Abstract:

A vast empirical and theoretical literature aims to elucidate the tangled web of interrelated factors which promote economic growth in developing countries. Australian policies to Papua New Guinea, including official development assistance, trade policy and the pilot program of the Enterprise Challenge Fund, must be evaluated in the context of these recognised sources of prosperity. The analysis draws conclusions about the incentive framework facing the PNG Government, and the possible contribution of Australian foreign aid to government failure and continual economic stagnation in PNG.

Introduction

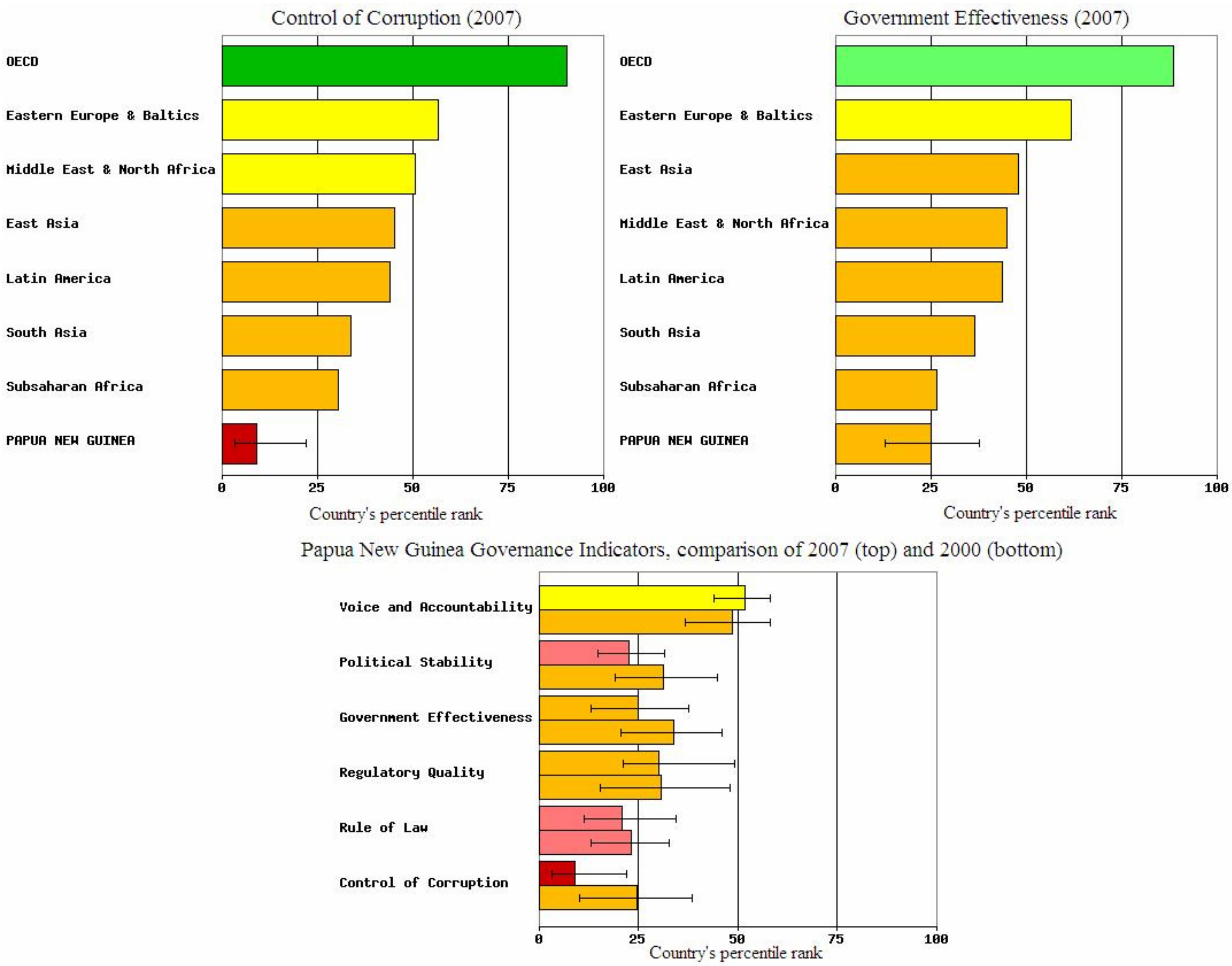
Economic development occurs through complex processes, and a vast theoretical and empirical literature identifies a range of interrelated and dynamic factors which are broadly supportive or unsupportive of sustainable economic growth in developing countries. By examining the policies of Australia toward PNG within the context of the studies of prosperity, important conclusions may be drawn about the possible successes or failures of our trade policy, official development assistance policy and the pilot program Enterprise Challenge Fund.

