FOREIGN AID IN PAPUA NEW GUINEA:
POLICY ISSUES AND PERSPECTIVES

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I. INTRODUCTION

In contrast to many developing countries, Papua New Guinea's rich and abundant but almost virgin resources are indicative of a considerable potential for rapid economic development. However, the country's economic performance during the past decade has not been impressive by regional standards. Among others, there are three clearly visible limitations to faster development of the economy: first, the shortage of trained manpower; second, the low level of infrastructure development; and third, the shortage of capital. The first two limitations can be considered as very much a consequence of the third. The capital shortage thus appears to be a crucial constraint in the economy.

The classical view considered that capital needs for economic growth are met through increased savings. However, the problem with a developing country like Papua New Guinea is the relatively low savings ratio largely due to low incomes particularly in the large subsistence sector. For instance, in 1982, Papua New Guinea's savings ratio was only 7 per cent of GDP, compared with an average savings ratio of 17 per cent for the group of lower middle-income countries to which Papua New Guinea belongs in the World Bank classification. Even if a substantial level of

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1 Annual average GDP growth rates 1970-82:

<table>
<thead>
<tr>
<th>Country</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malaysia</td>
<td>7.7</td>
</tr>
<tr>
<td>Indonesia</td>
<td>7.7</td>
</tr>
<tr>
<td>Thailand</td>
<td>7.1</td>
</tr>
<tr>
<td>Philippines</td>
<td>6.0</td>
</tr>
<tr>
<td>Burma</td>
<td>5.2</td>
</tr>
<tr>
<td>Papua New Guinea</td>
<td>2.0</td>
</tr>
</tbody>
</table>


2 The land tenure system and the law and order problem are the often cited other main constraints to development in Papua New Guinea.

3 World Bank, Ibid, Table 5.
savings is achieved, Papua New Guinea is unable to produce, on its own, capital and intermediate goods needed for development. Its ability to produce investment goods is limited by the lack of such factors as technical know-how, technology, capital equipment, and certain raw materials. In such situations external resources, by way of foreign aid and/or foreign investments, become crucially important in meeting the capital resource needs for development.

From the early days leading to Independence, Papua New Guinea has been heavily dependent on Australian aid to meet its resource needs. The aid relationship with Australia has been a unique one. At the same time both Papua New Guinea and Australia endeavoured to work towards a real reduction of Australian aid to Papua New Guinea over time. This paper discusses the role of foreign aid in the economy with special reference to Australian aid, Papua New Guinea's aid policy and prospects for non-Australian aid.

II. ROLE OF FOREIGN AID

There is worldwide consensus that the flow of economic assistance from developed to developing countries is essential to the uplifting of the economies of the latter. For a harmonious development of the whole family of nations, which is a principal aim of the United Nations's Charter for sustained peace among nations and for the promotion of world trade and commerce, it is considered that richer nations should assist the poorer ones to improve the latter's economic conditions through faster development.

The foreign aid rationale came to be widely accepted especially after the Pearson Commission was appointed by the World Bank in 1968 to study the consequences of twenty years of development assistance and propose policies which will work better in the future. Its report developed the rationale that from the point of view of the rich donor countries aid would need to be looked upon as a matter of moral obligation towards the needs of the poorer nations—-an extension of the inborn human moral incentive for co-operation to international development. From the point of view of the recipient countries, aid would need to be considered not merely as a donation, but as a matter of economic necessity in which economic assistance is received to assist in their own
efforts to develop their economies towards the achievement of self-reliance over a reasonable period of time.

Foreign aid constitutes any provision of foreign exchange or goods and services to a developing country from an overseas agency or a country which requires either no repayment, or repayment on more favourable terms than those offered on external commercial loans. External resource transfers thus effected to a recipient developing country contain an element of subsidy in favour of the recipient and at a cost to the donor.

The aid rationale emanates from the 'two-gap' theory of development which argues that the growth efforts of many developing countries are constrained by the lack of foreign exchange to meet a required level of imports for a satisfactory rate of economic growth. Being mostly primary producers, these countries are unable to increase their export earnings at a rate that would be sufficient to finance the required level of imports. Hence the foreign aid serves to fill their import-export gap which otherwise would have to be met through commercial borrowings. Resorting to commercial borrowings to fill the import-export gap is relatively more costly and would raise the debt burden; and for the same reasons, it would prolong the achievement of self-reliance. Hence, economic assistance in the form of grants and concessional loans could make development efforts of third world countries much easier and more manageable; also, it would enable these countries to reach the stage of sustained growth much quicker.

In other words, external assistance is expected to supplement domestic capital formation and relieve the external resource constraint of the developing country concerned. These effects would enable the developing country to launch a development strategy that would accelerate growth particularly in the export sector and aim towards self-reliance in its foreign exchange requirements. Thus foreign aid is not meant to assist a developing country indefinitely, but to help it accelerate its growth performance especially in the export sector, so that its needs for, and dependence on, foreign assistance could be reduced over time. Ultimately the country would reach the stage of sustained growth.

Foreign assistance can take various forms: grants, tied, partially tied or untied and loans, also tied, partially tied or untied. An untied grant will have a subsidy element equal to the face value of the grant; if tied or partially tied, it may be
somewhat less than the face value. In the case of aid loans, the extent of the subsidy element depends on the terms and conditions of the loan.

A measure of the extent of the subsidy contained in an aid loan is given by what is known as the 'grant element' which may be defined as the difference between the face value of a loan and the present value of all its future repayments in the form of amortization and interest, discounted at a market rate of interest.\(^1\) Usually, the higher the grant element, the greater is the element of subsidy transferred from the donor to the recipient country. Expressed as a per cent of the face value of the loan, the grant element would indicate what percentage of the face value of the loan will be repaid in present value. For instance, a loan with 2 per cent interest rate, a maturity period of 40 years, a grace period of 10 years and discounted at 10 per cent would have a grant element of 67 per cent. This means that the recipient country would repay only 33 per cent of the loan in present value, and 67 per cent is the subsidy or the concessionality appropriated by the recipient country. Under OECD rules, any official aid having more than 25 per cent grant element can be considered as 'official development assistance'.

Assuming that the aid loan is untied, the main determinants of the grant element are the nominal rate of interest, maturity period and the grace period. The lesser the interest rate and longer the maturity period and the grace period, the greater would be the grant element. However, the interest rate is the most important determinant. The grant element is zero when the rate of interest of the loan is equal to the rate of discount; the grant element is positive when the rate of interest is less than the rate of discount and vice versa. Given the rate of interest, the grant element also increases with the discount rate.

\(^1\) Grant element can be calculated by using the formula:

\[
A = (1 - \frac{i}{q}) \left[ 1 - \frac{qe^{-qG} - qT}{q(T-G)} \right]
\]

where:
- \(A\) = the grant element
- \(i\) = rate of interest of the loan
- \(q\) = rate of discount used
- \(T\) = maturity period of the loan
- \(G\) = grace period of the loan
If, however, the aid loan is tied, the conditions stipulated in a particular loan could have a considerable impact on the grant element. Generally, aid tying reduces the value of the amount of aid given to a recipient country. Because aid is tied by source and often to specific commodities, the recipient country is not able to purchase goods from those sources which have a comparative advantage of producing them. Aid-tying, therefore, may force the recipient country into non-optimal patterns of resource allocation.

