

Papua New Guinea and the Pacific - A Development Perspective



Australian Government

AusAID

September 2003

KEY POINTS

- *Much recent commentary on development and aid in Papua New Guinea and the Pacific has been simplistic and has lacked objectivity. It takes little account of approaches pursued in recent years.*
- *The region is confronted with significant challenges and seemingly intractable problems. But it is not homogenous and there are strong examples of where countries have had successes that need to be considered alongside failures.*
- *There have been substantial improvements in social indicators, particularly life expectancy. These have not been matched by economic performance, which has deteriorated particularly since the mid 1990s in a number of countries.*
- *On most economic and social indicators, the Polynesian countries are performing better than the Melanesian states.*
- *Social gains are under threat, particularly in Melanesia, from prolonged economic stagnation placing service delivery systems and traditional support mechanisms under stress, and from continuing population pressures.*
- *Political will to address governance is central to the Pacific's future but has proven difficult to sustain. Gains have been made where there has been sustained leadership. Alongside leadership, weak capacity is the major impediment to implementing reform.*
- *Corruption and weak adherence to the rule of law are significant problems. But poor economic and financial management, again stemming from weak capacity, is arguably a greater source of wastage and inappropriate use of resources.*
- *Aid to the Pacific is heavily skewed to the French territories and US associated states, generating perceptions that all Pacific states receive a disproportionate amount of aid. In fact, average aid per head in the former is almost ten times that of the independent states.*
- *Australia's aid program has delivered credible returns in a high-risk environment.*
- *Aid can only ever be part of the solution and only if it is well-targeted. The potential for aid to be fungible, while assessed to be limited in the Pacific, reinforces the need for enhanced policy dialogue and donor coordination.*
- *The poor outlook for many parts of the region requires the international community to create an environment conducive to development in the Pacific, particularly in regard to trade and aid, and for the region to explore more vigorously collaborative approaches that meet shared challenges.*
- *It also reinforces the need for a more substantial engagement and hands-on role for Australia, including the aid program.*
- *Expectations need to be realistic and tailored to individual country circumstances. The task ahead is a long-term development challenge and engagement strategies need to be coherent and framed in this light.*

Contents

Introduction.....	1
How Has The Region Fared?.....	1
Locking In Gains and Addressing Reversals.....	5
Financing the Pacific’s Future.....	10
Development in the Pacific: The Emerging Agenda.....	15

List of Figures

Figure 1: ‘Where They Stand Today’: A Comparison of Selected Countries in the Pacific, Caribbean and Sub-Saharan Africa.....	1
Figure 2: ‘Where They Came From’: Pacific, Caribbean and Sub-Sahara Africa.....	2
Figure 3: Intra-Regional Disparities.....	2
Figure 4: Annual GDP Growth – High, Low and Average, 1998-2002.....	3
Figure 5: Average GDP and Per Capita Growth, 1996-2001.....	4
Figure 6: Population Growth in the Pacific.....	5
Figure 7: Governance in the Pacific, Caribbean and Sub-Saharan Africa - Selected Countries.....	6
Figure 8: Fiji GDP Growth, 1998-2003.....	9
Figure 9: The Importance of Trade in the Pacific.....	10
Figure 10: Resources from Remittances.....	11
Figure 11: Aid in Perspective.....	13
Figure 12: Regional Aid Donors and Recipients.....	13

Development assistance has an important role to play in restoring stability to the South Pacific. But aid can only ever be part of the solution. And we must use our aid program to encourage and strengthen the framework for good governance in these nations. They must achieve higher standards of governance. The future of their peoples depends upon their willingness and ability to do so.

Prime Minister John Howard, 1 July 2003

Introduction

Recent media commentary on the PNG and the Pacific has presented the view that:

- since independence development has gone backwards;
- corruption, poor leadership and lawlessness are endemic; and
- aid has failed and has promoted rent seeking and fiscal indiscipline.

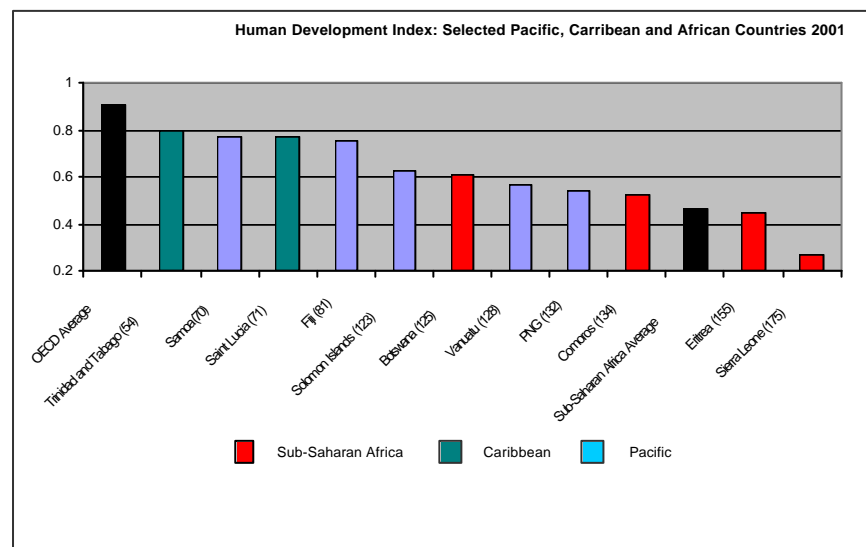
This paper seeks to provide an analysis of the status of development and governance in the Pacific and, in that context, an assessment on the role of aid within a broader context of financing for development.¹

How Has the Region Fared?

Significant gains have been made in social indicators

The development record of the Pacific has not been uniform. Against measures like the UN's Human Development Index (a composite measure comprising GDP growth per capita, life expectancy and educational attainment), the better performing Pacific states rank on par with the Caribbean states, while the weaker performing Pacific states still rank significantly higher than the average for Sub-Saharan Africa (Figure 1).

Figure 1: 'Where They Stand Today': A Comparison of Selected Countries in the Pacific, Caribbean and Sub-Saharan Africa



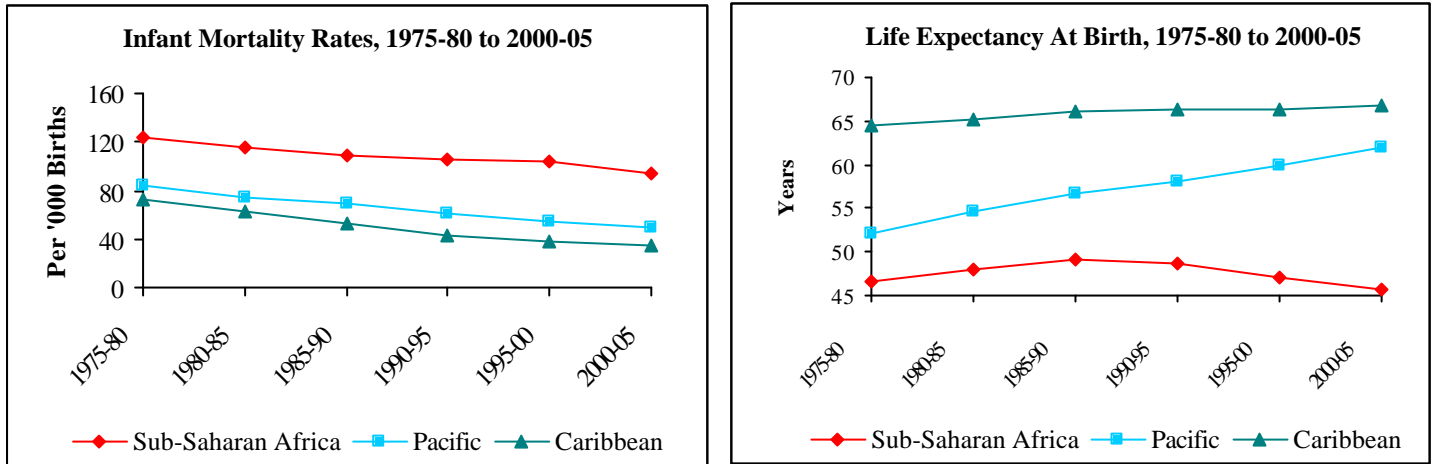
Source: UN Development Programme, *Human Development Report 2003*