The Papua New Guinean economy contracted almost every year from 1976 to 2002 amidst population growth of 2.7%, and recently has experienced a recovery based largely on commodity price rises (Department of Foreign Affairs and Trade Economic Analytical Unit 2004). Though classified as lower middle income with an average per capita income of A$771, PNG has some of the lowest social indicators in the Pacific. The income of Papua New Guinea is dominated by an enclave capital-intensive mining and petroleum sector, while 87% of the population are rural subsistence farmers (Department of Foreign Affairs and Trade Economic Analytical Unit 2004). The low labour productivity indicated by the predominance of subsistence agriculture may be caused by low levels of capital intensity, inability to achieve economies of scale on smallholder plots, uncertain property rights and low levels of health and education.

Paradoxically, Papua New Guinea is richly abundant in copper, gold, oil, forestry, fisheries and only 30% of arable land is currently in cultivation, raising concerns that it may be subject to a ‘resource curse’ (Manning 2004). A resource curse occurs when a dominance of extractive natural resource income crowds out the competitiveness of other sectors of the economy, induces volatility of export income creating extreme booms and busts, and has negative impacts on institutional quality (Collier 2007). An abundance of natural resources in developing countries are empirically associated with state dysfunction, patronage politics, poor economic policies and an expanding public sector (Robinson, Torvik et al. 2006). As the generation of income from mining and petroleum royalties represents a depletion of the nation’s natural capital, the revenues must be invested within other productive sectors of the economy to generate sustainable growth. A potential path to economic development may be to generate an increase in agricultural productivity via investment in capital accumulation and human capital, facilitating release of labour to increase production of ‘cash crops’ and diversifying export income into the manufacturing and service sectors.

At the core of Papua New Guinea’s failure to achieve economic growth since independence lies poor quality governance, weak political institutions, endemic corruption and a lack of authority in the rule of law (See Figure 1). Institutional deficiencies dually frustrate economic growth by increasing uncertainty and creating disincentives for domestic and foreign investment, and contributing to a distorted policy environment which fails to effectively support economic development. PNG’s political system is characterised by a lack of party loyalty and a multiplicity of candidates for each first-past-the-post-seat; leaving the eventual representative with a low popular mandate from the electorate (May 2004). Executive government vests in loose coalitions which frequently shift mid-term, ensuring a short term mindset which stimulates corruption and nepotism. A fluidity of political allegiance and culture of corruption in power-broking prevent the unicameral legislature from effectively scrutinizing the executive branch. Misallocation of resources occur as leaders seek political expediency; prioritizing visible construction projects which require self-aggrandizing “ribbon-cutting ceremonies…[while] lack of maintenance has become synonymous with capital projects in PNG” (Institute of National Affairs 2003). However, democratisation appears to be creating increased participation and involvement of citizens in public debate, supported by a robust media prepared to challenge corrupt government officials and a mobilisaton of community political pressure groups such as the Community Coalition Against Corruption (Transparency International 1st May 2007).

Figure 1. World Bank Governance Indicators for Papua New Guinea



Source: Kaufmann and Kraay 2008

Trade policy

Empirically, the only developing countries to achieve large reductions in poverty have integrated into the global economy on trade and investment dimensions (Dollar 2001; Brunner and Allen 2005). Innovation incentives are strengthened by openness to trade, as the costs of innovation are independent of the extent of the market but the rewards rise in proportion with market access (Sheshinksi, Baumol et al. 2007). Papua New Guinea has a very small and fragmented domestic market, with poor transport linkages between regions, which heightens the importance of market access. By developing a diversified range of commodities, manufactures and semi-processed goods, PNG can reduce its vulnerability to commodities prices while enhancing trade complementarity to some of the most dynamic parts of the world economy in the Asian region. Australia currently holds an agreement to eliminate tariffs on PNG exports, and currently is PNG's largest trading partner. However, non-tariff barriers to trade are "particularly prominent" in the Asia Pacific, and import restrictions and related hidden costs may impede the development of trade links (Ching, Wong et al, 2004)

