

**SENATE FOREIGN AFFAIRS, DEFENCE AND TRADE
REFERENCES COMMITTEE**

**INQUIRY INTO PAPUA NEW GUINEA AND THE
ISLAND STATES OF THE SOUTH-WEST PACIFIC**

SUBMISSION

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Submittor: **The Business Council of PNG and the
Institute of National Affairs**

Contacts: **Mr Mel Togolo
President
Business Council of PNG**

**Mr Mike Manning
Director
Institute of National Affairs**

Address: **PO Box 1530
PORT MORESBY PNG**

Tel: **(675) 3203 728**

Fax:

Email:

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The Australian-PNG Relationship

Submission to the Australian Senate Foreign Relations Committee

By
The Business Council of Papua New Guinea and the
Institute of National Affairs

Port Moresby May 29, 2003

Introduction

In making this submission the Business Council of Papua New Guinea (BCPNG) and the Institute of National Affairs (INA) will complement other submissions made to the committee and to give a slightly different view to that put by the PNG Government. Like the government, the BCPNG and INA both value the relationship between the two countries very highly and the purpose of this submission is to improve it and bring it to a higher plane.

For whatever reason Australian's generally do not understand PNG well. Foreign Minister Downer told a story a few years ago which illustrates the vague affection that Australians have for PNG. He pointed out that after the horrific tsunami at Aitape, Australian schoolchildren were in the streets of his electorate collecting money, they had not done this for any other natural disaster in any other country despite floods, landslides, famines etc. His point was that the Australian people hold PNG in special regard. Nevertheless Australians would never consider PNG as a tourist destination and are fed a continuous diet of sensational newspaper articles and press stories depicting PNG as the end of the earth.

There is no denying that PNG has its problems. Nevertheless for Australian and other diplomats to rank it as the worst hardship post in the world is an over exaggeration which has been perpetuated since independence. For the Economist magazine to rank Port Moresby 133 out of 133 cities for expatriates to live in is also a gross exaggeration, even by its own criteria it is difficult to believe that Port Moresby is a worse place to live than Johannesburg or Lagos¹.

There is a fear about crime and violence and its worst aspect is the seeming randomness and unpredictability. There are not the facilities available in some other cities but there are also opportunities to leave the city for other provinces where safety is not of such concern; for participation in all sorts of sports; for world class diving; boating at a first class marina; bushwalking and other recreational activities with sensible precautions.

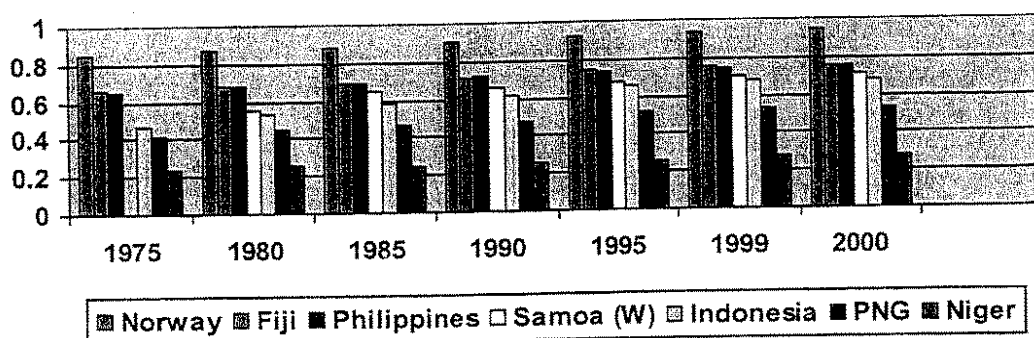
¹ In the last couple of days a visiting consultant was describing arrival at a Nigerian city. They were met and placed in armoured vehicles which themselves had arrived at the airport before sundown the previous day because they were too afraid to travel in the dark to meet an early morning flight. This would not happen in PNG.

