HSSP needed to make direct attempts to provide a motivational framework at the provincial level, in partnership with central agencies.

7.1.3 Ownership

Donors have assisted the health sector to introduce a performance monitoring framework at the national level. This framework is made up of twenty core indicators that are used to monitor changes in health output (e.g. incidence of

malaria) and input-type institutional processes (e.g. percentage of months facilities have all key medical supplies). These indicators are owned and utilised by both the PNG Government and donors. Through annual sector reviews, indicators are measured and reported to a wide audience. Although there is commitment to this monitoring principle, it has not yet been replicated at other levels. Nor have downward trends in the majority of outputs indicators triggered any behavioural change within the sector.

NDoH had reasonable ownership of HSIP, the concept of moving further towards a SWAp and the reforms associated with its implementation. Ownership has been facilitated through a PNG Government-led MTEF (with considerable TA) and the use of core health indicators. Healthy dialogue between NDoH and donor partners has led to a good understanding that donors' support to MTEF priorities requires NDoH to allocate its own resources within this framework. Although there is NDoH commitment to the SWAp and the HSIP Trust Account (HSIPTA), this was not always demonstrated or required by donors. For example, management of the HSIPTA was donor-staffed except for one Department of Finance staff member, raising serious questions about the level of PNG Government ownership and commitment to HSIP. The substantial focus on donor funding through HSIP also means there is a high risk that donors end up strengthening the HSIPTA, but not NDoH's own system which expends 70 percent of health sector funds (ADB, 2003a:43).

The AusAID-funded HSSP has not been controlled by NDoH (Lepani, Morris and Tuioti, 2004: 29), reflecting a lower level of ownership and joint interest. The HSSP Trust Account (HSSPTA) was controlled by a managing contractor (ADB, 2003a:41), and NDoH perceived they had little control over its 'day-to-day' activities. HSSP has often been referred to as the Third Division of NDoH, and behind closed doors referred to as being the "only division that functions".

Central agencies and sub-national governments have had less participation in, and therefore ownership of, the reforms introduced with donor assistance. This is partly a function of the inward-looking focus of the program on the health sector itself and one reason why aid interventions have brought about few tangible improvements to the sector outside the core planning and policy functions of NDoH.

Capacity constraints can also undermine ownership if donor programs evolve too quickly. A 2003 review of the sector warned that there was a high risk that the shift to SWAp was overly donor-driven, detracting from potential for ownership and genuine joint interests in the future (ADB, 2003a:19-20).

7.1.4 Fungibility

A PNG Government health expenditure analysis (NDoH, 2005b:13-16) found that total resources (including donor) to the health sector increased by 27 percent in nominal terms from 2001 to 2004. PNG Government expenditure has increased by 22 percent in nominal terms, but decreased by nine percent in real terms, over this period. Donor expenditure has decreased by one percent in real terms. Importantly, in nominal terms expenditure on non-salary goods and services increased from 37 percent to 40 percent. The positive aspects of these trends that can be attributed to the influence aid-donors on public expenditure management in the health sector, in particular the MTEF and the aid-financed debate around resource allocation. However, the real expenditure decline is reflective of PNG's overall macroeconomic performance and in this sense are somewhat outside the control of the health sector. Health sector expenditure has remained, as a percentage of total PNG and donor resources, in the 10.5 to 11 percent range.

At the provincial level, despite verbal agreement from Provincial Governors that they would allocate 15 percent of their discretionary expenditure to health in

2000, donor funding substituted for provincial expenditure on health in the first three years of HSIP. In some cases provinces expended none of their own resources on health (Bolger, Mandie-Filer and Hauck, 2005:17). This situation was corrected from the 2004 budget onwards with the introduction of the condition that provinces were required to spend six percent of their own goods and services funding on health to qualify for HSIP assistance. As a result, fungibility has improved with the proportion of total provincial goods and services expenditure allocated to health increasing from four percent in 2003 to an estimated ten percent in 2005. NDoH concluded this was due to the six percent requirement and Treasury's introduction of conditional health function grants (see PNG Government 2005 Budget). HSIP and HSSP have both been critical to assisting the PNG Government achieve these results.

The main concern with fungibility relates to human resources within the health sector. There is a clear tendency for highly qualified TA to take on considerable responsibility for NDoH planning and organisational tasks, and to step in where there is a crisis with both expertise and parallel funding. The independent review (AusAID, 2006:12-13) concluded that this approach has undermined pressure on NDoH management to fix the systemic human resource and funding constraints.

7.1.5 Impact

The institutional impacts of key donor interventions to the health system are now assessed in turn at the sector, community and macro level.