The cost of aid to the recipient country could also be affected by other factors such as the quality of the commodities, spares and maintenance costs in the case of heavy machinery. For instance, if the aid is tied to a particular commodity—say, wheat—which price charged may be normal, but whose quality may be inferior; then it would amount to an instance of overpricing. Similarly, if the aid is conditional on the goods being shipped in the donor country's vessels whose freight charges are higher than elsewhere, it would raise the cost to the recipient country. Sometimes aid is tied to heavy machinery and equipment, which would commit the recipient country to import spare parts for them for several years from the same donor country. If the required spares were not available elsewhere, the donor country could charge a monopoly price.

A measure of the additional cost that the borrower country would have to bear due to overpricing and other unfavourable terms and conditions that may amount to overpricing is given by the excess of the effective rate of interest over the nominal rate of interest payable on a particular aid loan. Table 1 illustrates how the nominal rate of interest is raised by instances of overpricing.

In the three examples given in Table 1, we assume that the borrower country receives, due to overpricing, only 90 cents' worth of goods per each dollar committed. Thus the nominal value of the loan is $10 million (column 1), but its real value is $9 million (column 2). Loan No. 1 is a typical long-term tied soft loan at 5 per cent interest repayable in 20 years. The total that would be repaid over 20 years is $16.05 million (column 6). But the borrower country, in fact, pays this amount on account of a loan whose real value is only $9 million. The effective rate of interest in respect of this total repayment of $16.05 million over ten years for a loan of $9 million is 6.3 per cent. Thus for a 20-year loan at 5 per cent interest, an overpricing of about 10 per cent would result in an additional cost
to the borrower, amounting to approximately 1.3 per cent interest.

Table 1

Examples of effective rates of interest
where 10 cents per $1.00 is lost due to overpricing

<table>
<thead>
<tr>
<th>Loan No.</th>
<th>Nominal value of loan $\text{Mn}$ (2)</th>
<th>Real value of loan $\text{Mn}$ (3)</th>
<th>Nominal rate of interest % (4)</th>
<th>Period of repayment years (5)</th>
<th>Total repayment amount $\text{Mn}$ (6)</th>
<th>Effective rate of interest % (7)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10.</td>
<td>9.0</td>
<td>5.0</td>
<td>20</td>
<td>16.05</td>
<td>6.3</td>
</tr>
<tr>
<td>2</td>
<td>10.</td>
<td>9.0</td>
<td>5.0</td>
<td>5</td>
<td>11.55</td>
<td>8.1</td>
</tr>
<tr>
<td>3</td>
<td>10.</td>
<td>9.0</td>
<td>8.0</td>
<td>5</td>
<td>12.52</td>
<td>12.0</td>
</tr>
</tbody>
</table>

In the case of Loan No. 2 (which is the same as Loan No. 1, except that it is repayable in the much shorter period of 5 years), the effective rate of interest is 8.1 per cent and hence the additional cost is an interest of 3.1 per cent. Thus the additional cost to the borrower resulting from overpricing increases as the repayment period is reduced, and vice versa, reducing as the repayment period increases.

Loan No. 3 can be considered as a typical short-term credit such as suppliers credit or an export credit whose interest rate is somewhat higher. In this case, overpricing results in a greater additional cost of 4 per cent interest. Compared with Loan No. 2, this illustrates that given the rate of overpricing, additional cost to the borrower increases with nominal interest rate. Thus given the rate of overpricing, the shorter the repayment period and the higher the interest rate, the greater would be the additional cost to the recipient country (as given by the excess of effective rate of interest over the nominal rate of interest).
The greater the excess of the effective rate of interest over the nominal rate of interest, the less would be the grant element of the aid loan. Therefore, in calculating the grant element in the case of tied aid loans where overpricing is possible, an effective rate of interest may be used instead of the nominal rate of interest. So long as the effective rate of interest is less than the discount rate, the grant element would be positive, and theoretically the recipient country would tend to gain from such tied aid than from a commercial loan where the grant element is zero.

III. PAPUA NEW GUINEA'S AID POLICY

In Papua New Guinea, the first time an aid policy was formally announced was in July 1978. Until recently, its basic principles remained more or less unchanged, although some minor changes were adopted over the years. These principles served to maintain consistency with the principles embodied in the National Development Strategy of 1976 (Central Planning Office 1976) and the National Public Expenditure Planning (NPEP) system that was introduced in 1978 to give effect to its objectives. The main guiding principle of the aid policy has been to seek assistance from the best value sources and to use it to support high-priority government activities.

The aid policy has been designed to serve two main purposes:

a. To ensure that overseas aid is used to support the priorities established by the National Executive Council (NEC) and not alternatives proposed by foreign institutions, and

b. To maximize the use of grant and loan assistance to enable the government to sustain as large a public expenditure plan as is possible.

Five central policies have been used to serve these two objectives:

1. All overseas aid must pass through the government budget.

In some countries aid projects are excluded from the budget, and aid is treated as additional income on top of the budget. Such practice can have serious implications for the
budget as aid-funded projects would invariably entail unforeseen expenditure with claims on the budget. For this reason, Papua New Guinea adopts the practice of including all aid (except Medium Grant Aid) within the Budget. All expected aid funds are treated as budget income; and all aid-funded projects form part of the budget expenditure. This practice has great merit for it enables the administration to exercise strict control on the budget and to prevent expenditure from overshooting.

The only exception to this is that in the case of small aid, called Medium Grant Aid, projects costing less than K250,000 can be handled outside the budget. However, in order to minimise the possible impact on the budget, funding for such small projects should be entirely in the form of grant aid.

2. Foreign aid is a matter for the National Government. The Provincial Government cannot enter into independent negotiations with aid donors. This prescription ensures that all aid is allocated according to national priorities.

3. Papua New Guinea's first preference is for untied grant aid such as the Australian aid. Quite understandably, such aid is as good as the government's own revenue which can be used according to its own priorities. The Government has the complete freedom over the use of such funds to support recurrent or development expenditure as determined through the annual budget process.

4. Procurement-tied aid (both loans and grants) would be accepted only if the donor agrees to the condition of open competitive bidding. Such aid therefore can be utilized only if a supplier from the donor country wins a contract under open tender. This is to ensure that maximum benefits from such aid funds are received by Papua New Guinea and also not to endanger the most favourable aid relationship with Australia.

In order to facilitate greater and quicker utilization of such aid, the donors are encouraged to commit the total assistance to a number of projects on a government-approved indicative list, with the possibility of transferring funds between projects whenever a donor-restricted source wins a tender, rather than to one project, in which case the disbursements are more likely to be delayed and prolonged.
Relative to the approaches to aid by other developing countries, Papua New Guinea's aid policy, characterized by the insistence for open competitive tendering procedure, can be described as somewhat overly restrictive. However, it had to be so mainly because Papua New Guinea is incessantly mindful of the potential damage that can be caused to its aid relationship with Australia if it entertained procurement-tied aid from other donors.

By accepting procurement tied aid, Papua New Guinea would be knowingly excluding Australian firms from the contracts funded by such aid. This would almost certainly increase the pressure from the Australian business community for the tying of their own country's aid to Papua New Guinea (National Planning Office, 1984:5).

5. The concessionality of overseas aid should pass to the government, and not to commercial bodies, be they private companies, joint ventures or statutory authorities. Where aid funds are used to finance projects belonging to commercial entities (including statutory bodies) the policy is to on-lend the aid funds to such commercial concerns at terms close to market rates, but with a marginal concession as an inducement.