This submission seeks to put before the committee some suggestions about where the Australian-PNG relationship might progress. It recognises that the backbone of the relationship is one of geographical and regional proximity as well as the past colonial history. It will also show that cultural links are beginning to contribute strongly to the relationship. It will concentrate on aspects of governance, financial and economic performance, development indicators and military and strategic issues.

Governance

The basic measure of governance is how well the government is able to provide services and bring development to its people. It is clear that the present relationship is not achieving its full potential, and despite billions of dollars of Australian aid and unprecedented mineral and petroleum wealth PNG's human development indicators remain amongst the worst in the world. Despite the fact that real progress has been made since independence that momentum has slowed and has to be restarted.

Human Development Index Trends 1975-2000



SOURCE: UNDP; *Human Development Report 2001*; New York, 2002

Not only has Australia poured in billions of dollars in aid but the two governments and their officials have spent thousands of man hours in design and monitoring of projects and programmes aimed at improving PNG's performance in many areas. In terms of real development they have had little success and it is the duty of both governments and both people to examine why this happened and what is required to remedy the situation.

The aid relationship has concentrated on trying to improve the present system through many capacity building exercises and assistance to restructure the public service. There seems to have been little gain from this and alternative delivery systems need to be encouraged and built on. It will not be easy and will require imaginative and innovative solutions. Building on the church network is one obvious way and emulating the ADB Smallholder Support Services Pilot Project (SSSPP) which seeks to encourage local private and NGO providers on a fee-for-service basis may be another.

It is not a foregone conclusion that the private sector and NGOs will be able to do better than the government and monies spent with either will need to be carefully monitored. Nevertheless the structural rigidities that have solidified in the public

service make it likely that efforts to reform it may be a waste of time, money and effort.

Perspective

When talking about the problems that PNG faces compared to Australia it is useful to make some comparisons with Australian territories.

Budget Comparisons (NT, ACT 2001-2002, PNG 2003)

Place	Population	Annual Budget		Budget/Head (\$)
		AUD	Kina	
Northern Territory	210,664	2,300,000,000	5,415,587,000	10917
ACT	299,000	2,337,000,000	5,502,707,000	7816
PNG	5,200,000	1,863,159,000	4,387,000,000	358

Exchange Rate: \$A1=K0.4247

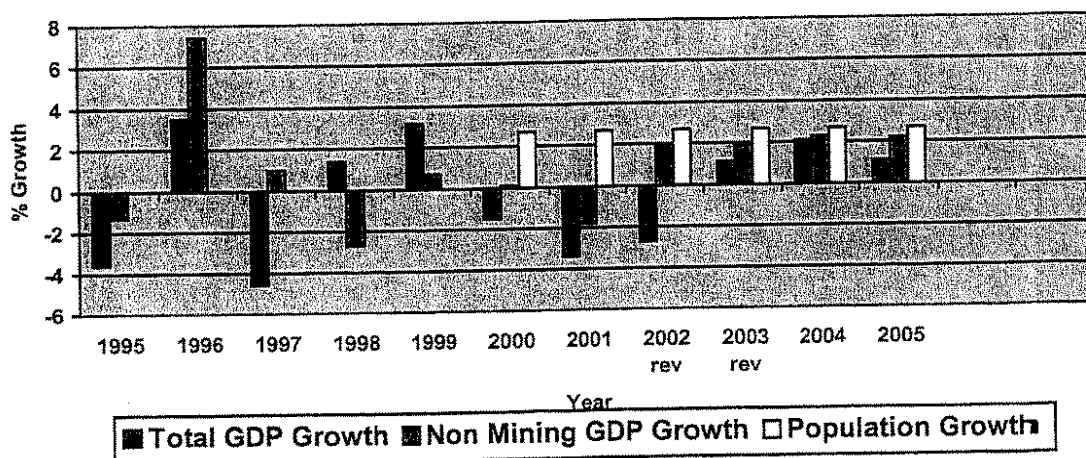
Source: NT, ACT Budget Papers, PNG 2003 Budget Papers

NOTE; Whilst not strictly comparable they do illustrate the very large difference between the available resources for Australian territories and PNG.