At the *sector* level, donor interventions have not been able to leverage an improvement in core health indicators at the national level. The annual sector review of 2004 showed an overall fall in performance of three percent from 2000 to 2004, made up of an eight percent decline in process indicators and a one percent decline in output indicators (NDoH: 2005a:52). The independent HSSP review (2006:v) concluded that donor assistance had limited impact on the quality

of health service delivery, which was continuing to deteriorate. For example, from 40-50 percent of aid posts are currently closed (AusAID, 2006:5)

Numerous reviews (see ADB, 2003a:21; Bolger, Mandie-Filer and Hauck, 2005:vi; AusAID, 2006:4-5) concluded that donor assistance has strengthened the planning, monitoring and policy functions within the health sector (predominantly at the national level), but had little impact on management, leadership and performance of staff (ADB, 2003a:41-42; AusAID, 2006:2-3). The abundance of TA in the health sector at the national level explains the gap between policy and implementation, both within NDoH and at service delivery points. TA has also undermined the internal incentives for management to take responsibility within the sector. For donors, this would mean accepting a much slower movement to a sectoral approach and being prepared to take a back seat to encourage long-run institutional change. In its review of the sector, ADB (2002a:48) made the recommendation to donors that if it was clear the health system was “not ready for a change of management culture and effectively organise supportive supervision at all levels, there is little scope for donor partners to support the sector”.

The performance of the health sector has been constrained by the enabling environment in which it operates, which is outside the sector’s direct control. A review of health outcomes in PNG found that only 20 percent of health indicators were attributable to the health system, with the remaining 80 percent of outcomes attributable to the enabling environment (quoted in AusAID, 2003a:44). Nevertheless, NDoH has performed poorly in engaging with its external stakeholders critical to its viability. For example, despite a sound MTEF and annual sector indicators that show health indicators are declining, NDoH has been unsuccessful in its attempts to secure a real increase in PNG Government resourcing and in preventing arbitrary cuts in staffing, whilst other sectors have grown (Bolger, Mandie-Filer and Hauck, 2005:9).

The enforcement of performance-based employment conditions are a public service wide problem, influenced by cultural pressures and the threat of retribution. Not surprisingly, existing external aid interventions has not been able to address this in the short-term. For example, in 2004 one NDoH Director tried to clamp down on chronic staff absenteeism in his division and was subsequently the object of death threats (HSSP Adviser, 2005). As a result of the threats, any attempts at performance management were halted and HSSP advisers thereafter undertook responsibility for the core work of this division. Again, it illustrates the limits to a sectoral approach if the broader institutional environment is not conducive to reform.

One factor which needs correcting is the inherent reputational and financial incentives for the managing contractor of HSSP to achieve outputs. This can often undermine the incentive for NDoH staff to perform. There are also incentives for donor stakeholders to achieve health outputs. For example, by implementing programs in parallel rather than through weak PNG systems donors can create perverse incentives by undermining the PNG health sector to take responsibility, and fill a gap they have partially created.

At the *community level*, HSIP and HSSP have not had a tangible impact on service delivery. The sector has relied on a top-down supply-based approach and has not focused on the role of community participation and civil society in mobilising support for health services (Bolger, Mandie-Filer and Hauck, 2005:23). Further, the investment through HSIP and HSSP at the sub-national level - where the majority of the population reside - has been low. Under HSSP, about 10 percent of overall resources supported provincial functions and implementation (PNG HSSP, 2006:45).

The *macro level impact* of the health approach has provided some useful lessons for other sectors moving towards whole of sector programs, and for donor partners. The introduction of the six percent conditionality through HSIP at the

provincial level may have contributed to some important cultural shifts around the importance of performance-based funding that may have a broader impact over the medium to long-term. The shift to the culture of using incentive-based approaches is embryonic, but at least it is starting to be considered by both donors and the PNG Government itself. However, this *political-pull* strategy is still a long way from influencing the weak management culture that pervades the public service across PNG.

7.1.6 Performance

The health sector approach does not currently incorporate a macro-level performance framework that determines the level of donor assistance to the sector. Most critically, there is little incentive for senior management within the health sector to take responsibility for the management and supervision of staff (AusAID, 2006:2-3).

Weak management is considered to be the main indicator of deterioration of health service indicators. To date, there is little global evidence that *functional-push* aid frameworks have influenced management performance where it is not driven by domestic political agendas. In the next phase of support to the sector, a more robust performance framework is required to institute an increased incentive-based approach to assistance. To avoid further entrenching dependency on a few individuals and aid-funded advisers, it will require a much more rigorous approach to managing the level of TA to ensure it does not fill the capacity and management gaps (Health Sector Adviser, 2005). Ultimately in health this means less TA, and donors accepting a drop in the standards of central planning and policy development. According to one health sector adviser (2005), performance expectations from donors to undertake many of the core functions of the PNG Government “rested with the managing contractor of HSSP, rather than with the PNG Government”.