The application of the aid policy is very much related to the NPEP system—a four-year rolling expenditure programme which allocates development expenditure to projects that have reached national priority ranking through the bureaucratic and political process. The objective of the NPEP has been to limit government expenditure to expected growth in revenue and to direct expenditure on new projects according to the government's objectives and priorities. A ceiling is placed on recurrent expenditure of the government, so that the growth in revenue each year provides a 'wedge' of new money which is available for new NPEP projects. The 'wedge' of new money is then allocated to nine strategic objectives, drawn from the National Development Strategy. Each year the strategic objectives are reviewed and an expenditure target ceiling is placed on each objective.

In preparing the NPEP, during the early part of each year all new expenditure proposals in excess of K15,000 are received by the
Department of National Planning and Development (DNPD)\(^1\) and are subjected to careful scrutiny by DNPD, a technical evaluation committee and finally the Budget Priorities Committee (BPC)--a committee of senior public servants.

Based on their evaluation, the National Planning Committee (a committee of senior Ministers chaired by the Prime Minister) approves a shortlist of projects called the 'Standing Design List' (SDL) which is then submitted to the NEC. The NEC finally selects projects from the SDL for inclusion in the NPEP. The projects so selected will as far as possible reflect the allocations of 'new' money made to the nine strategic objectives. The system thus ensures a high degree of discipline on all new major expenditures of the government. The projects that fail to be included in the NPEP continue to remain on the SDL and are carried over to the next NPEP cycle; they would remain on the SDL unless the NEC or the agencies concerned decide to have them removed from that list.

In order to meet the requirement that all overseas aid (except the Medium Grant Aid) must pass through the budget, all aid-funded projects have to be included in the NPEP. In order to facilitate this, the SDL, as soon as it is ready, is made available to prospective donors for consideration. Although every attempt is likely to be made to have the projects on which donors have shown interest included in the NPEP, there is no guarantee that such will be the case. Political decision-making and national priorities at the NEC level will alone decide on the final list of NPEP projects. Only those projects included in the NPEP will qualify for aid funding. Thus the system ensures that the 'new' money (including aid funds) available each year are allocated according to government priorities as reflected in the expenditure targets set for the nine strategic objectives.\(^2\)

The aid policy and the planning system together also ensure a certain degree of flexibility in deploying these financial resources, while maintaining at the same time national policymakers' autonomy of choice, and insulating them from the pressure

\(^1\) Formerly known as National Planning Office which in March 1985 was elevated to a level of a Department and in November 1985 was merged with the Department of Finance to form the new Department of Finance and Planning.

\(^2\) The NPEP system is being replaced as from 1986 by a Medium Term Development Planning system--see Section VI below.
of the donors' special interests. However, internal consistency of the aid policy did enable Papua New Guinea to persuade its major donors—mainly Japan, Germany and the European Economic Community—to operate within that policy. However, the aid receipts from these non-Australian bilateral sources remained very low (Table 2), and there is little doubt that this was due to the excessively restrictive nature of Papua New Guinea's aid policy.

Aid policy has been a subject of debate during the last few years. While many politicians and a few donor country representatives have seen it as a hindrance to their efforts to attract more aid to the country, particularly to projects they favour, the bureaucracy has defended it, quite successfully, as one that is sound and consistent. Politicians have often voiced their preference for project-tied aid; their concern has been more a reflection of the frustration of a number of both national and provincial leaders not being able to have their favoured projects elevated to national priority ranking—a prerequisite to receive aid funding—than a rational approach to a review of the aid policy. Donor country representatives would naturally prefer a more relaxed aid policy so that their efforts to fund projects of their choice are made easier.

The case of the once-proposed Jacksons Airport study by Plessey is a recent example where several interested parties favoured the project but where the aid offer failed to conform to the requirements of the aid policy. In this case, the UK government offered a grant of £500,000 to fund a development study of the Jacksons Airport, by Plessey (a British firm). The offer failed to receive the Papua New Guinea Government's approval for two main reasons: first, the Jacksons Airport development had not reached priority ranking in the NPEP process and second, the aid was procurement-tied to UK sources. There were criticisms from some quarters that the country had lost a 'free aid' of £500,000.

Project-tied aid, whether grants or loans, often involve on-shore capital costs as well as recurrent costs for years to come, all of which would have to be met out of budgetary resources. Therefore, the requirement that all aid-funded major projects must pass through the national budget process is no doubt a sound one. The competitive bidding requirement however required careful review.

If we disregard the possible effect on the Australian aid relationship, then a case for a relaxation of the competitive bidding requirement could be convincingly made. Procurement-tying results
in two main problems. In the first place, goods and services purchased are most likely to be more expensive (due to overpricing) than if the aid is not tied to source. However, overpricing is not likely to be more than 20-25 per cent and in some cases it could be much less.

An overpricing of 25 per cent will only reduce the grant element of the aid by 25 per cent. Thus a grant which otherwise gives a 100 per cent grant element will now give only 75 per cent and a soft loan whose grant element is 70 per cent will now give only 45 per cent. The recipient thus would stand to gain from a procurement-tied aid if its grant element were over 50 per cent, following the OECD criterion. Even though the recipient does not get the best value of the aid as is the objective of Papua New Guinea aid policy, in situations where the country receives aid from a variety of sources, the total aid received and therefore the sum total of the grant element can be increased more by accepting procurement-tied aid with a high grant element than by rejecting them. In fact, other conditions remaining the same, a non-procurement tied loan with a 60 per cent grant element and a procurement tied loan with 85 per cent grant element (assuming an overpricing of 25 per cent in the latter case) would be identically beneficial to the recipient.

The other problem with procurement-tied aid is that the recipient country, by accepting such aid, will be committing itself to depend on the same source for supplies of spares and replacements of machinery and equipment for years to come. This problem, however, is not peculiar to procurement-tied aid; it is true of other forms of procurement as well. Machinery, once procured from source 'A' even under competitive tender, will continue to depend for spares on the same source; and such spares could well face monopoly pricing.

Thus if the fear of retaliation by Australia can be removed, then there is no reason why Papua New Guinea should not relax the competitive bidding requirement in its aid policy. Such a possibility was provided for in the Jackson Report (Commonwealth of Australia 1984), and the Papua New Guinea Government, having taken the hint, sought to review the aid policy as part of its new initiatives for development (see Section VI below).

An Aid Policy Committee was set up in 1984 as one of the key committees working on the new Medium Term Development Strategy. A major task of this committee was to review the existing aid policy giving due consideration to the recommendations of the Jackson Report and also the resource needs under the proposed new
planning system (see Section VI). The committee came up with a number of recommendations designed to make it possible for Papua New Guinea to attract more aid, utilize aid more efficiently and at the same time safeguard the basic principles upon which the aid policy has been formulated. These recommendations have since received the approval of the government.

The most significant change in the aid policy that has been effected by the Review is in relation to procurement-tied aid. Where procurement-tied aid is provided in the form of a grant, the absolute requirement for international tendering is no longer applied. The previous policy, however, continues to apply in the case of procurement-tied loans. It does not stand to reason why the relaxation of the international tendering requirement could not be extended to soft loans with generous grant elements—say, over 50 per cent. Unless this is done, the impact of the relaxation of the aid policy is likely to be very minimal.

The other revisions serve mainly to improve the current aid policy. Those relate to mix credits, on-lending to commercial concerns etc. The revised policy provides clear-cut guidelines for the use of mix credits (i.e. a combination of grant or soft loan with an export credit) which are being offered more frequently in recent years.