It can be seen that the resources available to the PNG government are vastly less than those available to two Australian territories which rely on Commonwealth grants for income. The size of the PNG aid package is a large proportion of Australian aid but quite small when compared to the grants received by those territories. The task facing any PNG government is truly daunting compared to the amounts of money available to the territories.

Economic Data

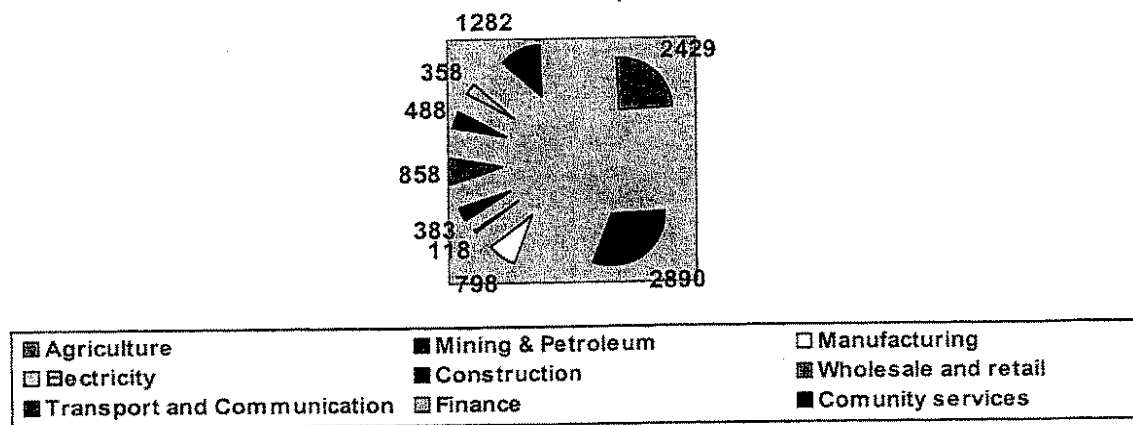
Real GDP Growth 1995-2005



SOURCE: Mekere Morauta, *Economic and Development Policies*; Department of Treasury 2001, BPNG Governor's Six Monthly Report, June 2002; Philemon, B, *Supplementary Budget 2002*; Department of Treasury August 2002, 2003 Budget

The GDP of PNG has shrunk over the last three years and is not expected by the government to reach population growth for the next three years. This means that per capita income, the generally accepted measure of wealth of a country, is shrinking.

Estimated PNG Gross Domestic Product 2001 (Kina Million)



Source: Philemon, B; *Economic and Development Policies 2003*; Department of Treasury and Finance November 2002

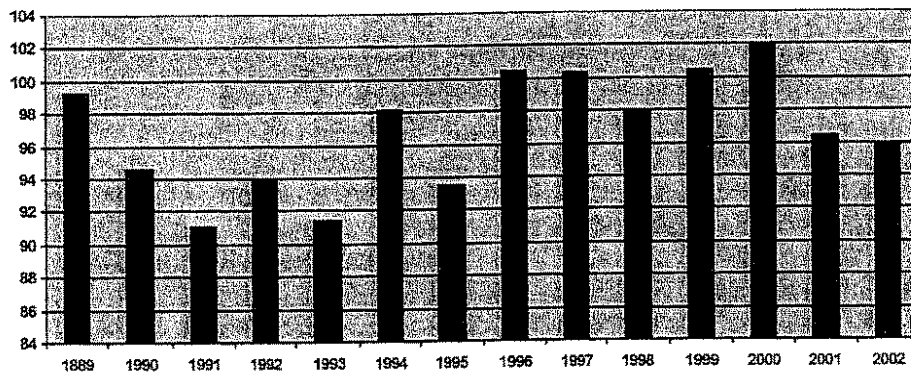
This chart shows the vulnerability of the present GDP to the imminent closure of all existing mineral and petroleum projects except Lihir. However changes in the taxation regime in the 2003 budget have increased interest in exploration as well as potential development of some existing prospects² and new projects could come on stream. There has also been significant new petroleum exploration as a result of changes in the tax regime³.