In the case of Australia, the health sector did not meet the benchmarks set out in the bilateral Treaty between the PNG and Australian Governments as a result of a drop in real funding to the sector from 2000 levels (Lepani, Morris and Tuioti, 2004:55). Although there are question marks about the appropriateness of the sector benchmarks, and the link with the macroeconomic performance of PNG, the failure of the PNG Government to meet the benchmarks has not directly influenced the level of overall resources from Australia to the health sector. The same criticism could be applied to other sectors, and directly relates to the challenges of Australia spending a fixed amount of \$300 million a year in PNG.

7.1.7 Concluding Comments

Section 7.1 has revealed many of the shortfalls in donor interventions effectively leveraging change in the health sector, and their inability to influence overall outcomes in the sector. Despite this criticism, assistance has had some positive impacts. It has helped introduce a culture of planning and budgeting within a realistic expenditure framework, and a culture of monitoring outcomes. It has also begun to introduce the concept of performance-based aid at the provincial level. Importantly, donors themselves are monitoring impacts and realising the negligible, or negative, macro impact of their assistance on both sustainable outcomes and PNG performance.

Introducing a genuine performance-based approach to aid in the health sector raises a number of moral questions for Australia. Health interventions have development, humanitarian and sometimes national interest objectives for Australia. For example, Australia has a strong interest in PNG controlling emerging pandemics that potentially will adversely affect Australia. Taking a more 'back-seat' approach to TA and direct responsibility for delivery of services (for example, under HSSP Australia provided pharmaceutical kits outside the PNG medical supply system) requires Australia to accept a further short-term worsening in health planning and some aspects of service delivery. Interestingly,

a review of the Australian aid program commissioned by AusAID concluded that the main achievement of aid to the health sector was that it had prevented a collapse of the system by providing essential health infrastructure and equipment, pharmaceuticals, immunisation, health education, institutional strengthening, TA and training (AusAID, 2003b:42). A hard-end interpretation of the fragile state paradigm promotes donor funding of core services to prevent collapse. It is not clear in practice how this approach intersects with the softer-end interpretation of the fragile state paradigm which advocates the use of a performance-based framework that *may* leverage institutional change and sustainable outcomes over the long-term.

7.2 PNG Incentive Fund

7.2.1 Outline of Program

The PNGIF was conceived during the Development Cooperation Treaty ('Treaty') negotiations between the PNG and Australian governments in 1998 and 1999. It was agreed the PNGIF would provide direct funding to PNG organisations under the basic principles of incentives, contestability, excellence, awarding results and accountability. Its agreed goal was to "provide an efficient and effective facility that supports and encourages the efforts of both private and public sector organisations in PNG to participate in, and contribute to, national development in accord with the development policies of the PNG and Australian Governments" (AusAID, 1999:11). The PNGIF commenced in 1999, and was intended as a five year \$155 million (K387m) program. In 2005, the PNGIF was extended by two years until mid-2007.

The PNGIF is made up of two streams. The Program Stream, aimed to support proposals from PNG organisations that could demonstrate excellence in program management and financial accountability. The second component - the Policy

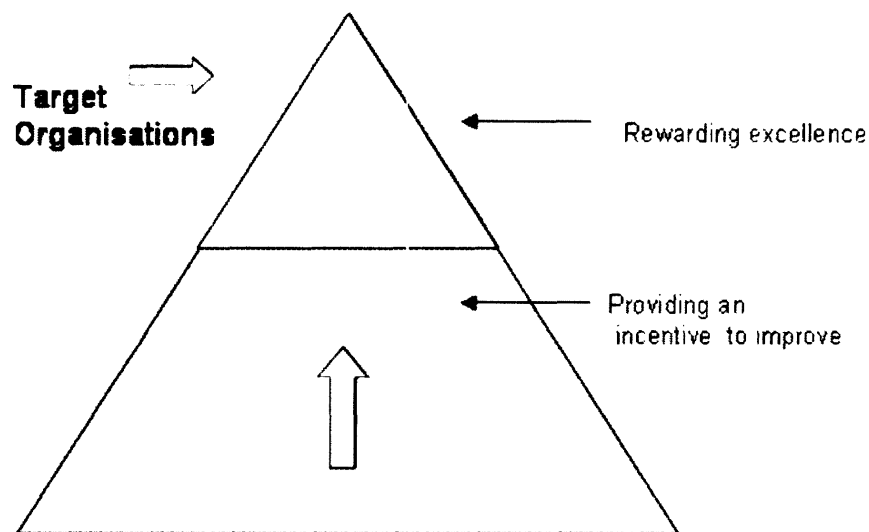
Stream - was designed to encourage and reward organisations to implement PNG Government policy in sectors that reflect the longer term goals of the Government and the Australian aid program. In its original design the Policy Stream was envisaged to be about one-third of awards, increasing to one-half over its lifetime (AusAID, 2002c:1). The Policy Stream was suspended in 2001 and not resurrected until 2004 to support the Government of PNG's Provincial Performance Improvement Initiative (PPII) where it was agreed K1 million would be allocated to three selected provinces to support their reform plans.