¹ Problems relating to the consistency and reliability of economic and social data in the Pacific are well documented. The data presented in this paper relating to social indicators is based on an AusAID commissioned report recently compiled by Mr. Ian Castles, former head of the Australian Bureau of Statistics. Mr. Castles has endorsed this data as 'best available'. The selection of countries that comprise inter-regional comparisons is based on considerations of comparable population size and other factors.

Human development gains have been substantial in comparative terms

Improvements in overall life expectancy in the Pacific have been substantial. They have improved at rates that have significantly outpaced those in both the Caribbean and Sub-Saharan Africa. Infant mortality rates have decreased at a rate comparable to that of the Caribbean and are well below rates in Sub-Saharan Africa (Figure 2).

Figure 2: ‘Where They Came From’: Pacific, Caribbean and Sub-Saharan Africa

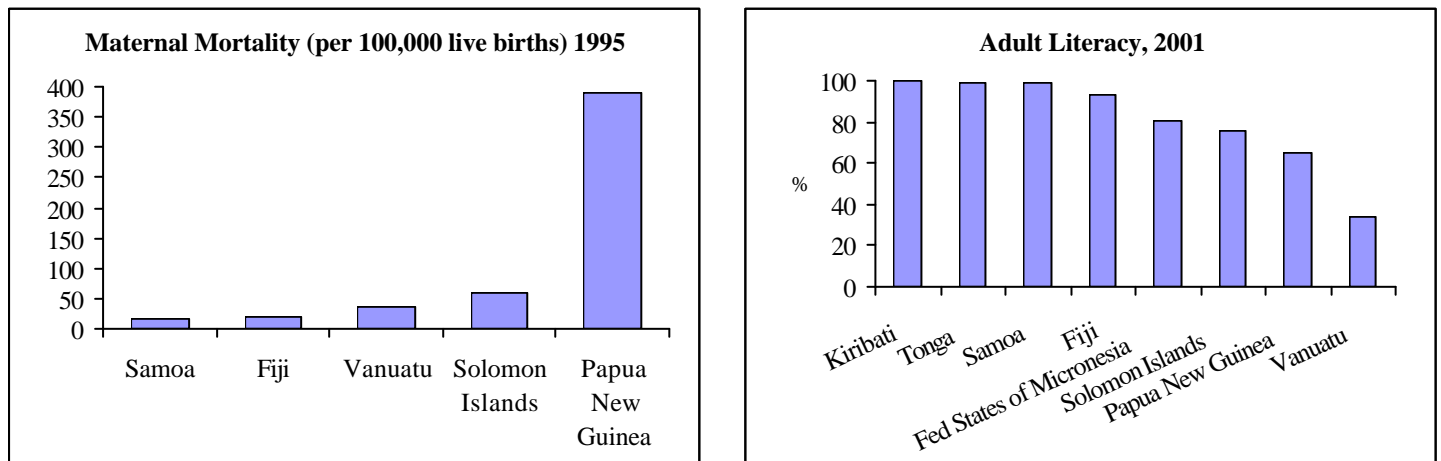


Source: UN Population Division *World Population Prospects: 2002 Revision*.

Disparities exist within the region

Nonetheless, there are significant disparities *between countries* in the region. In the Melanesian states, gains have been made but these countries rank lower than other parts of the Pacific, particularly Polynesia (Figure 3). There are also significant disparities *within countries* – in PNG, several of the Highlands provinces have extremely low access to safe water, low literacy rates and low school enrolment rates compared with the coastal and island provinces.

Figure 3: Intra-regional Disparities



Source: UNDP Human Development Report 2003; UN Population Division *World Population Prospects: the 2002 Revision*; WHO; and UNICEF.

A volatile and, in Melanesia, deteriorating growth record

Economic gains have been weak and volatile

Since 1975, average GDP per capita in the Pacific has increased by 0.5% per annum. Over the same period, it shrank by 0.9% in sub-Saharan Africa.

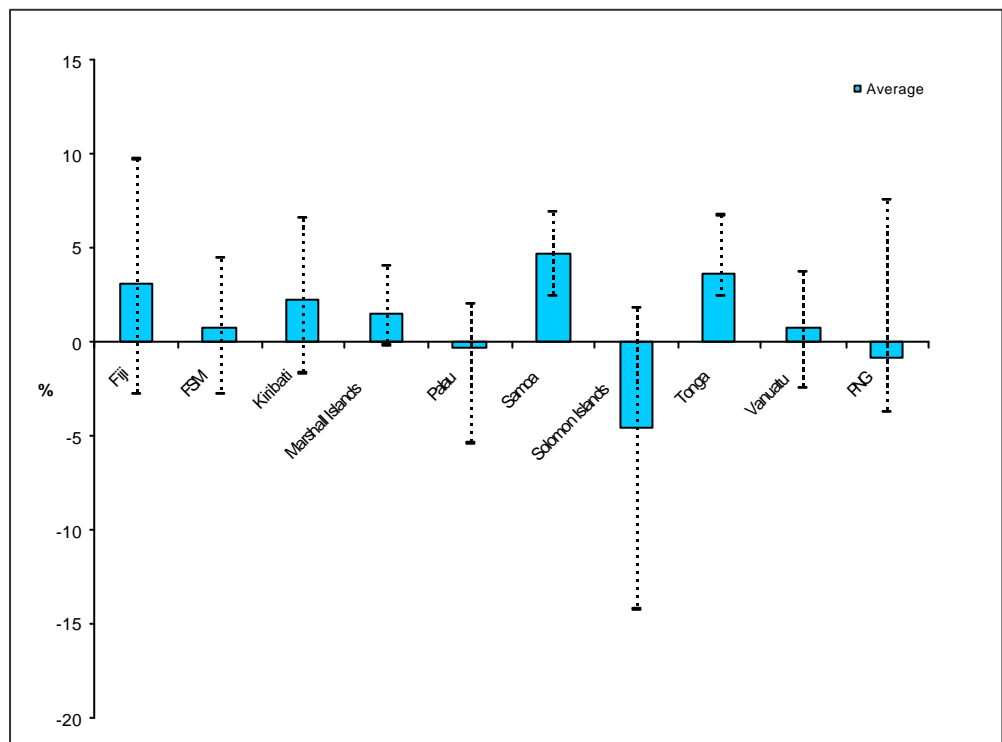
Performance in the Pacific has recently deteriorated. Most of the larger regional economies experienced a fall in per capita income between 1996 and 2002.