One of the main problems associated with the lack of growth in PNG is the fact that formal sector employment has hardly grown since independence. This has been most pronounced in rural areas with the demise of the plantation sector in PNG's major tree crops. It is estimated that there are between 50-80, 000 people joining the workforce every year and it is unrealistic to expect that formal sector employment will absorb them people in the near future. Production from smallholder cash crop farmers has significantly declined due to the deterioration of the roads and other infrastructure. It has been estimated that more than 30% of coffee production in the Highlands is lost annually because of poor roads and law and order problems.

² These include abolition of additional profits tax (APT), relaxation of ring fencing provisions for existing producers, double deduction for pre-explorations costs, accelerated depreciation and a promise to review state equity requirements.

³ Reduced company tax, removal of APT, removal of limits to loss carry forward and special tax credits for the gas project.

Employment Index (June 1989=100)



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, September 2002

Informal Sector

PNG is one developing country where the informal sector has not thrived as it has in most others, particularly in Asia. There are many regulations restricting the informal sector which have been inherited from Australia at independence. They may be appropriate for a developed country but are not inappropriate to a developing country. In addition the attitude of the authorities has been one of antagonism to the informal sector because of perceptions of hygiene, cleanliness and aesthetic values. This antagonism has been vigorously and often violently displayed by authorities enforcing the regulations and laws.⁴

This has been reinforced by the proximity to Australia and the fact that many of PNG's leaders spend leisure and business time in clean and orderly Australian cities and towns. The Consultative Implementation and Monitoring Council (CIMC)⁵ has been trying to change the perception and remove many of the inappropriate restrictions. Legislation to do this is in the final stages of preparation after an exhaustive consultation process with local level governments and national government departments. The legislation is based on a survey and public opinion poll which was carried out to gauge public feeling about the sector.

The CIMC and the government of PNG recognize that the rural and urban informal sectors are the only likely basis for growth in employment or income generation in the near future. The rural informal sector relies almost completely on agriculture for its existence. Apart from the traditional tree crops this sector has seen an expansion in spices (vanilla) and European vegetables especially potatoes in recent years. A lot more resources should be given to this sector if PNG is serious about creating more employment.

The main potential for sustainable economic growth in PNG is the expansion of its tree crop industries. Apart from oil palm these have been stagnant over the last decade

⁴ Street vendors are often violently evicted and their produce stolen or destroyed.

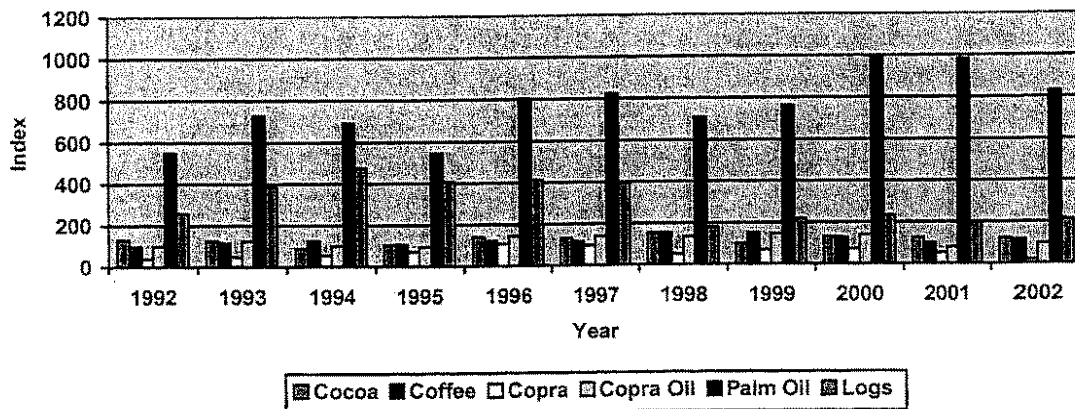
⁵ A body set up under government auspices to bring together government, private sector and civil society to discuss problems and issues of development through various consultative forums.

despite often large increases in prices for reasons of devaluation as well as increased world demand. It is important to recognize that PNG is a very small player in these markets and therefore a price taker. The outlook for most of the tree crops looks reasonable and there has been significant investment in the cocoa⁶, copra and oil palm industries over the last few years. Australia has played a significant role in providing support for research and extension to these industries through AusAID and ACIAR.