The PNGIF was originally intended to be a major plank of the Australian aid program, to the extent that it was the only program included as an administrative arrangement in the Treaty and was projected to be \$50 million (K125 m) (about one-sixth of Australian aid) by 2004/05. In 2004/05, expenditure through the PNGIF was around \$22 million (K55m). To July 2005, 38 Program Stream awards had been approved costing K245 million. Program Stream awards are a minimum of K1 million and were originally up to K15 million; however, the upper limit was reduced in 2004 to K7.5 million. These awards are a significant size in the PNG context. By comparison, Simbu Province's total annual goods and services budget was around K5.5 million per annum (NEFC, 2005c).

7.2.2 Incentive-based Aid

The PNGIF's core objective, as its name suggests, is explicitly to use aid funds as an incentive for PNG organisations to demonstrate excellence in program management and financial accountability. In the case of the policy stream, it aimed to reward effective implementation of PNG Government policy. The intention was that the rewards attached to PNGIF would have a catalytic effect on the institutional architecture in PNG over the long-term. Figure 16 below simply illustrates its intended long-term leveraging effect on PNG organisations

Figure 16: Incentive Fund Development Philosophy



Source: AusAID (1999:3)

The PNGIF Mid-term Review and Policy Stream Review (AusAID, 2002b:i; AusAID, 2002c:5) concluded that these overall principles were innovative and visionary, and that the Program Stream did provide a motivational framework to organise, plan and implement activities. In evaluating the broader nature of incentive systems in PNG, this review (2002b:12) further argued that moral, coercive and remunerative incentives were all relevant in PNG society and therefore supported the centrality of an incentive-based framework. However, these formal reviews and ongoing management of the program have revealed significant shortfalls in PNGIF's original design and implementation which have undermined the effectiveness of an incentive-based approach. These shortfalls are outlined in turn.

First, the original design did not adequately consider PNG's existing development context (AusAID, 2002b:i) and institutional capacity constraints. This is partly a consequence of the program being designed in the period when Australia was largely working in project modality and did not have an in-depth understanding of

the PNG system, and the costs of service delivery. The design overestimated the number of PNG organisations that met the minimum 'organisations of excellence' requirements and made assumptions about their ability to manage the implementation of programs. As a result the majority of awards have been given to organisations of 'relative' excellence (AusAID, 2002b:ii) that often had significant internal governance and sustainability problems. For example, concerns over procurement accountability have also meant that the PNGIF contractor has had to become involved in the management and implementation of awards. The high-order organisational requirements, and minimum K1 million funding level, mean PNG organisations have a strong incentive to contract in proposal writers to lift their short-term capacity to receive an award (sometimes on a commission basis). The PNGIF has also attracted 'copycat' proposals. Both factors undermine the original intention of the program to reward excellence.

Second, the Mid-Term Review found that the contestability criterion underlying its incentive-base framework remained valid, but in practice was rhetorical rather than real (AusAID, 2002b:11). As a result of misjudging the development context, the PNGIF had not adjusted itself to operate on a development basis to help build the capacity of organisations to meet minimum requirements. Thus, the incentive-based principle of contestability was diluted because of the oligopolistic nature of the market and absence of a healthy 'level playing field' for competition. For example, the PNG Salvation Army has been awarded four awards and the University of PNG has been awarded three, together comprising 18 percent of total program stream awards to July 2005. Many of these awards are phase II programs which in effect fund the recurrent costs of these activities. Recurrent funding was not the original intention of the PNGIF. Interestingly, a publication by AusAID of incentives in the Australian aid program (2003b:23) praised the PNGIF as a model program, due to its effective promotion of a competitive market for awards!

To overcome the problem of the oligopolistic market for awards, the PNGIF Mid-Term Review recommended reducing the minimum requirement to K250,000 which would facilitate more competition if coupled with a reduction in minimum accountability requirements (AusAID, 2002b:ii). However, to date this recommendation has not been agreed to by the two governments reflecting the difficulties of changing the status quo given the high level of goodwill associated with the PNGIF brand name. The goodwill comes from the high amounts of funding available for infrastructure and its philosophy of working through PNG organisations.

The third major design and implementation problem undermining the incentive-based nature of the PNGIF was its failure to consider the governance context, in particular in the design of the Policy Stream (2002c:10,17). The Policy Stream was a last minute addition to the design (2002c:34), was not appraised and did not take into account the nature of PNG's decentralised system (AusAID, 2002c:15). The 2002 Policy Stream review (AusAID, 2002c:52-61) recommended that awards should be made on a trajectory of acceptable financial and administrative management, not absolute good governance. It also highlighted major concerns about how to measure good governance in the PNG context where there was a lack of accurate and timely information from which to assess 'governance attributes' of government departments. For example, in 2001 education awards were in the process of being awarded to selected provincial education departments but at the time awards were to be disbursed, at least one of these provincial governments was in the process of being suspended for maladministration.