PNG, in particular, is in deep recession and the economy contracted by 3.3% between 2000 and 2002. The Solomon Islands economy has experienced a downturn of 25-30% since the eruption of the ethnic tension in mid-1999.

The Pacific economies have also suffered from volatility in economic performance (Figure 4). This stems from their economies being small, open and dependent on a narrow range of exports. They suffer from poor capacity in public and private sectors, are remote from major markets and face uncertainty in the changing world trade regime. They are also particularly vulnerable to the economic consequences of natural disasters.

Real annual GDP growth in the region has fluctuated from a low of minus 5.5% in 1997 to a high of 4.1% in 1999.

Figure 4: GDP Annual Growth - High, Low and Average, 1998-2002



Source: DFAT, *Country Factsheets* (from ABS, IMF and various international sources).

Population Growth is Complicating Efforts to Improve Living Standards

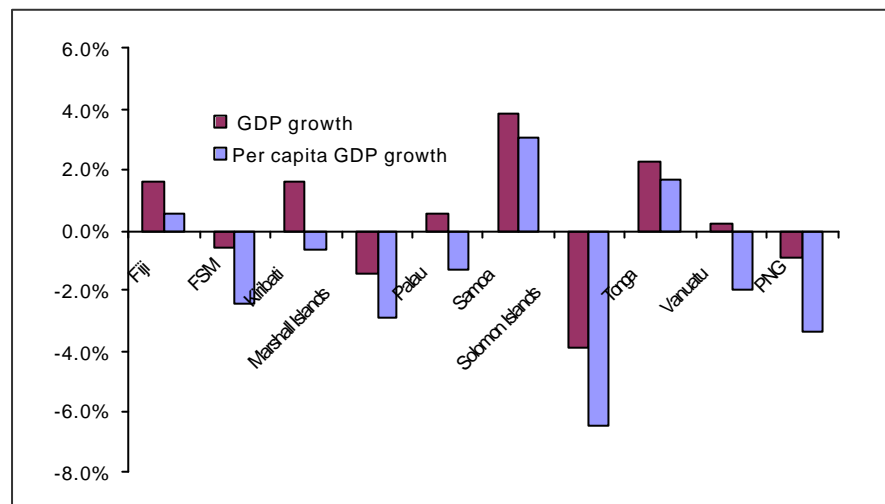
Weak growth and high population increases have restricted per capita growth in GDP since 1996 to only a handful of countries, notably Fiji, Samoa and Tonga. These countries have comparatively low growth in populations, achieved in part through access to emigration.

Population pressures are strong and are increasing, especially in Melanesia

By contrast, Melanesia has had negative rates of per capita growth (Figure 5) and has very young demographic profiles. In the Solomon Islands and Vanuatu, almost half the total population of the two countries is under the age of 14. Approximately half of PNG's total population is under 19. This contributes to their poor per capita income performance.

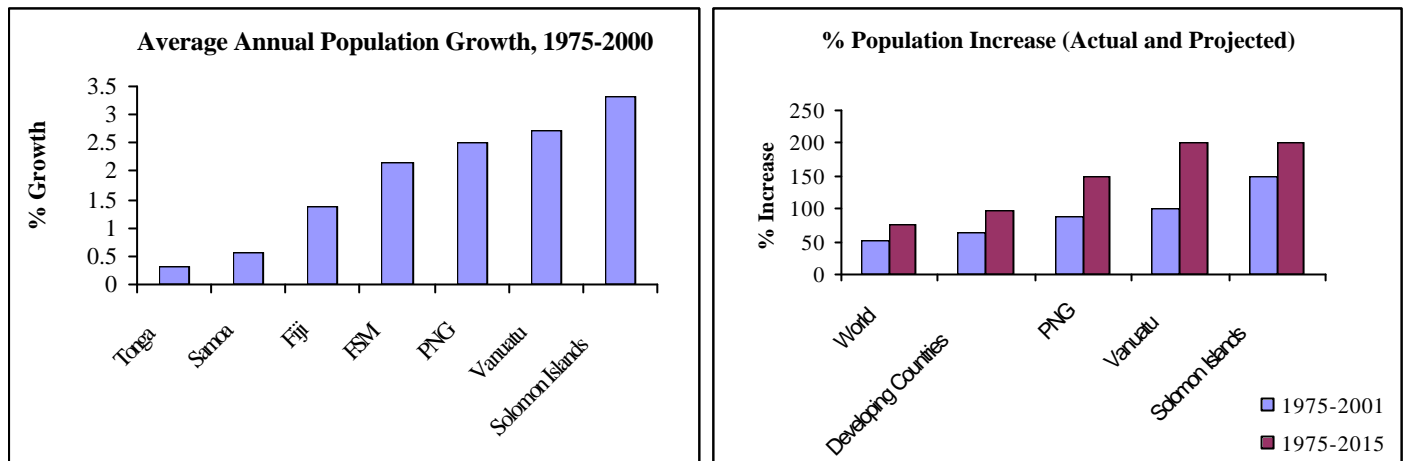
Figure 6 shows the relatively high annual population growth of the Melanesian countries (over 2.5 per cent). In the case of Vanuatu and the Solomon Islands, on current trends it is expected that by 2015 these countries' population growth rates will have grown from 1975 levels at twice the developing country average. Population in PNG is expected to double in the next twenty years.

Figure 5: Average GDP and Per Capita GDP Growth, 1996-2001



World Bank, *World Development Indicators 2002*; 2003.

Figure 6: Population Growth in the Pacific



Sources: *World Population Prospects 2002*; *Human Development Report 2003*; *CIA Factbook 2002*

Improved social indicators in the face of economic decline

The continuing improvement in social indicators in the face of modest economic performance is a feature of the Pacific, particularly since the early 1990s. It is likely that this improvement is attributable to effective investments in basic health and nutrition, a robust informal and subsistence economy, and traditional practices that provide a social safety net.

Human development gains threatened by lack of growth

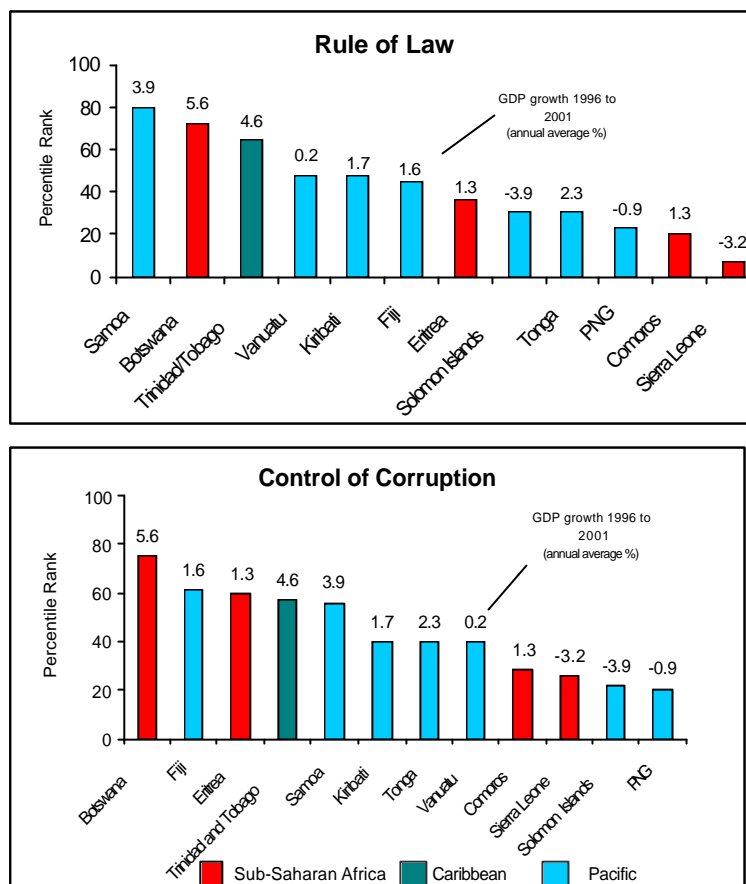
The extent to which these gains can be maintained in the face of economic stagnation is open to question, particularly in Melanesia, with signs that many service delivery systems and traditional support mechanisms are under stress and with population pressures intensifying.