PNG is concerned to reintroduce the cooperative movement which was successful in the 1960-70s to help growers obtain better prices for its produce and obtain materials and supplies at a cheaper price and more reliably. Australia may be able to assist with this proposal but its potential may be limited unless real inroads are made into the law and order and infrastructure problems.

The coffee industry faces very strong competition from Vietnam which was an insignificant producer ten years ago and now produces over 12 million bags of coffee (PNG produces around 1 million.).

Export Volume Indices (1980=100)

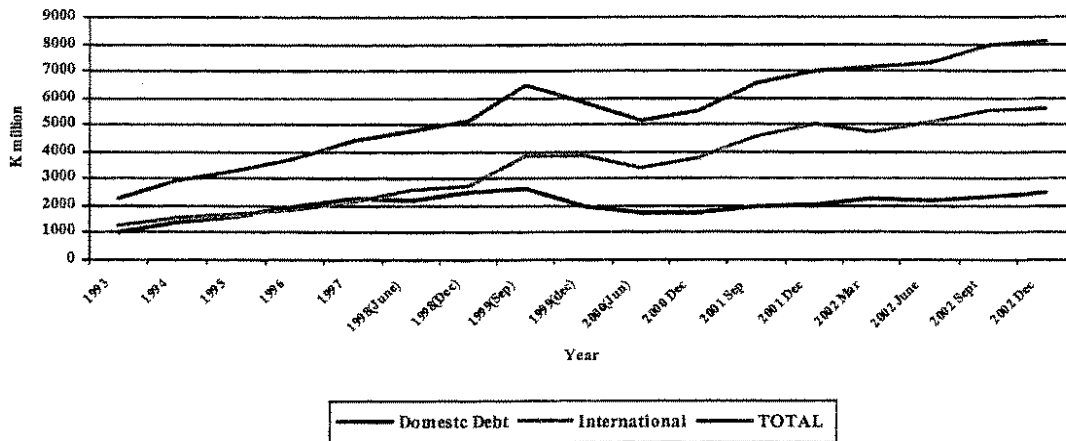


SOURCE: Bank of Papua New Guinea; *Quarterly Economic Bulletin*; December 2002

The solution to the production of more sustainable crops is relatively simple. It is restoration and rehabilitation of transport infrastructure which affects production of all of these crops. Feeder roads and major highways in PNG are in such bad shape that they can seldom be used after rain and the cost of air and sea transport has become prohibitive.

⁶ Much of this investment has been in Bougainville and has been sponsored by AusAID through the UNDP.