The fourth major constraint that detracts from the effectiveness of the PNGIF is the problem of perverse incentives that arise through information asymmetries. The review has identified the high risk of rewarding the wrong organisations where the operating environment is characterised by weak accountability systems (AusAID, 2002c:15). The selection guidelines also tended to reward

organisations on the basis of the quality of its proposal, rather than the inherent governance qualities or its contribution to the PNG Government's development priorities.

A final constraint that has mitigated the positive impact of this incentive-based approach has arisen through the contract with the PNGIF managing contractor. AusAID's contract with the managing contractor provides for a number of Key Performance Indicator payments commensurate with its ability to foster high-quality proposals and meet predefined expenditure targets. This provides an institutional incentive for the managing contractor to approve high value projects (i.e. up to the original K15 million ceiling) and low administrative input projects (e.g. capital works) (AusAID 2002b:21). It also provides a strong incentive for the managing contractor to step in to take over core functions of the project where implementation is poor. In some cases, if performance had been strictly enforced it should have led to the suspension of the award.

7.2.3 Ownership

The PNGIF enjoys strong ownership in PNG (AusAID, 2002b:ii; Lepani, Morris and Tuioti, 2004:62-65). The PNG and Australian Governments are in agreement about the principles and contestability criteria of the PNGIF. However, beyond broad principles, the perceptions of the effectiveness of the PNGIF have diverged, indicative of different understanding of the performance criteria and incentive-based framework of the program. Following the 2002 Mid-Term Review the Australian Government has sought to evolve the program to suit the development context in PNG, and correct some its distortionary impacts. The PNG Government was less enthusiastic about the Review recommendations. In particular, it did not agree with the recommendation that the program be focused to fit within core development priorities. This impasse led to the Program Stream being put on hold in 2003 for 12 months. Four years after the Review, a number of recommendations have not been implemented.

This divergence in ownership of the PNGIF is a consequence of different understandings of organisational excellence, and therefore the performance basis of the program. It has led to a situation where many of the organisations being rewarded are only 'relatively' good and, in this sense, the scale of the reward (currently up to K7.5 million) is disproportionate to their performance. For example, Alotau Provincial Hospital was a recipient of a Policy Stream award in 2000 and a current beneficiary of a K9.7 million Program Stream award, but is not able to pay its power bill (*Post Courier*, 9 August 2005). This state of affairs raises serious questions about its management and ongoing ability to manage its new capital acquired through the PNGIF.

7.2.4 Fungibility

In theory, the design of the PNGIF seeks to deal with the question of fungibility by awarding funds on a once-off and performance basis. This design assumes the PNGIF is not alleviating reasonable demands on the government to prioritise funding for maintenance and core development priorities. However, this assumption was misguided in implementation with PNGIF funds being awarded outside a PNG affordability and sustainability framework. For example, a K4 million award was given to the Catholic Health Services in Simbu Province primarily for capital works in one district hospital. In comparison, Simbu Provincial Health had an annual budget of less than K550,000 in 2005 (PNG Government, 2005). The high levels of funding awarded through the PNGIF have tended to create a high standard of capital works which surpasses affordable levels of infrastructure through other sources (AusAID, 2002b:13).

In order to assess fungibility, it is necessary to assess the alternative market for funding PNGIF awards. In its first four years, 77 percent of PNGIF expenditure was in the education and health sectors, of which the majority of funds were for capital works. In most awards, PNGIF included funding for maintenance after

years of limited maintenance. Unless the PNG Government implements a major reform program, there is limited funding available for capital works outside the PNGIF and infrastructure projects derived from resource sector benefit flows. The PNGIF may be creating a disincentive for reform over the medium term. The funding of core maintenance from past neglect also raises serious questions about the affordability of ongoing maintenance on PNGIF facilities.

In the case of the non-government sector, PNGIF funds are either substitutional or additive (AusAID, 2002b:12). A number of non-government organisations have informally advised AusAID that they would be unable to run programs without receiving ongoing awards from the PNGIF.

7.2.5 Impact

The institutional impact of the PNGIF is now assessed in turn at the institutional, community and macro level.

At the *institutional* level, successful PNG organisations have had an internal incentive to meet minimum financial accountability requirements. Over the six years of its operation, the Program Stream has made awards to 30 organisations (with five organisations receiving more than one award). It seems that the main ongoing external incentive to maintain this minimum level of financial accountability is the prospect of another PNGIF award. For the few organisations that are able to meet the criterion, this is an important incentive that acts as a motivation for change (at least over the short term while the organisation has an interest in applying for PNGIF awards). It is, however, possible that smaller sized awards could also leverage institutional reform and have a more beneficial impact. Smaller sized awards would benefit a larger range of organisations given that most organisations in PNG are small and operate in rural areas.