IV. PAPUA NEW GUINEA’S AID RELATIONSHIP WITH AUSTRALIA

For both historical and geographical reasons, a strong relationship developed between the two countries in trade, commerce and aid. Particularly in aid, the relationship is a unique one. Australia’s responsibility for Papua New Guinea’s economic development, or perhaps the inadequacy of it during the period when Papua New Guinea was under its administration, is well-reflected in the most generous aid arrangements that Australia had made for Papua New Guinea. No other country has received so much untied grant aid as has Papua New Guinea from Australia. Up to this date more than 95 per cent of Australian aid to Papua New Guinea has been provided in the form of an untied cash grant which flows directly into government revenue as budget support.

During the final years leading to independence, this budget support from Australia amounted to more than 50 per cent of Papua New Guinea’s annual budget expenditure. Over the years, Australian budget support declined slowly in real terms, and more
rapidly as a percentage of Papua New Guinea's total budget. Today it amounts to about 27 per cent. However, Australian aid still forms the bulk of Papua New Guinea's overseas aid—about 85 per cent.

Upon independence, the Papua New Guinea Government's concern for clearer and more definite long term-commitments of Australian aid led, in March 1976, to a five-year aid agreement between the two countries. This agreement provided for a minimum annual budgetary grant of $180 million during the five years (1976/77-1980/81) with the possibility of annual top-ups to take account of inflation, and other unspecified factors.

During the first two years of the agreement, the top-ups were fixed at A$10 million each, and towards the latter part of the period, the top-ups were worked out on the basis that they would provide for inflation but at the same time allow for a 2-per cent annual reduction of Australian aid in real terms. This was in line with the objectives of the new Development Strategy adopted in 1976, particularly the aim towards self-sufficiency, under which Papua New Guinea felt that it ought to reduce gradually its dependence on Australian aid.

The second five-year aid agreement with Australia provided for continued untied budget grant assistance for the period 1981/82-1985/86, more or less on the same basis as before, but allowing for a 5-per cent annual decline in real terms, while allowing for inflation in Australia up to a limit (full compensation up to 10 per cent, half between 10-14 per cent and none above 14 per cent).

The aid arrangement under the second agreement was a sequel to the recommendations of Sir John Crawford who was commissioned in 1980 by the Australian Government to advise on the matter. However, in 1979 the report of a Committee on Australia's Relations with the Third World (also known as the Harries Report) already made some disturbing recommendations concerning aid to Papua New Guinea. In sum, the Harries Report had recommended a significant shift from budget grant to project aid with a view to increasing Australian identity in the development assistance provided. Given the administrative procedures developed in Papua New Guinea for public resource allocation to development projects—which were explained earlier—these recommendations

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1 In 1984 the Australian budget support amounted to K225.9 million—about 27 per cent of the total budget outlay.
were counter productive,\textsuperscript{1} and the fears and concerns expressed by Papua New Guinea authorities probably led to the appointment of Sir John Crawford.

The Government of Australia accepted the main recommendation of the Crawford Report that budget support grant be continued while allowing for an annual 5 per cent real decline. It also recommended that provision be made for a review of the level of aid, should Papua New Guinea's government revenue from mineral resources decline significantly from those envisaged at the time the agreement was reached, for revenue from mineral resources (Bougainville copper and gold mine) constitutes a significant part of the government's total revenue.\textsuperscript{2}

The annual rate of decline of 5 per cent could be effective only for the first year of the agreement. The world recession hit Papua New Guinea badly; its export incomes, particularly from minerals, fell considerably and it became clear that the mineral revenue prospects for the remaining period of the agreement would be poor. As the effects of the recession were beginning to be felt in late 1981 the Papua New Guinea Government adopted a tight fiscal strategy which aimed to reduce public expenditure by 3 per cent in both 1982 and 1983. The rate of decline in 1983 was later raised to 5 per cent which resulted in a major retrenchment of public servants. In order to avoid further drastic measures, and in view of the country's inability to raise more commercial borrowings, the Papua New Guinea Government at this stage requested the Australian Government, as provided for in the Crawford Report, for a review of the future aid levels. In

\textsuperscript{1} For a critical assessment of Harries Report recommendations for Papua New Guinea, see Conroy 1980.

\textsuperscript{2} All revenue flows to the government from Bougainville Copper Ltd. (BCL) in the form of corporate income, profit taxes, dividend withholding taxes and government equity dividends are all received into the Mineral Resources Stabilization Fund (MRSF). Outflows from MRSF into the consolidated government revenue occur each year at a rate which is judged to be sustainable over the mineral price cycle. These flows are regularized on the basis of an eight-year forward projection of receipts by the MRSF. Any variation in the outflows in any year are limited by the MRSF Act.
particular, it was asked that the rate of decline in aid levels be reduced to the following:

<table>
<thead>
<tr>
<th>Year</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982/83</td>
<td>0%</td>
</tr>
<tr>
<td>1983/84</td>
<td>0%</td>
</tr>
<tr>
<td>1984/85</td>
<td>2%</td>
</tr>
<tr>
<td>1985/86</td>
<td>2%</td>
</tr>
</tbody>
</table>

Underlying this proposal was 'the view (shared by the Australian government) that Papua New Guinea's progress towards fiscal self reliance should not be so rapid as to disrupt the country's economic development and political cohesion' (Papua New Guinea National Planning Office 1982:45).

In response to this request, the Australian Government agreed to revise downward the rate of decline from 5 per cent as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982/83</td>
<td>1% approx. ¹</td>
</tr>
<tr>
<td>1983/84</td>
<td>1%</td>
</tr>
<tr>
<td>1984/85</td>
<td>2%</td>
</tr>
<tr>
<td>1985/86</td>
<td>2%</td>
</tr>
</tbody>
</table>

subject to a trigger mechanism, should metal revenue increase beyond K60 million in any of those years.²

The Jackson Report

In late 1983, a committee headed by Sir Gordon Jackson was commissioned by the Australian Government to review and 'advise on the future directions and form of the Australian aid programme.' The committee's report (Commonwealth of Australia 1984)--which will be cited here as the Jackson Report--was

¹ An extra grant of $10 million was provided after the negotiations which represents a little over 1% reduction in 1982/83 over the previous year.

² The trigger mechanism provided for slightly higher rates of decline in the event of increased revenue inflows from BCL. The mechanism was to activate when the mineral revenue rose above K60 million, K100 million or K140 million in any year (in mid 1983 prices), in which case the rate of decline would rise to 2.5 per cent, 3.75 per cent or 5 per cent respectively. The depressed mineral prices kept the trigger mechanism unactivated.
Presented to the government in March 1984, and its recommendations relating to Papua New Guinea have already influenced Australia's future aid arrangements for Papua New Guinea.

The main recommendations of the Jackson Report relating to Papua New Guinea were:

1. After the present aid agreement, budget support should decline by 5 per cent per annum in real terms; and that as a move toward normalizing Australia's aid relationship with Papua New Guinea in the long term, additional bilateral aid to Papua New Guinea be provided on the same basis as aid to other recipients of Australian aid so that the rate of decline in total Australian aid to Papua New Guinea should be 3 per cent a year in real terms;

2. Australia should continue to provide Papua New Guinea with generous levels of aid;

3. There should be no major immediate change in the level and form of Australia's aid to Papua New Guinea;

4. Untied budget support should continue, but it should continue to decline gradually but predictably;

5. Independent annual reviews of the Papua New Guinea economy should be undertaken and should form the basis of continuing annual government consultations;

6. Papua New Guinea may seek to form an aid consultative group with potential donor countries. Such a group will be useful in increasing the volume, diversifying the sources and improving the quality of aid received.