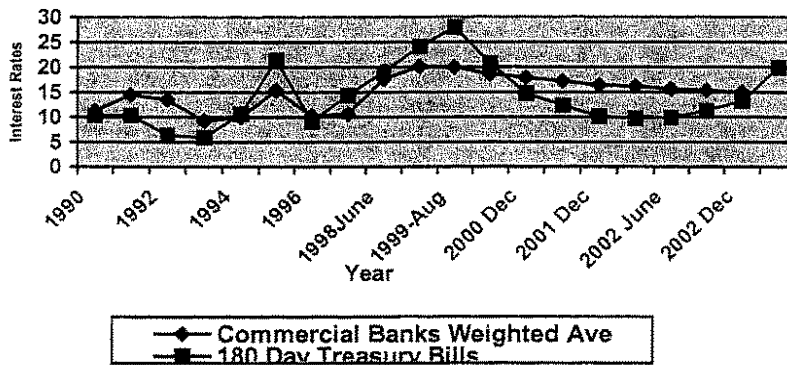
Public Debt 1993-2002



Source: Bank of Papua New Guinea; *Quarterly Economic Bulletin*, December 2002

Public debt in PNG is currently running at around 80% of GDP, this has implications for interest rates and also the proportion of the budget which is spent on interest and loan repayment. Interest payments in 2003 were expected to be K580 million or 23% of recurrent expenditure. However the assumed average interest rate for 2003 was 13.2%⁷ and rates have been significantly above that for the whole of 2003 (currently 180 day treasury bills are in excess of 20%).

Interest Rates 1989-2002



Source: Bank of Papua New Guinea; *Quarterly Economic Bulletin*; December 2002; *Bank of PNG Treasury Bill Weekly Outturn*.

The main reason that interest rates are currently so high is that the government expected K200 million from the sale of assets (privatization) before this and also expected to receive a second tranche of an Asian Development Bank loan for structural adjustment of \$US 35 million (K140m.). Neither has yet eventuated although the Treasurer expects them to be received before very long⁸. PNG has had a bad history of fiscal restraint and control and this has also tended to put pressure on

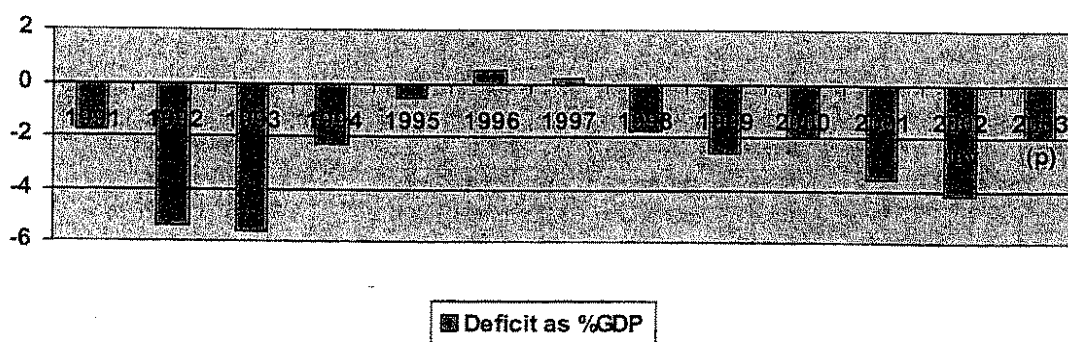
⁷ 2003 budget papers.

⁸ Talk to Business Council of PNG 15/05/03

both interest and exchange rates because of the high import content of government expenditure.

It needs to be noted that total T-Bills issued increased from K1.9 billion in June 2002 to the current level of K2.4 billion. T-Bills are issued by the Central Bank to the public to make funds available to lend to the government. Currently the interest rate is 20% compared to the 2003 budget assumption of 13%. Such a situation has implications for deficit financing problems, the exchange rate and could affect current and major future projects.

Budget Surplus/Deficit as % GDP



Source: Department of Treasury and Finance; *Economic and Development Policies*; November 2002, Tarata, K; *Statement to National Development Forum*; March 28th 2003

Interest rates remain one of the more serious disagreements between the government (Bank of PNG) and the private sector. The Bank maintains that high interest rates are necessary to contain inflation and maintain foreign reserves. The private sector including sections of the commercial banking system argue that rates are too high, that relaxation will not flow into imports of consumption goods and an increase in imported investment goods is needed to start growth in the economy. There has been a precedent when Sir Julius Chan as Minister for Finance publicly threatened the Banks and they reduced their interest rates. Treasury Bill rates can be manipulated by the government if it has the will to do so.

The growing public debt is also a direct result of deficit bias in budgeting adopted by PNG (often involuntarily) as a macroeconomic management tool. Since independence PNG has allowed a deficit bias in its budgeting to provide macroeconomic stability. During this period there were only two years (1996-97), in which there were small surpluses. Deficit budgeting can be useful as a form of long-term investment if funds were directed on building productive capacity and maintaining public asset. Unfortunately this was not the case for PNG for more than two decades.