One concern about all externally funded projects is that organisations become focused on external rather than internal mobilisation of resources to achieve their own development. This external focus has a negative impact on the internal incentives within organisations. Many organisations in PNG have expended considerable scarce resources hiring consultants to write proposals to the PNGIF which have not been successful.

The PNGIF has had a significant and direct effect on the *communities* that directly benefit from the projects. This is however a small amount of the overall percentage of the population. As an example, the PNGIF funded a K11 million secondary school upgrade in the Southern Highlands Province which about 800 children attend. This province has a population under 18 of around 250,000 people.

At the *macro* level, the PNGIF has had some impact in promoting a culture of financial accountability and auditing within large organisations that are able to benefit from the PNGIF. The Mid-Term Review (AusAID, 2002b:i) concluded that the Program Stream was achieving its objectives within the limitations of the present operational criteria and guidelines. However, the PNGIF is not positioned to influence a shift in the organisational culture and performance in PNG, as anticipated in the original design, as illustrated in Figure 16. The Mid-Term Review (AusAID, 2002b:13) noted that its impact will only be optimised if the policy environment in which it operates is effective, and without this enabling context the PNGIF will not achieve its institutional and development objectives. Further, the project was not sufficiently contextualised to this environment. Thus, given the weak institutional environment within which the PNGIF has been implemented, the development impact is sub-optimal because it does not meet the social and economic needs of most of the population (AusAID, 2002b:22). The Policy Stream review concluded that the synergies between sectors were not being captured. Accordingly, its holistic impact for civil society was limited to the benefits of the individual supported activities (AusAID, 2002b:5). Unfortunately,

the managing contractors' own monitoring and evaluation do not require it to assess rigorously the macroeconomic and development impact of its awards. Rather, its' evaluations are focused on assessing the project outputs (see PNGIF, 2005).

PNGIF funding is inconsistent with the jointly agreed sectoral development priorities of the PNG and Australian governments. In the education sector, both the PNG and Australian Governments have prioritised basic education, yet a total of 57 percent of PNGIF funds have been awarded to the secondary and tertiary education sector, and ten percent to basic education. In the health sector, the PNGIF has distorted its MTEF towards capital works, which is a low-level expenditure priority in the MTEF.

A further macro concern about the PNGIF is its focus on large rewards and, relatedly, large capital works contracts. This plays into the rent-seeking culture that permeates PNG and may contribute to the broad perception that 'development' comes through large projects rather than internal mobilisation of resources.

7.2.6 Performance

The PNGIF does not lend itself well to a general performance framework. In broad terms it has not lived up to Australia's expectations that the PNGIF may have a catalytic effect on PNG organisations. As a result, only half of the volume of awards originally estimated to be expended through the PNGIF has been delivered to PNG organisations. In this sense, although the standards of excellence have dropped to 'relative' excellence, the Australian Government has recognised the PNGIF's weaknesses and reduced expenditure in 2004/05 to around \$20 - \$25 million per annum to prevent standards of excellence dropping even further.

7.2.7 Concluding Comments

The PNGIF has been a well intentioned and high risk attempt to use an incentive-based approach to encouraging good governance in PNG. Despite its good intentions, by designing the program without a thorough understanding of the development context it is perceived not generally to have yet acted as a *political-pull* or *push* factor in leveraging improved governance in PNG.

7.3 Overall Findings and Lessons

Australia's experience, and that of most other donors, of using incentive-based approaches in PNG is new and evolving. The use of incentives as a means of endogenously changing behaviour is highly complex and requires an in-depth understanding of the broad environment within which the program will be operating to leverage change. Drawing on the aid sector failure analysis in chapter 6, if aid interventions are well positioned to induce behavioural change, it is likely to result in MSB shifting outwards significantly more than MSC, and maximising long-term development outputs. This scenario is illustrated by Figure 14 in sub-section 6.3.3. However, if incentives are misjudged and result in the creation of perverse incentives, then MSC shifts outwards more than MSB and development outputs are reduced, as shown in Figure 13 in sub-section 6.3.3.

A number of lessons can be derived from this early experience in working with incentives in the health sector and through the PNGIF. These lessons need to be applied to any future attempts to use incentives.

First, incentive-based funding was a small component of the overall program in the health sector and has not been significant enough to have a *political-pull* effect on the sector's overall performance. In particular, assistance to NDoH was

not explicitly linked to the performance of management in NDoH. The provincial HSIP requirements have provided a useful pilot approach which is being further rolled out. The next phase of support needs to make better use of incentive-based compacts between all stakeholders – including NDoH, central agencies, provincial governments, communities and donors – to effect change at macro and service delivery level. This exercise will be extremely challenging in the context of a worsening HIV/AIDS epidemic and any general economic downturn.