Locking in Gains and Addressing Reversals

Addressing governance lies at the core of development in the Pacific

The quality of governance has a decisive influence on development, particularly in small, open states with limited economies of scale and opportunities for diversification. Figure 7, based on recently developed World Bank governance indicators, demonstrates the relationship between good governance and growth. Countries like Botswana, Trinidad and Tobago and Samoa that perform well on indices like corruption and the rule of law have also achieved consistently credible growth rates.

Figure 7: Governance in the Pacific, Caribbean and Sub-Saharan Africa - Selected Countries, 2002



Source: World Bank *Governance Matters III: Governance Indicators for 1996–2002*

Capacity and Political Will for Reform

The Pacific record on governance is mixed, stemming from a lack of institutional capacity, including issues of smallness and affordability. It also results from the legacy of inappropriate colonial structures that have seriously impeded internal political integration and nation building.

In many cases governance has also been affected by a lack of political will. Political leadership for reform has not been sustained and has been derailed by short-term political expediency and the self-interest of elites.

Examples from Melanesia stand as a stark warning to the rest of the region. After twenty-five years or more of independence, the capacity and accountability of core national institutions has deteriorated. This deterioration reveals that if the institutions responsible for governance quality are allowed to wither, social and economic prospects become seriously impaired.

The pressures to deliver tangible benefits from reform quickly have compromised the performance even of reformist governments. However, countries like Samoa, which have diligently and consistently pursued governance reforms, show the gains that can be made from sustained support for change.

Capacity, scale, inappropriate colonial structures and lack of political will affect the Pacific's record on governance

Continuing deterioration of governance in Melanesia

Implementation challenges to reform remain

There is clearly an ongoing need for institutional and policy reform in the region. The challenge has been in implementing these reforms. This has proven onerous for small countries like Kiribati and Tuvalu. The larger nations, such as PNG, are not short of good legislation and policies. Their problems lie in an inability to implement these policies.

Poor fiscal management has the potential to further undermine growth and impede service delivery

Better Fiscal Management

Sound fiscal management is essential for Pacific states. Only with sensible, well-planned public investments and service delivery can healthy, productive economies be established and sustained. Moreover, poor spending decisions by governments can have devastating effects on growth prospects, particularly when governments dominate the local credit market as a means of funding deficits and drive up interest rates to levels that make it impossible for private businesses to borrow and invest.

The record on economic management in the region has varied significantly

Pacific governments have had difficulties in managing their public expenditure over the past few years. Exceptions exist, including Samoa, Kiribati, Tuvalu and, more recently, Vanuatu. However, there has been a trend towards high wastage and poor management of public spending.

Examples abound. In PNG, recent work indicates that savings of between 20 and 30 percent are possible simply by strengthening government procurement. Similarly, a recent public expenditure review in PNG identified 2,000 unattached civil servants - each of whom is being paid a salary. And a recent audit of the Southern Highlands Provincial Government found evidence that around 50 million kina had been wasted in undocumented, misappropriated and/or misspent funds. In the Solomon Islands, there has been a complete breakdown in budget discipline. Recent estimates show that over the first seven months of 2003, the police alone spent four times their permitted budget – an overspend which amounts to one fifth of the country's entire annual budget.

In addition to damaging the prospects for private-sector growth and employment, poor public expenditure management impacts on the quality and distribution of key services. In PNG, for instance, weak management capacity has hampered the supply and distribution of essential medicines and education material as well as the maintenance of key infrastructure such as roads.

Australia is sharpening its focus on public expenditure management in the Pacific

Donors have long been aware of the weaknesses in the region's public expenditure systems, with the multilateral agencies in particular taking a lead in developing potential solutions. In retrospect, however, these solutions have lacked coherence, slowing rather than reversing decline. In response, Australia and the International Financial Institutions (IFIs) are developing clearer, more focused programs of public expenditure reform that build on the increased international awareness of the importance and practice of sound budget management. This is reflected in PNG in the 2003 Public Expenditure Rationalisation and Review, and in the Solomon Islands through the Regional Assistance Mission to the Solomon Islands (RAMSI) budget stabilisation initiative. More broadly, this is reflected in Australia's support for programs designed to strengthen public expenditure management throughout the region, including in PNG, Fiji, the Solomon Islands, Vanuatu, Tonga, Samoa and Nauru.

Corruption remains a problem and its nature is changing

Confronting Corruption

Corruption in the Pacific has centered on the exploitation of natural resources (e.g. forestry in PNG and the Solomon Islands). Outside interests, in concert with corrupt elites, have been able to expropriate national economic endowments. Corruption linked to traditional or clan based systems of loyalty is particularly prevalent in Melanesia. There has been very limited scope for corrupt access to aid funds from credible donors.

Trans-national forces and outside influences are driving new, more sophisticated forms of corruption such as money laundering, drug and people trafficking. This has been driven in part by the growth in trade in what Transparency International (TI) has called the 'tokens of sovereignty' (passport sales, money laundering, provision of tax havens).

Corruption is a symptom and a cause of poor governance

TI points out that corruption is both a symptom and cause of poor governance. Strong leadership legislation (in Fiji, Vanuatu and Papua New Guinea), an active press (PNG, Vanuatu), a spread of Internet access, and public advocacy are positive developments. Strong regulatory institutions are central to combating corruption. However, these institutions suffer from weak preventative and enforcement capacities. And cultural traditions continue to blur the line between corruption and legitimate transactions, making cronyism more prevalent.

Strong domestic regulatory and oversight agencies play a critical role

Evidence is also emerging that local political behaviour contributes to corruption. Fluid party membership, poverty and low levels of voter education conspire to produce short-lived governments, where the emphasis is on immediate gains rather than long-term reform. Ineffective public oversight agencies allow the powerful to corner resources, with little likelihood of being held to account for the use of resources.

Internal pressures for greater transparency are emerging

There are indications that internal demands for an end to corruption are rising (e.g. PNG Media Council's campaign). Whilst still the tip of the iceberg, recent prosecutions by PNG's Anti-Fraud Squad, the relative success of the PNG Leadership Tribunal and work of the PNG Ombudsman's Commission suggest an important foothold is being established both within government and civil society more generally. This is exemplified in the demands being made by civil society in the Solomon Islands of RAMSI to address corruption.