The Report also notes that when Papua New Guinea was under Australian administration, although well-meaning, Australian policies were not developmental for the native population (Ibid.: 148):

Since independence, Papua New Guinea has been successful in attaining cohesion and stability, but the economy remains at a disappointingly low level of development...There are two main reasons for this: the inherent problems of development in Papua New Guinea, and the low priority accorded to development goals during the period of Australian Administration.
These statements do imply that in view of the inadequacies of past colonial policies Australia has a continued responsibility to help Papua New Guinea development.

Among other concerns of the Report, the need to ensure political stability in Papua New Guinea through aid and Papua New Guinea’s strategic importance to Australia are recognized. At the same time, a substantial change to project aid is not considered advisable even though the present arrangement is thought not to be satisfactory either; generous Australian aid is believed to have reduced the need for Papua New Guinea to look for other aid; and Papua New Guinea is advised and encouraged to seek other aid and in that respect the formation of an aid consultative group is suggested.

As for the longer term, the most disturbing message of the Jackson Report is the proposal to move gradually towards normalizing the aid relationship with Papua New Guinea as that with other recipients of Australian aid by progressive reductions in budget support and increases in other forms of aid (which could mean project aid, commodity aid, technical assistance, co-financing etc.), over a period of 25-30 years. These other forms of aid are almost entirely tied and a good proportion of them is provided in the form of soft loans instead of grants. Furthermore, the bulk of Australian project aid funds only the foreign exchange (off-shore) costs of the projects. The proposal envisages that in about 30 years’ time, the budget support will be reduced to about 65 per cent of total aid and the balance of 35 per cent should take other forms of aid. Such a scenario is bound to have serious repercussions for Papua New Guinea’s fiscal management as well as for its efforts to diversify its aid sources. We shall return to these issues later on.

Although the recommendations of the Jackson Report have not been officially accepted by the Government of Australia, they seem to have been followed to the very letter in drawing up the third five-year aid agreement (for the period 1986/87 to 1990/91) which was announced recently. During the negotiations for this agreement, the Papua New Guinea Government argued strongly for a much less reduction in the budget support than that envisaged in the Jackson recommendations. In support Papua New Guinea cited its poor internal revenue prospects in the medium term, the financial constraints that limit its capacity to absorb project-tied aid, and the resource needs for the new development efforts under the proposed Medium Term Development Strategy (see Section VI).
On the other hand, the Australian Government pressed for a more rapid reduction in the budget support and accelerated increases in tied aid. Although the Papua New Guinea negotiators did fairly well at the beginning, their negotiating position was apparently weakened badly towards the end by certain ill-advised public statements made at the time by some responsible political leaders--some of whom even voiced preference for project-tied aid. After lengthy negotiations the compromise formula that finally emerged was basically the one recommended by the Jackson Committee: 5 per cent per annum real reduction in the budget support and gradual annual increases in non-budget support such that the total aid to Papua New Guinea will decline by 3 per cent per year in real terms (Table 2)--indeed an unfavourable outcome for Papua New Guinea. It is most likely that this is what the Australians had in mind all along.

### Table 2

**Australian Aid to PNG**  
**1986/87-1990/91**  
**Under the third Five Year Aid Agreement**  
(A$ million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Budgetary Support</th>
<th>Non-budgetary Support</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base</td>
<td>302.799</td>
<td>3.946</td>
<td>306.745</td>
</tr>
<tr>
<td>1986/87</td>
<td>287.659</td>
<td>9.884</td>
<td>297.543</td>
</tr>
<tr>
<td>1988/89</td>
<td>259.612</td>
<td>20.346</td>
<td>279.958</td>
</tr>
<tr>
<td>1989/90</td>
<td>246.632</td>
<td>24.927</td>
<td>271.559</td>
</tr>
<tr>
<td>1990/91</td>
<td>234.300</td>
<td>29.112</td>
<td>263.412</td>
</tr>
</tbody>
</table>

**Source:** Australian Information Service.

**Note:** All figures are in 1985/86 prices.  
Base figures are as per 1985/86 aid allocations to PNG.
Under the new agreement budget support aid will drop from the present 99 per cent of total aid allocation to 89 per cent in 1990/91. The tied aid component will rise correspondingly and normal terms and conditions of Australian tied aid to other developing countries will apply to Papua New Guinea:

(a) **Procurement via Australia:** although procurement is untied in principle, Australian and New Zealand tenders receive a 20 per cent discount for award of contracts, which makes procurement practicably tied to goods of these two countries, with the possibility of an over-pricing up to at least 20 per cent.

(b) **Project aid:** Australia would have the right to select contractors, and Papua New Guinea would only have the right to veto any such selection;

(c) **All consultancy services financed from tied aid would have to be from Australia:** and

(d) **On-shore costs of aid-funded projects, in principle, would have to be met by Papua New Guinea.**

These terms and conditions will not only limit Papua New Guinea's freedom to choose its priorities but also will reduce the grant element of the aid on the one hand and cause budgetary restraints on the other.

V. **PAPUA NEW GUINEA'S AID RELATIONSHIPS WITH OTHER DONORS**

Australian aid occupies a predominantly large proportion—about 85%—of all overseas aid to Papua New Guinea. Of the balance, more than 3/4 comes from multilateral agencies. Thus the aid receipts from non-Australian bilateral sources remain minutely small and are shared mainly by three donor countries—Japan, West Germany and New Zealand (Table 3).

Aid from multilateral agencies such as the World Bank and ADB are, as usual, free from procurement-tying but are tied to projects. Papua New Guinea used to receive highly concessional loans from the World Bank through its IDA window. These loans, which carried a grant element of more than 80 per cent, used to fund 90 to 100 per cent of total costs of the projects. Unfortunately, since 1982, Papua New Guinea has been denied this highly
### Table 3

Aid flows to Papua New Guinea, 1980-84
(Million Kina, current prices)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Australian Grant Aid</td>
<td>175.5</td>
<td>284.3</td>
<td>186.7</td>
<td>212.7</td>
<td>225.9</td>
</tr>
<tr>
<td><strong>Other grants</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UNDP</td>
<td>1.7</td>
<td>1.2</td>
<td>1.2</td>
<td>1.4</td>
<td>1.4</td>
</tr>
<tr>
<td>New Zealand</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Other</td>
<td>1.7</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td><strong>Sub-total other grants</strong></td>
<td>4.9</td>
<td>3.7</td>
<td>3.7</td>
<td>3.9</td>
<td>3.9</td>
</tr>
<tr>
<td><strong>Loans</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>World Bank</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>IDA</td>
<td>7.5</td>
<td>6.6</td>
<td>6.7</td>
<td>13.7</td>
<td>2.0</td>
</tr>
<tr>
<td>IBRD</td>
<td>1.3</td>
<td>1.0</td>
<td>2.0</td>
<td>7.8</td>
<td>18.1</td>
</tr>
<tr>
<td>Asian Development Bank</td>
<td>8.8</td>
<td>14.3</td>
<td>8.0</td>
<td>12.6</td>
<td>6.9</td>
</tr>
<tr>
<td>Japan</td>
<td>0.3</td>
<td>1.2</td>
<td>3.0</td>
<td>-</td>
<td>10.1</td>
</tr>
<tr>
<td>West Germany</td>
<td>0.6</td>
<td>1.8</td>
<td>0.4</td>
<td>0.1</td>
<td>0.9</td>
</tr>
<tr>
<td>EEC</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.5</td>
<td>2.3</td>
</tr>
<tr>
<td>Kuwait Fund</td>
<td>0.3</td>
<td>0.2</td>
<td>0.2</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Sub-total loans</strong></td>
<td>18.8</td>
<td>25.1</td>
<td>20.3</td>
<td>34.7</td>
<td>40.3</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>199.2</td>
<td>213.1</td>
<td>210.7</td>
<td>251.3</td>
<td>270.1</td>
</tr>
</tbody>
</table>

* estimate

concessional aid on the ground that it is a middle-income country. Assistance now available from the World Bank is on relatively much less attractive terms (giving not more than 17 per cent grant element) and can be used to fund only about 60-65 per cent of the total project costs, which approximate to their foreign exchange costs, thus making heavy demands on the budget for on-shore costs. Aid from the ADB, too, involves budgetary funding to similar extents.