Second, donors need to slow down and adjust their expectations to fit with the developing country context in which they are working. This requires donors to have a thorough grasp of staff capacity, and what could be achieved with an incremental improvement in capacity and management. If minimum requirements are set too high, it will require substantial use of TA to achieve program objectives. This action can defeat the purpose of setting a performance indicator and result in a shift in responsibility for delivery of outputs from the recipient to the agent of the donor.

Third, it is critical to get the development context right, and understand the range of stakeholders and enabling factors that affect overall performance of the institutions on which aid is focused. If the context is not right, the impact of the program could result in no effect or, at worst, could be perverse. The use of pilot programs to test and iron out implementation problems is key to effective aid. In a poor governance environment where there is a paucity of information, substantial resources will need to be expended in the assessment process, often relying on subjective judgment on a range of criteria that assess incremental change rather than absolutes.

Fourth, PNGIF has demonstrated that large incentive payments can be harmful and distort the system by encouraging rent-seeking behaviour. Incentive-based schemes need to start off small to ensure they are competitively based.

The fifth key lesson emanates from the difficulty of introducing the concept of incentive-based programs into cultures and partner Governments where measurement of performance is not usually linked with the distribution of resources. The length of time it may take to come to a similar understanding of performance-based systems cannot be understated and needs to be built into the implementation of programs. The joint learning process attached to the piloting of incentive systems is important. The resurrection of the PNGIF Policy Stream to support the PPII, and the placement of AusAID staff within each provincial administration - to ensure it understands the context and impact – has the potential to lubricate reform. Key to its success will be getting the nature of the incentives right in terms of the size of additional financial support and based on the right kind of measurable indicators of reform. Less than a year into its implementation, it is too early to judge its success or otherwise.

The final conclusion relevant to all program-level interventions is the requirement for broader objectives of the overall aid package to be clear in order for incentive-based approaches to have a positive macro effect. When an aid program has dual objectives it will be plagued with time inconsistency problems in achieving these dual objectives. Australia's aid relationship with PNG epitomises this classic dilemma. On the one hand, Australia recognises the importance of incentive-based approaches, linked to performance, as a measure of leveraging change (AusAID, 2005f:51). It is also starting to understand the adverse impacts of supplying TA as a capacity building mechanism where management and the culture of performance is weak (AusAID, 2005f:39-40). On the other hand, choices of aid interventions are driven by Australia's unwillingness to allow Papua New Guinea to fail beyond a certain point over the short term. This latter objective does not lend itself well to an incentive-based approach.

CHAPTER 8: CONCLUSION

The main purpose of this thesis has been to examine the efficacy of the consensus that 'institutions matter' and emerging frameworks that have sought to apply this finding to aid policy. The conclusion draws the thesis together by relating the main findings of each chapter.

The review of the institutional economics literature in chapter 2 concluded that the process of institutional development and change is slow and incremental, and is best explained by comparative-institutionalist development models where conflict and incentives structures are placed at the centre of the development path. It found that institutional frameworks are embedded through endogenous processes, and as a result, external agents aiming to affect the development path need to work with both informal and formal systems. Externally implanted structures will not lead to legitimate institutions without prior broad-based acceptance.

Chapter 3 assessed the development aid policy literature with a focus on the fragile states paradigm. It concluded that although the existing paradigm had led to useful frameworks for *thinking differently* about aid interventions it had lost its focus on the centrality of institutional foundations to development. Instead the literature has overly focused on state-building and the prevention of state collapse and may not have led to any change in actual aid effectiveness on the ground.

Chapter 4 drew chapter 2 and 3 together by comparing and contrasting the economics and development aid literature. It argued that there is a major inconsistency between the soft and hard end of the fragile state paradigm where the soft end advocates a longer term incremental approach to institutional development based on building local capacity, and the hard end adopts a capacity substitution approach premised on restitution of the formal systems. The

two ends are frustrated by a time inconsistency problem which inevitably hinders implementation of coherent aid strategies on the ground. Chapter 4 concluded that, given the conflicting objectives of aid, the best outcome is to aim for the 'least worst' aid interventions based on a long-term marginal social costs and benefits model. A framework for assessing aid in fragile states, centred on institution building, was presented in Figure 8, chapter 4.

The 'Drivers of Change' analysis on PNG in chapter 5 pointed to the need for donors to premise strategies on a long-term development path and focus interventions on building the capacities of people and their development needs. It argued that interventions that target rural transport infrastructure, the informal sector and basic education, are most likely over time to provide the building blocks for political, social and economic development. These basic foundations are required to be built before the bulk of higher end aid funded governance interventions (i.e. TA to support reform at the national level) and greater citizenry demands on the state for reform are likely to be sustained.