Causes of lawlessness and instability are complex

Building Law and Order, Peace and Stability

The emergence since the late 1980s of lawlessness and instability has compounded the inability of Pacific countries to attract investment and generate growth. The causes of lawlessness in the Pacific are rooted in a complex interplay of factors, including social and political transformation, unemployment, ongoing demographic change and the breakdown of traditional structures.

The Bougainville conflict was not only a conflict between separatists and the PNG government but also a conflict between different elements of this society. Similarly, tensions in Fiji have centred around competition between different groups of indigenous Fijians as well as between Fijians and Indo-Fijians. Continuing concerns regarding law and order are significantly impacting on investment, particularly in PNG.

The economic costs of instability have been high

The costs of such instability are substantial. The impact on PNG of the closure of the Bougainville copper mine was only offset by the fortuitous start of other mining ventures. In 1995, it was estimated that the cost of crime

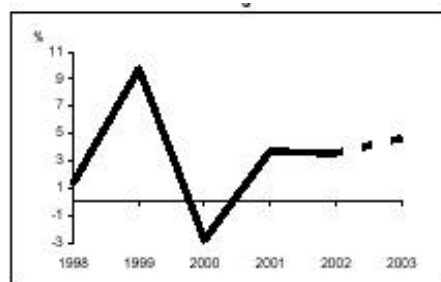
to PNG was K191 million – about 3% of its GDP. If anything, these costs would have increased over the last seven years. The instability in Fiji in 2000 had a dramatic and sudden impact on Fiji's economy, particularly the tourism sector. A return of stability quickly reversed the downturn. In the Solomon Islands, by July 2003 the fiscal deficit had reached double figures, exports had fallen by two-thirds and international reserves had dwindled to zero.

Challenge is to build robust and durable law and order institutions

A key challenge in the short to medium term is the capacity of law and order institutions to maintain their impartiality and effectiveness, particularly during periods of crisis and unrest. Over the longer term, strong police, legal and judicial systems in large part determine the capacity of countries to combat corruption, achieve growth and attract foreign investment.

There have been some promising signs. Australia has provided substantial support since the late 1980s to the PNG police who, while still dogged by operational deficiencies and insufficient resources (there are the same number of police as at independence), have shown improvements in performance. For example, there has been a doubling in fraud and anti-corruption cases that have been brought to trial since late 1997 as well as significant improvements in successful prosecution rates (from 65% to 75% over the last ten years). Over the years, the police have also shown reliability in the face of instability, ranging from the Sandline crisis to more recent cases of unrest. Vanuatu's justice system, again with significant Australian support, has shown resilience over recent times. Fiji has also managed to improve its growth prospects following 2000 (Figure 8).

Figure 8: Fiji GDP Growth, 1998-2003



Source: DFAT, *Country Factsheets*

Australia is playing a leading role in strengthening policing

There are now Australian-supported law and justice programs in all Melanesian countries as well as in Samoa, Tonga and Nauru. In addition, the Pacific regional policing initiative will provide a comprehensive approach to police training across the region as well as provide a flexible mechanism to provide targeted support to national police agencies. Through the Regional Assistance Mission, Australia is supporting the stabilisation of law and order, including through providing Australian Federal Police (AFP) officers to work with their Solomon Islands counterparts.

State legitimacy, service delivery and growth are intertwined

A lasting solution to lawlessness and instability requires growth, employment and development that can generate investments in those basic services that help underpin government legitimacy and national unity. If governments fail to fulfil this responsibility, their domestic legitimacy will be questioned and fragmentation pressures could intensify.

This raises the question - what are some of the key resources for employment, development and growth in the Pacific and how can aid best catalyse these resources for development?

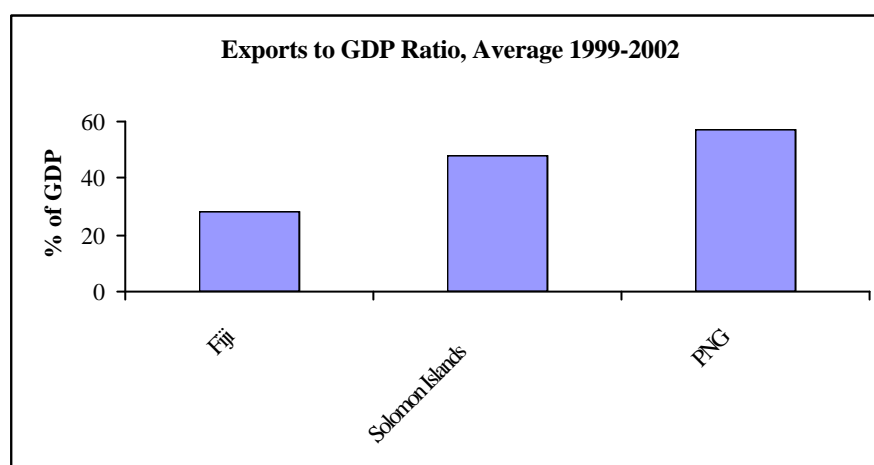
Financing the Pacific's Future

The record of progress and failure in small island states shows that the quality of domestic policies, the ability to identify and exploit trading opportunities, and the capacity to attract and retain private capital, whilst maintaining investments in human capital, are essential.

Trade is central to the Pacific's development

Countries in the Pacific are highly reliant on trade. Revenues from exports comprise a significant component of GDP in many Pacific countries – averaging around 60% of PNG's GDP between 1999 and 2002 (Figure 9). Australia's ratio of exports to GDP was around 20% in this period.

Figure 9: The Importance of Trade in the Pacific



Source: World Bank, *Pacific Islands Regional Economic Report 2002*

Recent multilateral and unilateral efforts towards freer trade are eroding the preferential access granted to Pacific countries in developed country markets. This erosion will need to be offset by new arrangements to enhance intra-regional trade, maintain access to developed country markets and manage the transition costs of adjustment.

Greater liberalisation will bring greater benefits

While the quantum of benefits that could flow to Pacific countries from liberalisation might be disputed, the direction of such benefits is clear – greater liberalisation will bring greater benefit. As intra-regional trade is currently small, benefits from the Pacific Islands Countries Trade Agreement (PICTA) will be correspondingly small in the short term.

Broader liberalisation that includes key trading partners, such as Australia and New Zealand will, however, see significantly greater returns. Unilateral liberalisation would bring greater returns again.

It is also hoped that PICTA will provide an expanded market of nearly seven million people to enable fuller exploitation of economies of scale and attract foreign direct investment. For these benefits to be exploited, integration would have to be deeper than an elimination of internal trade barriers. Trade facilitation measures will be crucial in this respect and agreements on investment regulations, tax policies, and labour mobility would further deepen integration.