Official Development Assistance (ODA)

Australia's official development assistance program to Papua New Guinea is estimated to amount to $389.4 million in 2008, or around 11% of total PNG government revenues (OECD 2008). In 2006-07, 16% of aid funded education, and 18% funded healthcare, the two traditional focuses of Australian aid to PNG (Australian Treasury 2006). While education and health represent significant contributions to quality of life and human development, improvements in these areas, such as an increase in literacy from 45% in 1976 to 64.6% of the population in 2002, have not transformed labour productivity and driven economic growth (Department of Foreign Affairs and Trade Economic Analytical Unit 2004; Heinecke, Dollery et al. 2008). The empirical literature has emphasized the strong complementary linkages between investment in human capital, technological capacity and increased capital accumulation, where technological capacity refers to the ability to selectively acquire mature technologies and adapt them to local circumstances (Szirmai 2005). In light of these complementarities, the success of investment in education relies on the extent of opportunity to utilize and maintain the skills acquired in the formal economy employment (Pomponio and Lancy 1986). Smirzai concludes the education and health are necessary but not sufficient preconditions for economic development, and given that the formal economy only provides 13% of employment in PNG, it is to an extent unsurprising that these gains have not successfully transformed into drivers of economic growth. Additionally, the effectiveness of core service delivery relies largely on government effectiveness in transparent resource allocation, quality of project prioritization and efficiency of the bureaucracy, which are considerable institutional weaknesses in Papua New Guinea.

Another forty four percent of Australian aid consists of technical assistance or "governance", which is aimed at improving the capacity of PNG government institutions to effectively manage economic and social development (Heinecke, Dollery et al. 2006). The performance of technical assistance has been widely criticized, as preventing the evolution of sustained local capacities and yet though "TA appears to have failed massively…. the consequences of this new discourse on and assessment of the impact of technical assistance has not yet led to the radical changes on the ground that one might have expected" (Riddell 2007, p 207). The evaluation of Australian TA to PNG reflects these broader criticisms, as technical assistance has been a mixture of capacity substitution and capacity building, in some circumstances displacing and deskilling locals (Heinecke, Dollery et al, 2006). There is a danger that the donor country can assume responsibility for the key responsibilities of the state through technical assistance, further isolating the PNG government from the citizens and undermining governance capacity.

The evidence of the failure of Australian aid to contribute to economic development within PNG squares with international studies of aid effectiveness. Through empirical cross-country regressions, official development assistance has yielded only a small, positive effect on economic growth of dubious statistical significance; foreign aid has failed to be a significant determinant of growth (Riddell 2007). Additionally, the context of the Australian aid injections into PNG reflects precisely the country-specific circumstances where aid is deemed to be least effective: in a weak institutional environment plagued by corruption, with low public demand for policy reform, and little recipient 'ownership' of aid directions.

However, Australian foreign aid to Papua New Guinea also may create a strikingly perverse incentive structure for the PNG Government, firstly through the fungibility of aid and secondly the possibility that aid volumes may be buttressing institutional deficiency and corruption within the country. Feeny's analysis suggests Australian aid to PNG may be highly fungible, meaning that aid funding of core service delivery simply enables shifting of other revenues to non-development expenditure (Feeny 2005). While the counterfactual is difficult to assess, PNG would shift expenditure from the high-cost, unwieldy bureaucracy to core service delivery if Australian aid volumes decreased.

The provision of the majority of funds for core public services by Australia as the major donor raises the question of whether the accountability of government to local citizens can be preserved. The key relationship which drives a democratic constituency to press for better governance is through the contribution of citizen's tax to government expenditure, yet the composition of the 2008 budget reveals a high level of foreign aid and natural resource reliance. 28% of government revenues are derived from mining and petroleum taxes, 16% from foreign aid, and only 14% from income tax and 9% from company tax (Pricewaterhouse Coopers 2008). The OECD suggests that "aid can inadvertently undermine the foundations of a tax-based bargain between the state and its citizens", as a higher level of contribution to government revenues stimulates a higher propensity to mobilize demand for transparent and effectual government expenditures (OECD 2008). A high proportion of aid income has also lead to a decrease in efforts to collect domestic revenues in PNG (Feeny 2005).