As an ACP member country under the Lome conventions, Papua New Guinea has the potential to receive substantial aid from the EEC. Apart from the STABEX transfers which it receives to offset shortfalls in export earnings from agricultural exports, Papua New Guinea receives highly concessional soft loans and grants from the EEC. STABEX transfers, which Papua New Guinea has already received twice--K10 million in 1982 and K17.5 million in 1983--are repayable interest-free in seven years, only if the specific agricultural export commodities recover sufficiently.

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This is, of course, a debatable viewpoint. In terms of overall per capita income, Papua New Guinea has been classified as a middle-income country. Apart from the wide income disparity that exists between the per-capita income of the expatriate population and that of the nationals, the recognized social indicators show that Papua New Guinea remains poorer than many of the so-called low income countries, e.g.:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>PNG</td>
<td>820</td>
<td>53</td>
<td>99</td>
<td>65</td>
</tr>
<tr>
<td>Burma</td>
<td>190</td>
<td>55</td>
<td>96</td>
<td>84</td>
</tr>
<tr>
<td>India</td>
<td>260</td>
<td>55</td>
<td>94</td>
<td>84</td>
</tr>
<tr>
<td>Kenya</td>
<td>390</td>
<td>57</td>
<td>77</td>
<td>109</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>320</td>
<td>69</td>
<td>32</td>
<td>103</td>
</tr>
</tbody>
</table>

These transfers can be treated as virtually untied budget support. About 2/3 of EEC aid constitute such budget support grants; however, both grants and loans are tied to EEC/ACP sources and thus Papua New Guinea’s agreement to receive them represents a slight deviation from its aid policy concerning procurement-tied aid. But the utilization of EEC aid had remained pitifully low, largely due to inadequate planning in the initial stages for identification of projects.

Both Japan and West Germany, the two main non-Australian bilateral donors of any significance, have more or less agreed to operate within Papua New Guinea’s aid policy. Both provide small amounts of soft loans which carry over 50 per cent grant element. While the German aid is fully untied for procurement, Japan has accepted the procedure (known as ‘selective draw-down’) by which a procurement-tied loan would only be utilized when suppliers acceptable to Japanese authorities won contracts in open competitive tender. In addition Japan has indicated repeatedly its willingness to provide small amounts of grant aid, amounting to about K3.5 million a year, on a procurement-tied basis. However, Papua New Guinea has rejected these offers on the grounds that they do not conform to its aid policy in that the aid is procurement-tied to Japanese goods and therefore there is no guarantee of receiving the best value and also that their acceptance would have the danger of giving further ammunition to the proponents of tied Australian aid. From now on, of course, such aid will be acceptable under the revised aid policy. Papua New Guinea’s other main bilateral donor, New Zealand, provides about K1.5 million a year both in the form of Medium Grant Aid (i.e. for small projects costing less than K250,000 and handled outside the budget) and project-tied aid through the NPEP.

The other bilateral aid sources such as USA, UK, Canada, and the West European countries (except Germany), which could be potential donors to Papua New Guinea, remain virtually untapped. One exception, however, is France which did provide financial assistance under a French Protocol concluded some years back. The protocol expired in 1984 and was not renewed due to difficulties or delays in drawdowns which resulted from the aid being tied to French suppliers.¹ Recently France has shown interest in provid-

¹ Papua New Guinea’s disapproval of French policy on New Caledonia and its opposition to French nuclear testing in the South Pacific could also be the reasons for Papua New Guinea’s reluctance to renew the French Protocol.
ing 'mixed' credits (export credits plus small soft loans) accepting the principle of open competitive bidding. The combined grant element of French mixed credits however are reported to be very low.

A number of factors appear to be responsible for the acutely low level of bilateral aid to Papua New Guinea from non-Australian sources. Firstly, the absorptive capacity of the type of aid that is likely to be received is reported to be limited. Absorptive capacity limitation is caused by two types of constraints—administrative and financial. Administrative constraint is a lack of personnel and adequate planning capacity for project identification and project formulation. Financial constraint is a lack of budgetary funds to finance on-shore costs of aid funded projects.

The second constraint is the overly restrictive aid policy, primarily the open competitive bidding requirement in procurement-tied aid (which has been recently partially relaxed), which deterred potential aid donors. It is no secret that many reputed bilateral donors prefer to achieve some degree of trade promotion through foreign aid and in that process would wish to provide a certain proportion of the total aid package in the form of procurement-tied aid. Where no such tied aid is accepted, the total aid received from the donor remains very low (Japan) or zero. The third constraint is that aid administration in Papua New Guinea is so diffused that there is no one office which can play an active role in looking for aid from new sources. We will return to aid administration later on.

VI. NEW INITIATIVES FOR DEVELOPMENT

The National Development Strategy of 1976 (Central Planning Office 1976) placed high priority on income distribution, but made no mention of economic growth as a specific objective. The NPEP system—the mechanism to implement it—therefore was not geared specifically to promote economic growth although it had many good features in terms of ensuring fiscal discipline. During the decade 1973-82 the annual average growth of Gross Domestic Product (GDP) was only 0.8 per cent. This, against an annual population growth rate of about 2.3 per cent, means a negative growth of per capita income during the decade.
The concern about the lack of growth in the past and the need for reorientation of policy towards growth have been points of concern in the Jackson Report as well as in a recent World Bank Report (World Bank 1982) on Papua New Guinea:

...Papua New Guinea's growth since independence has been somewhat disappointing. Cohesion and stability have been achieved, but growth, particularly in the subsistence and other agricultural sectors, has been limited. Papua New Guinea's growth in the 1970s was only half way up the sub-Saharan Africa performance ladder, and it lagged behind the ASEAN neighbours. In per capita terms a small gain in output was more than offset by population growth. It is now time for more debate on options that Papua New Guinea faces (Jackson Report:7).

The major task following self government in 1973 and independence in 1975 has been the establishment of a set of policies for managing the economy and maintaining economic stability and a set of objectives for allocating public expenditures so as to promote the development of the country in a way that benefits all citizens. Economic management has been sound....However, growth, has not been strong during the period....During the 1980s, the Government's aim will be to promote more rapid growth on the basis of the framework for a stabilisation now in place (World Bank 1982:3).