These regional liberalisation efforts will only deliver benefits in the context

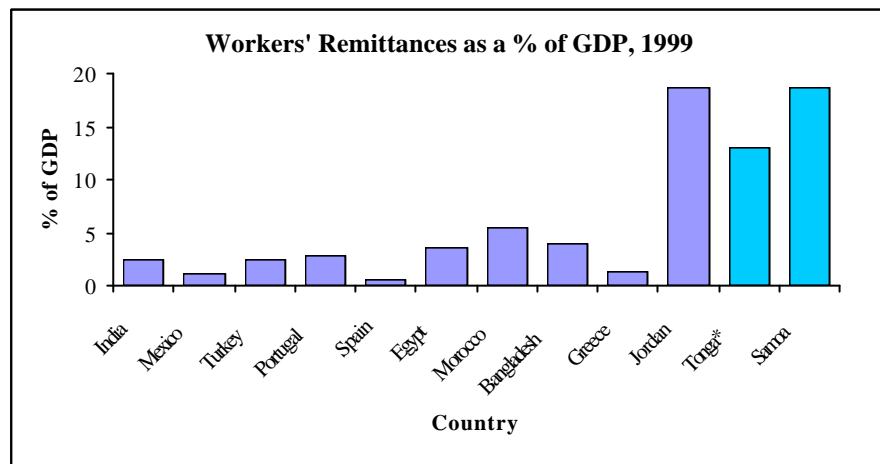
of strong domestic policies and institutions that can successfully harness the gains from freer trade and can create an enabling environment conducive to successful private sector development and diversification.

Labour mobility is an important provider of capacity and resources in the Pacific

Remittances Play A Critical Role in Fiji, Polynesia and Micronesia

Emigration of workers from Fiji, FSM, Marshall Islands, Palau, Samoa, and Tonga has acted as an escape valve for qualified workers in search of better employment opportunities. Citizens of FSM, Marshall Islands and Palau have emigration rights to the United States under the Compact of Free Association. Samoa and Tonga have had reasonably easy access to New Zealand and the United States. Entry to Australia by Pacific islanders has included those who are New Zealand citizens. An almost equal number of Tongans and Samoans reside abroad as live in these countries. In Samoa, earnings from remittances comprise a higher proportion of GDP than that found in the top ten remittance earning countries, including Mexico (Figure 10). More recent estimates for Tonga range from a massive 40 to 50 per cent of GDP.

Figure 10: Resources from Remittances



Source: UN Conference on Trade and Development, *Handbook of Statistics* (*figure for Tonga for 1993)

Remittances provide an incentive for Pacific states to invest in skills

Emigration opportunities have induced investment in skills acquisition. In Fiji, to facilitate emigration, the Indo-Fijian population is investing more in education than the indigenous population - the difference between the two ethnic groups was most apparent following the two coups of 1987. As a further illustration of this phenomenon, literacy rates in Palau, Samoa, and Tonga, where emigration is easy, are high as compared to the Solomon Islands and Vanuatu where emigration to high-income countries is difficult and there are internal cultural barriers to mobility.

The Role of Aid

Aid plays different roles in different country contexts

Aid plays an essential role in the development of the Pacific. As would be expected from such a diverse region, this role differs from country to country.

Aid plays a catalytic role in larger Pacific countries

In the largest countries, particularly in Melanesia, aid is intended to support the emergence of an effective state that can supply cost-effective services to its people and establish an environment supportive of private sector-led growth. In these states, aid is largely catalytic, and this is reflected in relatively small aid to GDP ratios (Figure 11). Australian aid to PNG for example has decreased significantly as a proportion of GDP over the last 25 years - from around 16% of GDP in 1977 to less than 5% in 2000 (Figure 11 – blue trend line). And historically, Australian aid to the Solomon Islands has not been high by regional standards up until the beginning of ethnic conflict in 1999 (Figure 11).

Aid is source of predictable resource flows in smaller Pacific countries

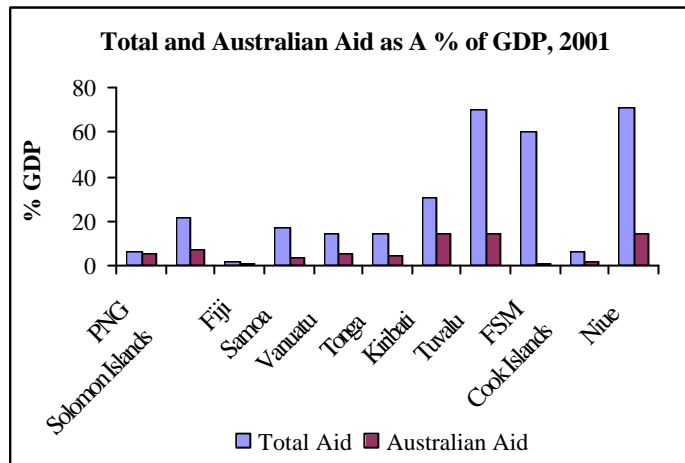
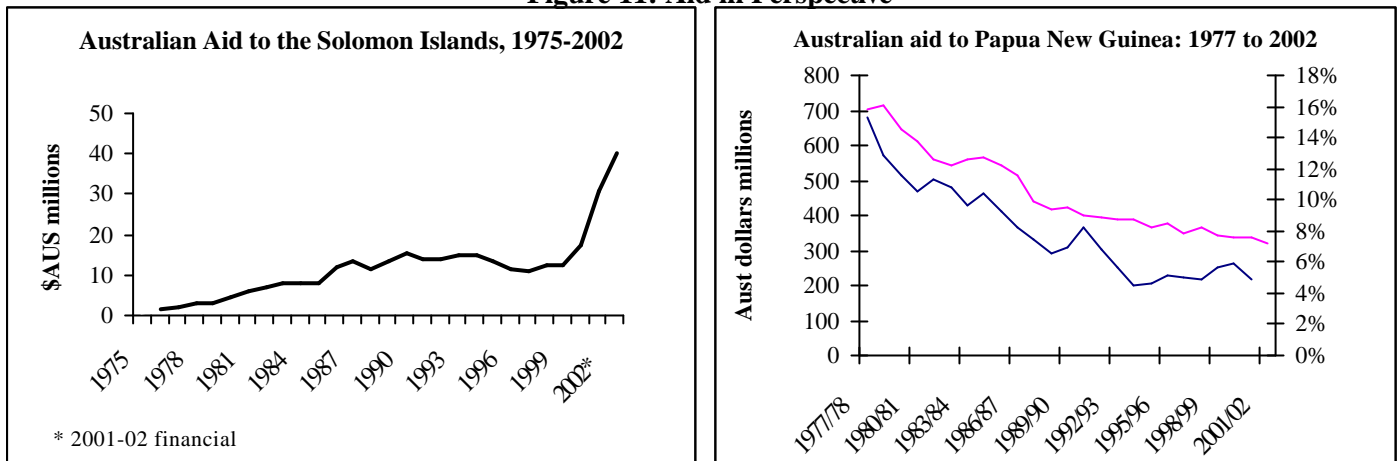
In the smallest countries, such as Tuvalu, Nauru and Kiribati, aid plays a different role. It still supports service delivery and private enterprise, but with such low populations and geographic remoteness, the prospects of a self-sustaining economy are limited. Aid therefore plays the additional role of assisting the government to manage resources and of providing a predictable and durable source of external funding. In these small countries, the realities of scale and potential imply a large aid to GDP ratio (Figure 11).

French territories and US compact states receive significantly more aid per capita than PNG and the Solomon Islands

Most of the countries with higher ODA/GDP ratios are those that enjoy ‘special relationships’ with external administrative powers. Taking the Pacific as a whole, Figure 12 shows that the largest aid donor in the region is France (over 3 times Australia’s regional aid in 2001) and the largest recipients of aid remain the Francophone territories (which accounted for around 50% of all aid to the region in 2001).