When the effect of weakened accountability to citizens through aid is viewed within the context of the broader pressures on the government of PNG, the true picture of the accountability linkages becomes alarming. The volumes of aid which flow to PNG have been virtually guaranteed since independence, regardless of government policy performance, as the conviction to demand policy conditionality has been overcome by political constraints. As identified previously, the democratic political system of PNG contains deficiencies in accountability between the legislature and executive, and each representative has a low popular mandate (for example in the 1997 elections the average winning candidate received 19.7% of the vote (May 2004)). Additionally, in this climate of low accountability, the perverse influences on government institutions from resource abundance and a low tax linkage between citizens and government further isolate accountability and transparency from the institutional system. These interrelated effects constitute a virtual recipe for bad governance.

In August 2008, the new Papua New Guinea – Australia Partnership for Development seeks to herald a new era of aid accountability by providing for evidence-based review of specific performance indicators, and by engaging the PNG Government in determining development priorities (Australian Government 2008). While this may appear to mitigate concerns about aid effectiveness, the claims of aid based on performance and policy conditionality ring false when the Australian government commits to "provide long term and predictable engagement" with scope for increases in aid spending to reward progress. The fundamental structure which creates a lack of accountability in Papua New Guinea's governance, in which the executive lacks links of scrutiny and responsibility to the legislature, the citizens, and the donor community, should be expected to continue.

Enterprise Challenge Fund (ECF)

The ECF seeks to 'commercialise' business projects in the private sector of Pacific nations by providing a grant of $A 100,000 to $A 1.5 million, though requiring that the firm contribute a minimum of 50% of the project funds required (Enterprise Challenge Fund 2007). The pilot program is encouraging as a support of private sector entrepreneurship as a dynamic determinant of economic growth, yet the structure of the program could be enhanced to provide a greater return. Firstly by choosing to use a grant system, applicants may incur high costs while attempting to obtain the grant through rent-seeking behaviour; however this may be partially mitigated by the co-contribution requirement. Secondly, it may be questionable to prioritise funding such large projects for firms which by definition must have sufficient financial capital or borrowing capacity to raise $A 100,000, while “more than 85% of the population is in the informal sector [and] virtually that same percentage has no access to formal credit or saving arrangements” (Barker and Kiopa 2008).

Within this context, support of a microcredit scheme for PNG’s urban and rural poor would increase their opportunity to invest in small purchases of capital with the potential of dramatically increasing future productive capacity and income. Capital market can fail to provide optimal levels of credit and savings provision where there is a large informal economy, small amounts of borrowing and saving, uncertainty in property rights, difficulties in credit risk assessment and a large rural population (Hume and Mosley 1996). Urban microcredit projects have previously successfully supported growth in the service and small manufacturing sectors, whilst rural microcredit has increased productivity substantially through small investments in soil replenishment, tools or seeds. Clearly the effectiveness of a microfinance strategy would be supported by improvements in telecommunications and rural transport infrastructure, as identified in a PNG survey which found that 51% of informal economy participants identified transport infrastructure as their major growth barrier while only 12% identified lack of access to credit (Shaw 2004; Barker and Kiopa 2008).

Conclusion

Australia has a broad responsibility to the citizens of both Australia and Papua New Guinea to utilize policies which support economic growth and development in our nearest neighbour. While Australia cannot control the actions of the PNG Government, it can evaluate its policy design within the context of the empirically and conceptually recognized sources of growth and prosperity. The analysis raises some significant questions about potential unintended consequences of Australian official development assistance policy, whilst holding cautious optimism for the new directions of Australian policy embodied in the Enterprise Challenge Fund and the Partnership for Development. By investing in grassroots community organisations or microfinance institutions, Australian aid could invest in a domestic constituency for reform and improved governance within Papua New Guinea. The engagement in debate about the wisdom of our policies regarding PNG which is centered around concrete economic arguments has potential to enhance the prospects for economic development within the country.

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