The new Somare Government that took office in late mid-1982 recognized the need for a full review of the earlier development strategy and the planning system that followed it. While delivering the opening address at the 1983 Waigani Seminar, the then Deputy Prime Minister who was also in charge of planning indicated the government's intention to review policies, and to take new initiatives:

In the past few years our growth performance has been rather poor for a developing country. This has been largely due to two factors: namely, the poor performance of our export sector which is dominated by primary products; and secondly, the lack of policy initiatives to promote growth in other sectors where potential for development exists. By this I mean our policies for industrial development as well as the development of
other sectors such as food production, fisheries and tourism have been either inappropriate or inadequate....

The assessment of our economic policy reveals that the time is now ripe to place equal priority to growth as to income distribution...

The majority of our people live at a subsistence level of income. Therefore, it is important that we now increase our total income so that we can have more to distribute (Wingti 1983).

Two main initiatives have been taken in the direction of growth and development: the White Paper on Industrial Development (Papua New Guinea 1984) and the reforms to the existing planning system. The White Paper, which has been already published, announced the new policies and incentives for industrial development, export promotion and diversification of the economy.

In May 1984 Mr Wingti announced in Parliament the intended reforms to the existing planning system. These include the preparation of a Medium Term Development Strategy and a Five Year National Development Plan which will be implemented as from 1986. The proposed planning system is expected to overcome the shortcomings of the present NPEP system which is based on short-term and departmental resource allocations. The proposed system is expected to reorientate the NPEP system to more longer term and sectorally based planning.

The principal objective of the proposed planning system is 'the creation of productive work opportunities', meaning the promotion of 'growth in the economy and the creation of employment' (Wingti 1984:10). In justifying this objective, Mr Wingti stated:

When we took over.... the economy was in a very bad shape; formal sector employment had dropped to a very low level; the overall unemployment in the country was very high; the economy was stagnant and not growing; and the average incomes per person were on a downward trend (ibid.:2).

In allaying the fears of the private sector that the new planning system will result in more government intervention, Mr Wingti assured that:

Although the proposed planning system will contain a detailed plan of the pattern of government expenditure it will not attempt to plan for the private sector.
The private sector is expected to be guided largely by our macro-economic policies (Ibid.:169).

The new development initiatives are likely to raise the levels of public sector resource needs in the medium term. Major growth sectors such as industry and agriculture, to achieve any significant progress, are likely to require as pre-requisites, further developments in infrastructure which certainly would absorb a good amount of public resources. Although no estimates of resource needs under the new Five Year Development Plan have yet been made, the levels of such needs could be expected to be somewhat higher than those in the recent past. The development programmes under the plan will be revised in the final stages to suit the revenue forecasts for the period; and further revisions are expected to be made annually, too, through the budget process to take account of the changes in revenue perceptions.

For the present, however, the prospects for substantial growth in internal revenue for Papua New Guinea in the medium term do not appear to be good. Preliminary forecasts indicate only about 1.8 per cent real growth in revenue for the rest of the decade. Poor outlook for Papua New Guinea's major export commodities will limit revenue from the export sector. The revenue flows from the minerals sector are expected to remain very low due to depressed prices. In the longer term, the prospects of mineral prices remain uncertain. With the prevailing uncertainty about the future of Ok Tedi—the second giant gold/copper mine—the government is likely to face a difficult budgetary situation in the medium term.

Given this scenario of rather dim internal revenue prospects, and therefore the possibility that Papua New Guinea's ability to achieve the growth and development objectives of the new initiatives being limited, its future aid outlook becomes crucially important. In this respect the Jackson Report's suggestion that Papua New Guinea should seek additional assistance from non-Australian aid sources is well-intended (Commonwealth of Australia 1984:162).

The importance of the resource aspect in the proposed new planning system is well reflected in two other initiatives that have been taken by the government. One is the revision of the aid policy by the Aid Policy Committee set up under the new Medium Term Planning system. The revised aid policy, as outlined earlier, now provides for more opportunities for aid from non-Australian sources.
The other initiative refers to the short-term Resource Management exercise that has been instituted. The main objective of the exercise is to effect better resource management in the public sector in terms of more efficient and more productive utilization of resources. The exercise involves examining into ways of (1) facilitating the growth process, (2) redirecting public expenditure and (3) improving provincial relations. A Project Management Unit has been established and given the responsibility for the exercise. The exercise is expected to result in an improvement in the country's budgetary position within two to three years by building up a projects pipeline to attract foreign aid, by eliminating gross instances of waste, and by placing new emphasis on the importance of revenue generation.

VII. AID ADMINISTRATION

There is no centralized aid administration in Papua New Guinea. The practice had been for the relevant departments—the Department of Finance (DF), Department of Foreign Affairs and Trade (DFAT) and the Department of National Planning and Development (DNPD)—to coordinate and share various aspects of aid administration.

The arrangements for sharing responsibilities and carrying out various functions relating to aid administration have changed from time to time. At one time the overall supervision on foreign aid was exercised by a Ministerial Committee headed by the Minister for National Planning and Development. This committee has ceased to function since 1982. Since then two committees have been entrusted with the responsibilities relating to aid administration.

The Technical Assistance Committee (TAC) is officially made up of the Secretary, DNPD (Chairman); Secretary, DF; Secretary, DFAT; and the Secretary of the Department of Public Services Commission (PSC). However, these officials are not actually on the committee and they are represented by officers from their respective departments. A unit in the DNPD called Aid Coordination Centre serves as the secretariat to this committee. TAC administers all aid-funded projects including technical assistance costing less than K250,000. Programming and monitoring of assistance for manpower training are handled by a sub-committee of TAC called the Training Priorities Committee made up
of representatives from the Department of PSC, DFAT, DF, DNPD, Department of Labour and Employment and the Commission of Higher Education.

The Capital Assistance Co-ordinating Committee (CACC) has its secretariat located in the Department of Finance. Its members are: Secretary, DF (Chairman); Secretary, DNPD and Secretary, DFAT. Like the TAC, these officials are not actively on the Committee and are represented by subordinates. This committee is responsible for foreign aid policy and the administration of aid for projects valued over K250,000. It reviews the foreign aid policy as and when required by NEC and selects projects from NPEP for offering to suitable donors.

Technically the two committees are also responsible for the monitoring of aid utilisation. But presently monitoring is confined only to technical assistance which is exercised by the TAC. As for capital assistance, no monitoring by the CACC seems to be considered necessary simply because the aid financed projects are included in the NPEP and are therefore taken care of under the normal NPEP monitoring system.

The CACC is responsible for most negotiations with aid donors, particularly in relation to the drawing up of government-to-government aid agreements. In the case of bilateral aid, the Papua New Guinea Government's first contact point is the DFAT. Thereafter negotiations are undertaken on an interdepartmental basis with political, financial and planning aspects being dealt with by DFAT, DF and DNPD respectively. So far as the multilateral agencies are concerned, DF is the initial point of contact, but negotiations involve the other two central departments as well.

Thus the present arrangement for aid administration in Papua New Guinea is rather a loose one. The responsibilities are so divided that decision-making and processing of aid matters have become time-consuming and inefficient. From eight to ten senior officers have to meet for hours to arrive at a single decision which could have been made by one departmental head after proper consultations. The committee system has tended to erode the responsibilities of the departmental heads who have been effectively reduced to mere figureheads as far as aid administration is concerned. Furthermore, it has led to gross duplication of functions—officers in the three departments, DNPD, DF and DFAT doing more or less the same work. This certainly does not appear to be the most efficient and economical way to handle aid administration.
This arrangement would have been adequate in the past when non-Australian aid component remained very small. But with the prospects of Australian aid declining over time and the need for non-Australian sources of aid to diversify and expand in the future, it might be desirable to centralize all aspects of aid administration in one single institution. Such an institution could take the form of a division either in the DF or DNPD, and be headed by a First Assistant Secretary. Thus formed, the new Division would need to be a specialized agency on all aspects of foreign aid. It should be noted that donors normally prefer to deal with a single aid administration body.