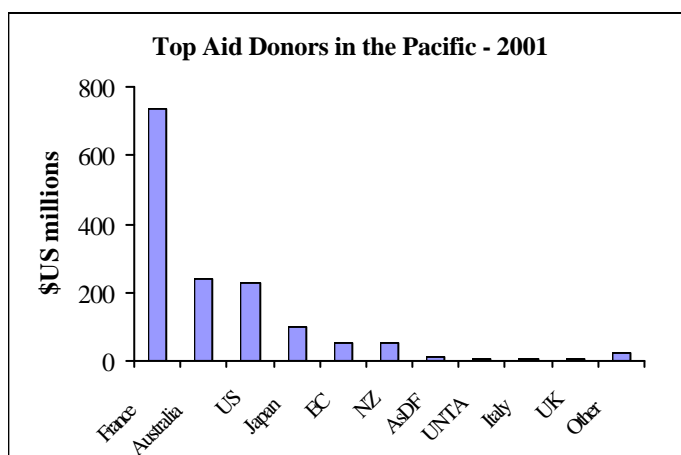
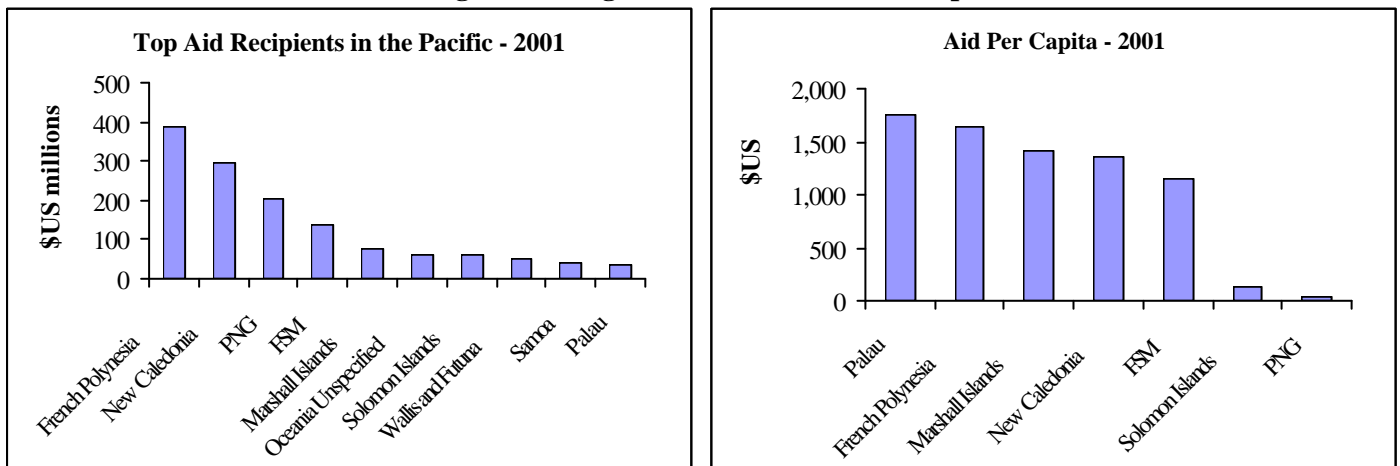
In terms of aid per capita measures, the highest recipients of aid remain the French territories and US compact states by a massive margin. For instance, French Polynesia receives over 40 times the aid per capita of PNG (Figure 12).

Figure 11: Aid in Perspective



Source: OECD-Development Assistance Committee; *World Development Indicators*, 2003

Figure 12: Regional Aid Donors and Recipients



Aid is an effective means of reinforcing reform in strong policy environments as well as encouraging reform in weaker policy environments

The Aid Effectiveness Debate

The past five years have witnessed a vigorous debate on the role and effects of aid in developing countries. A broad consensus has emerged that aid is more effective in countries with sound policies.² Nonetheless, there is also evidence to show that even where policies are weak, aid plays an influential role in encouraging and supporting policy and institutional reform. This debate demonstrates that it is not aid *per se* that leads to development. Rather, aid affects outcomes by influencing policies, institutions and processes.

In this regard, the Pacific is no different from any other developing region. Aid has a role to play in supporting those countries - like Samoa - that have adopted sustainable growth policies. Once these countries have embarked upon a cycle of sound policies and sustainable growth, aid provides support to consolidate the gains. Such support can also offset the fluctuations caused by vulnerability to events like natural disasters. But aid also has a variety of roles to play in those countries where policies are less coherent and in post-conflict environments. It can, for example, be used to provide rapid, post-conflict support in infrastructure (often seen as a form of peace dividend), build platforms for future growth and support service delivery to the poor.

But poorly targeted and poorly managed aid can have a range of negative effects

No discussion of aid effectiveness would be complete without an examination of the potential deleterious effects of aid. In the Pacific, these revolve around four areas. First, aid has probably helped to concentrate economic activity in the region's capital cities. To some extent this is unavoidable as a function of communications and travel difficulties. Nonetheless, aid has added to a tendency on the part of the region's leaders to neglect the needs of those living outside the capital.

Second, aid has probably helped to contribute towards the inflated size and cost of the public sector and propped up unsustainable systems. Since aid is largely a government-to-government process, its management and implementation requires considerable additional resources in recipient governments.

Third, aid has in some areas contributed towards a weakening of public sector structures. This has occurred as a result of an emphasis on project delivery, which can distort the deployment of public sector resources.

Finally, aid has sometimes added inappropriately to the size of the recurrent budget. Roads need to be maintained, schools staffed and hospitals supplied with drugs, and sometimes the budgetary realities of this are not reflected in aid planning decisions.

Australia's aid program is conscious of the potential for aid to damage rather than improve conditions and responded consistently in each of these areas to ensure a better quality program across the region. A community-based peace and restoration fund, for example, has led the way in taking donor programs to the remoter regions of the Solomon Islands, and pioneering work is being done with the education sector in PNG to ensure that support is consistent with medium-term budget resources. Broader sector based and longer term interventions are increasingly being used.

Donor coherence and coordination is essential

Low levels of donor coordination have exacerbated each of these weaknesses. In the Pacific, Australia is responding by exploring ways to adopt common strategic approaches, undertake common work programs, and engage in joint policy dialogue with other Pacific donors. For example, in PNG, Australia is engaged in an unprecedented initiative to develop a joint AusAID-World Bank-ADB Country

² For a comprehensive discussion of the importance of sound policies see the Minister for Foreign Affairs' Eleventh Statement to Parliament on Australia's Development Cooperation Program (September 2002), *Australian Aid: Investing in Growth Stability and Prosperity*.

Assistance Strategy that will enable coordinated engagement with PNG on the critical reform agenda. In the Pacific, Australia is harmonising the administration of its aid programs with those of New Zealand. And in the Solomon Islands, Australia has led the establishment of the Multi-donor Economic Governance Mission.

Aid can be fungible but only under certain conditions

Another common criticism of donors to the region concerns the perceived “fungibility” of aid. In essence, the fear is that all aid is fungible and encourages overspending by Pacific governments.