Chapter 6 concluded that given the underdeveloped nature of modern social and political institutions in PNG, and its nascent stage of economic development, Australian aid to PNG has been overly state-centric and has had limited sustainable impact at the macro level. It is argued that its impact has been reduced due to its supply-based approach and high levels of TA to substitute for weak capacity. It suggests that Australia, and other donors, need to increase attempts to adopt *political-pull and push* aid strategies to help PNG develop the basic economic institutions that ultimately underpin state effectiveness. The chapter argued that capacity substitution strategies, although they may generate short-term outcomes, risk keeping PNG weak by creating an external dependency, especially with regard to the public sector.

The case study on two Australian aid program interventions in PNG in chapter 7 demonstrates that, even where aid interventions are designed to influence the

institutional environment, it is difficult to get incentives right in implementation. It concluded that aid sector failure will continue to be high without perfect information in designing and assessing aid incentive-based approaches. Programs need to be implemented on an incremental basis to ensure that the size of the incentive is appropriate in order to have a *political-pull* effect that is not distortive. The chapter also argued that incentive-based approaches needed to be consistent with the overall objectives of the program. It concluded that in PNG Australia's attempts at implementing incentive-based approaches were less effective due to Australia's overall interest in preventing state failure. Further cross-country analysis of incentive-based approaches in fragile state environments is needed to draw further conclusions on the efficacy of *political-pull* effects.

The thesis has highlighted the inherent tensions between the hard and soft ends of the fragile state paradigm. This has been illustrated in generic terms in chapter 4 and in the analysis of Australian aid to PNG in chapters 6 and 7. At the hard end, the scope and focus of Australian aid to PNG illustrates Australia's predominate state-building approach - where aid design has been concentrated on supplying TA to strengthen the performance of national institutions demonstrates its unwillingness to let PNG fail. This has been most recently characterised by the ECP intervention and through the concept of capacity substitution which Australia has sought to promote as a legitimate and effective fragile state intervention (AusAID, 2005f:39-40). It is argued in this thesis that this approach has short-term benefits, but over the longer time may undermine the objective of state-building by creating more dependency on external assistance to fulfill core tasks and may ameliorate the need for development of strong indigenous institutions and leadership. This case of aid sector failure was shown diagrammatically in Figure 13, chapter 6.

At the softer end of the fragile state paradigm, Australia is increasingly recognising in its policy documents (AusAID, 2005f:37-38; AusAID, 2003b) that

aid will be more effective when it is performance-based and consistent with a *political-pull approach*. However, performance-based aid is long-term, slow, and may often mean a lower volume of aid is delivered if mutual obligations are not met - much of which could often be unacceptable on a foreign policy basis to Australia.

This thesis's portrayal of the soft and hard end of the fragile state paradigm illustrates the classic aid donor dilemma:

"...how to best prevent a state collapsing, which is largely captured by the political elite, whilst simultaneously building local capacity and leadership so it will sustain itself".

Australia's experience in PNG epitomises this classic development dilemma and could be similarly applied to most donor governments and international agencies. This thesis has argued that there is no blueprint to solve this dilemma. Rather, accepting the dual objectives of aid, donors need to find equilibrium between interventions at either end of the continuum of the fragile state paradigm, and seek to minimise the perverse incentives that interventions create. Thus, positioning the bulk of aid interventions too far towards the hard end risks undermining the long-term institutional development of the country. On the other hand, interventions at the softer end risk undermining aid donor country's short-term geopolitical objectives and may not address acute instability in the recipient country.

The non-market failure framework examined for the aid sector in chapters 4 and 6 is a useful tool for focusing aid donor governments' attention on the overall institutional effect of aid interventions at the macro and program level. At the design and monitoring stages this framework may assist donors to make more conscious decisions about the precise objectives of aid interventions, and the costs and benefits on a recipient country. It is proposed that this type of

framework, and the analysis that stems from it, is a useful contribution to the fragile state paradigm. It may help donor governments to correct the balance between strategies that employ interventions at the hard and soft ends of the continuum, especially when they act against each other.

Drawing on this analysis, it suggests that trickle-down 'governance' interventions will have limited impact on sustainable development over the longer term in PNG. Instead, Australia should select interventions that bring real broad-based economic benefits to peri-urban and rural areas. This conclusion suggests Australia should substantially increase aid interventions that:

- (1) target rural transport infrastructure which provide opportunities for economic development, and;
- (2) work with the state and non-state actors at the local level to improve problem solving at the service delivery point.

At the same time, Australia should substantially reduce the scale of assistance targeted at policy, planning and broader governance reforms at the national level. This may mean a shift away from sectorwide approaches which assume political will and on the ground impact from trickle-down governance reforms. It however makes sense to retain a small amount of capacity substitution in core functional areas (i.e. treasury, finance).

After further development of the base, it is more likely that a conducive environment for improving governance will follow over the long-term. It is acknowledged that there will be an element of fungibility and parallel delivery in many of these interventions. However, provided the benefits can be proved to outweigh the perverse impacts of fungibility over the long-run then the intervention should proceed.