The new division could take over all the functions presently handled by the Technical Assistance Committee, the Capital Assistance Co-ordinating Committee and the aid administration functions of the Loans, Investment and Co-ordination Division of the DF and of the Aid Co-ordination Centre of DNPD. Servicing of aid missions, co-ordinating meetings and discussions between aid missions from donor countries and the heads of various institutions involved in individual projects would all be handled by the new division. In short, it would act as the principal arm of the government which will spearhead aid administration.

Together with these institutional improvements in aid administration, Papua New Guinea should also consider very seriously the formation of an Aid Consultative Group (Aid Group)—a suggestion also made in the Jackson Report. Papua New Guinea's bureaucracy does not show much enthusiasm for this suggestion because of their usual dislike of outside interference in internal policy matters. The antipathy is ill-advised and the Aid Group mechanism does not serve to interfere with domestic policy matters although it may serve to provide well-meaning advice on development policy where such advice is welcome. If such a body were to be set up, a single aid administration unit would be better suited to liaise with it.

The formation of Aid Groups is a mechanism for aid co-ordination among donors, that developed during the last two decades. Today more than 20 recipient countries have Aid Groups. Most of them

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1 Since this paper was first written, the two key departments—FD and DNPD—have been merged under one department called the Department of Finance and Planning. Centralization of aid administration suggested here would be now more practicable under the new department.
are low-income countries, large either in size or in population. A few are middle-income countries.

An Aid Group is a group of donors (both bilateral and multilateral) to a particular recipient country. It meets once a year, mostly at World Bank's office in Paris. Institutional support for the group and its meetings is provided by the World Bank. The World Bank reports on the economy of the recipient country and any other relevant documents are circulated to members in advance for the annual meeting; and the recipient country circulates a list of projects for which it seeks aid from the members of the Group.

The forum provides for a cordial exchange of views and discussions on specific problems relating to the development of the country; it also provides an opportunity for donors to discuss among themselves and decide on projects for joint assistance.

At the end of the meeting, an estimate of the country's external resource needs in years ahead is made and an indicative aid commitment by each donor is also made. The total aid pledged by most Aid Groups have often shown an upward trend over time.

The Aid Group is a useful mechanism for both donors and recipients alike. For donors, it helps to draw up their aid budgets in the light of an agreed judgement by the international aid community. It also helps them to focus their thinking on a particular developing country in anticipation of a forthcoming aid group meeting. For the recipient, the mechanism is helpful in seeking a certain level of aid regularly from the Group. This is very important for planning purposes.

The mechanism also promotes a certain degree of competition among the donors, from which the recipient could stand to benefit in terms of improved quality and quantity of aid.

Annual meetings of the Aid Group help reduce costs of consultations with individual donors.

In the face of a decline in Australian aid, it is important for Papua New Guinea to have an alternative source of assured aid on a regular basis; the Aid Group mechanism would provide for such an alternative source. It would also help Papua New Guinea to create a growing interest among donor countries to assist Papua New Guinea's development.
VIII. SOME IMPLICATIONS FOR THE FUTURE

The new policy initiatives, discussed earlier, provide for a co-ordinated development effort in the medium term. These include improvements in the planning system, new policies to promote productive investments in the economy, improvements in public sector resource management and policy changes to attract more aid. While these initiatives are likely to help remove some constraints, such as personnel and institutional constraints to external resource absorption in the economy, there would still exist a crucially important constraint, namely the financial constraint. This refers to the availability of budgetary resources needed to meet on-shore costs of aid-funded projects, which could limit considerably the expansion of non-Australian aid to Papua New Guinea.

Most aid-funded projects require some or all of their on-shore costs to be met by the government from its own resources, forcing it to resort very often to commercial borrowings, mainly from overseas. Although the country's overseas debt is still within manageable levels, it has grown over the years—the debt service ratio has risen from 5.9 in 1981 to 11.6 in 1983. Even the project aid now available from the World Bank and the ADB would fund only about 60-65 per cent of the total project costs.

Thus the effective use of most of the non-Australian aid is dependent upon Papua New Guinea's ability to supplement aid receipts at least by about 35-40 per cent of the costs of aid-funded projects. This financial constraint has already resulted in slow drawdowns of aid already committed. Currently the World Bank budgets to lend to Papua New Guinea about US$50 million per annum and the ADB plans to raise its loan allocation from US$30 million to US$50 million per annum. There is doubt about the country's ability to effect drawdowns of this magnitude, for it would require Papua New Guinea to find additional untied funding to the tune of about US$55-65 million per year, leaving alone the on-shore costs involved in other non-Australian aid programmes.

Given this scenario, Papua New Guinea's future aid relationship with Australia, and particularly the implications of the Jackson Report recommendations for that relationship, seem to be crucial for the country's new development efforts. In the context of internal revenue limitations, it is quite clear that any attempt by Papua New Guinea to increase its aid receipts from other
sources, which it must, in view of the new development initia-
tives, would require continued budget support from Australia. In
short, the greater the amount of Australian budget grant, the
greater would be Papua New Guinea's ability to absorb non-
Australian aid.

In this context, the Jackson Report recommendation that untied
budget support should continue is most pertinent. The Jackson
Report rightly notes:

If the present system of budget support were to be
largely replaced by project aid tied to specific activi-
ties in Papua New Guinea, major problems would arise.
Apart from the strains that would be imposed on the
Papua New Guinea budgetary system, Australia would need
to initiate large-scale planning and implementation
operations in Papua New Guinea. There would be an
undesirable tendency for responsibility and decision
making to be taken over by Australian officials
(Ibid:162).

However, the decision to reduce the budget support annually by 5
per cent is likely to cause strains on Papua New Guinea's capa-
city to absorb other aid and thereby limit its ability to
diversify non-Australian sources of aid at least in the medium
term.

The figures in Table 2 indicate, under the Third Five Year Aid
Agreement with Australia, a substantial reduction in the absolute
level of real budget support and an annual average increase of
about 49 per cent in other forms of aid which will be tied to
projects and procurement via Australia. At a time when Papua New
Guinea is already having absorption difficulties in project aid
for want of on-shore cost finance, any resort to project tied aid
by Australia is likely to cause additional problems for expansion
of non-Australian aid which Australia would very much like to see
happening in Papua New Guinea.

It is creditable that Papua New Guinea has been always willing in
principle for a gradual and predictable decline in Australian
aid. However, that willingness should be taken advantage of only
after a proper assessment of Papua New Guinea's ability to
maintain adequate levels of development expenditure, in the event
of a reduction in Australia aid. In the present circumstances,
Papua New Guinea's ability to cope with a 5 per cent reduction in
Australian budget grant seems most doubtful, especially in view
of the need to achieve higher levels of growth and development to
which the Jackson Report has correctly drawn attention.
The following words of Papua New Guinea's Foreign Minister (then the Hon. R.L. Namaliu, MP) sums up the government's view:

... we also are keen to see as rapid a reduction as possible in Australian bilateral aid to our country. But that reduction must not jeopardise our economic and political stability. That reduction must give due account to the availability of resources for the more rapid development of a self-reliant Papua New Guinea (Namaliu 1983).
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