In fact, evidence accumulated by the international community over the past decade shows that aid is fungible only under certain conditions. According to this research, the more substantial the scale of donor assistance, the weaker the government, and the less control that is exercised through the budget, the smaller the scope for fungibility. This is an interesting finding for the Pacific, where governments are often weak (because of political systems that encourage frequent changes) and budgetary control is often poor. It suggests that regional governments in receipt of donor support may not yet possess the levels of capacity and sophistication that are needed to (in effect) manipulate public spending in a damaging way.

Potential for fungibility reinforces the need for enhanced policy dialogue

Nonetheless, there is no room for complacency. It is for this reason that Australia and other donors have placed greater emphasis on the overall coherence of the policy framework in Pacific countries, and on the quality and consistency of the budget process. Only by having confidence in the across-the-board quality of country policies can donors hope to control the potential negative impacts of aid fungibility.

Development in the Pacific: The Emerging Agenda

Challenges are fundamental and require Pacific to take up leadership of its own development

Australia’s Pacific neighbours are facing fundamental challenges to their economic and social futures. Their ability to meet these challenges will depend on a capacity to implement sound domestic policies, create environments for private sector investment, overcome financial mismanagement and corruption, promote stability, and to provide an appropriate level of services.

However, the outlook for parts of the region is poor. While Pacific countries themselves must take leadership over their development future, the international community, particularly Australia, has a critical role to play.

Expectations must be realistic and tailored to country circumstances

The expectations that inform this engagement must be realistic and tailored to specific country situations. The Pacific will remain a region with significant development challenges, pockets of poverty, and relatively low standards of living. Reform challenges will need to be tackled over the long term and be constantly reinforced.

A coherent international approach

Market access, employment opportunities, predictable and coordinated aid approaches and enhanced investment will play key roles

The international community has a responsibility to engage in coherent and sustained approaches that support national development efforts in the region. Opportunities to build such an approach include:

- providing efficient market access for Pacific exports with sensitive management of preference erosion.
- exploring options to enhance employment opportunities to boost remittances and strengthen the flow of technology, ideas and capacity.

- providing predictable levels and coordinated approaches to aid in the region
- promoting financial and technological transfers through policies that encourage Foreign Direct Investment (FDI) to the region.

Regional approaches that meet shared challenges

Pooled regional resources and shared approaches can help overcome capacity constraints

The demands on nation states to meet the requirements of effective governance are onerous. In the Pacific, small size and low capacity hinder the ability of small states to meet these demands across all service areas. There is scope for the region to investigate more vigorously the pooling of resources or to adopt regional approaches to overcome these constraints, building on the lessons of the past.

As well as the recent regional policing initiative, other areas of potential cooperation include economic management (such as common financial regulations), and common regulatory frameworks in aviation, customs, quarantine, trade and migration. As agreed at the recent Pacific Islands Forum meeting, a study to explore economically viable cooperation in aviation and shipping is being undertaken.

Regional approaches also need to be informed by less successful attempts in the past. These reaffirm that the issue must drive the mechanism/approach.

More substantial engagement by Australia backed up with resources

The starting point for international engagement with the region must be the development frameworks of the countries themselves. The issues confronting countries are not solely sector or institution based. They are issues of development and capacity. External engagement must be informed by coherent strategies grounded in a detailed knowledge of development and the country concerned.

Within this framework, Australia's engagement with the region is becoming broader in coverage, more substantial in depth and wider in participation. This involves:

Australia's engagement will be based on robust dialogue

- increasingly robust dialogue at senior political and bureaucratic levels to encourage reform efforts. Australia's participation at the Pacific Islands Forum and Forum Economic Ministers' Meeting provides important regional avenues to pursue substantial issues of governance to support enhanced bilateral dialogues.
- deepening strategic partnerships with key Pacific counterparts, particularly with economic, financial, and law enforcement agencies. This would include a greater commitment by key Australian Government agencies to the region but with access to expertise remaining open and contestable.
- targeting future Pacific leaders to study and undertake work attachments in Australia through initiatives such as the Pacific Scholarships for Governance. Change in the Pacific will be generational and building relations with the region's future leaders is a key investment.

This engagement is underpinned by the effective positioning and strong performance of the aid program.

Australia will underpin this engagement through a more 'hands-on' approach

To further assist our Pacific partners address their complex development challenges, Australia is adopting a more hands-on approach. Timely direct assistance can serve to reduce the financial and human costs of addressing more serious issues associated with further decline.

The aid program will build on existing footholds by providing senior personnel, sharpening the focus on economic management and law and justice, and building longer term capacity

The program is well positioned to do this. In the Solomon Islands for instance, existing initiatives in the law and order, basic services, community development and public sector reform areas provided a solid foundation for the work of the Regional Assistance Mission.

In partnership with the countries concerned, the program must be able to build on these critical footholds. It is important to point out, however, that investments in longer-term capacity building still need to be emphasised. As well as providing avenues to engage in substantial dialogue, weight would be lent to the strategic partnerships outlined above through the provision of senior level personnel. Particular areas of priority include economic governance and law and justice (including oversight agencies to help address corruption and financial mismanagement).

Importance of incentives and services

And we will strengthen incentives and contestability

There is also a need to strengthen incentives within the aid program to support governance reform and, in certain circumstances, attach conditions in concert with other donors. While experience shows that conditions without country ownership will fail, it is equally clear that without reform, scarce resources, including aid dollars, will not be used to their fullest potential. Incentives need to be based on the expectation that countries will genuinely pursue the reforms that formed the basis of any request for assistance and which will maximise the effectiveness of assistance. Failure to meet agreed conditions would precipitate alternative forms of assistance, for instance through sub-national or non government service providers.

Continued support for basic service delivery is a priority

Continued support for basic service delivery functions will continue to be a major feature of Australia's engagement, particularly in countries where conditions are deteriorating. Breakdowns in health, education and essential infrastructure services not only have a significant human cost, they also serve to undermine the legitimacy of nation states and can provide the catalyst for instability. Assessments must be continually made of the most effective means of providing service delivery support in such circumstances.

Donor coherence and differentiated responses

An Australian leadership role in helping coordinate regional development efforts

Australia must build on its leadership role in the region. Australia needs to facilitate donor coordination efforts in the region, as it has done in PNG, the Solomon Islands and more recently Vanuatu, building on partnerships developed with the other major donors, particularly the World Bank and ADB, as well as New Zealand, the EU and Japan.

Diversity in the Pacific requires differentiation of response

The diversity of the region means that it remains appropriate to differentiate the aid response. Some of the smallest states are unlikely ever to become fully self-sufficient and the response will continue to focus on sensible and sustainable management of resources, including trust funds in Tuvalu, Kiribati and Nauru.

The larger states, however, have substantial potential and the focus will be on areas such as law and order, public expenditure management, service delivery and private sector development.

Conclusion

The success or otherwise of Australia's Pacific neighbours will depend fundamentally on the quality of domestic policies implemented, the robustness with which improved governance is pursued, and the willingness of Governments to work collectively to address shared problems.

Australia's increased engagement with the region has to be backed up with resources. This engagement, including the aid program, will need to continue to increase its focus on Melanesia, to bolster Australia's political support for reform in this troubled part of the region.

The challenges are complex and will require long-term investments in capacity building and the conditions to deliver broad based, sustainable growth or at least the highest possible levels of self-reliance.