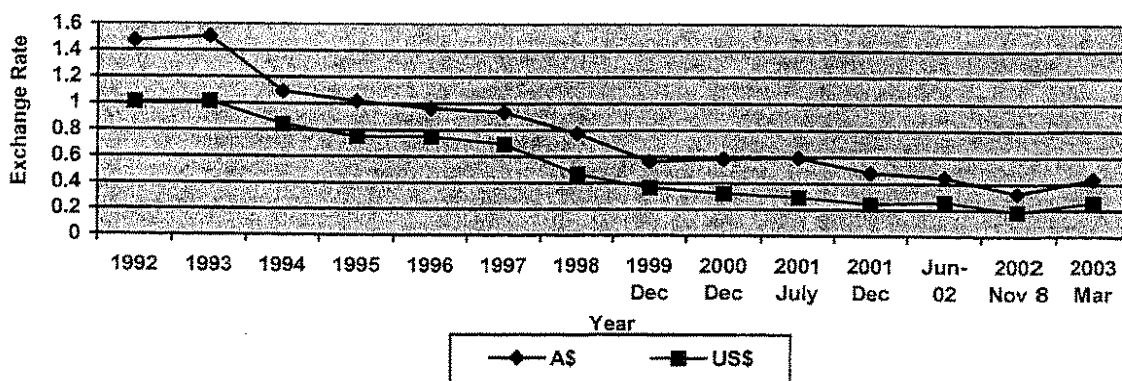
Deficits were allowed to occur even during periods of high revenue inflows from the mining and petroleum industry. Deficits occurred because of excessive expenditure on consumption and to support a series of political superstructures with high time preference for expenditure. PNG is currently in a "deficit trap," in which we continue to have a deficit budget to shore up ever-increasing future deficit budgets. This is a reflection of poor fiscal governance and lack of expenditure controls.

The current Minister for Treasury and Finance is making great efforts to remedy the situation but he seems to be a lonely voice in the wilderness. To reduce the deficit, currently estimated to be around K450.0 million, the government has to reduce the public service, rationalise or re-prioritise projects and apply tight expenditure controls.

One of the moderate successes of the present government (including Bank of PNG) has been the relative stability of the exchange rate against the two major currencies, the US and Australian dollars. It can be seen that the exchange rate dipped sharply last year but recovered after production from the OK Tedi and Porgera mines were temporarily halted due to extraneous factors. PNG will remain vulnerable to exchange rate movements due to the openness of its economy and the propensity to import of the government sector.

The key to exchange rate stability and long term interest rates is control of government expenditure and improvement of export performance in the sustainable industries of agriculture, forestry, fishery and tourism. In addition conditions conducive to expansion of food crop production need to be concentrated on to continue the substitution of traditional foods for imported ones.

Exchange Rates-1992-2002



Source: Bank Of Papua New Guinea: *Quarterly Economic Bulletin, December 2002*, PNG National 1/04/2003, Department of Treasury *Economic and Development Policies 2002*.

The Aid Relationship

Australia has given PNG around \$A 8.1 billion in cash terms or \$A14 billion in aid since independence in 1975. Australian aid represented 41.4% of PNG expenditure in 1975 and now provides around 17% of government expenditure in 2003⁹. In 1975 around 75% of Australian aid was budget aid and by 2003 this was more than 95% programme aid. The reason for the initial budget aid was to allow the new nation to order its own priorities and learn from its own mistakes, it was also an important capacity building exercise to have PNG public servants forming their own budgets and later their own development budgets.

⁹ Economic Insights; *The Contribution of Australia's Aid to PNG Development-1975-2000*; AusAID, Canberra, 2003 and PNG Budget papers.

During the 1980s both governments became increasingly uneasy with the budget assistance which provided \$A 9.3 billion of untied aid but which appeared to provide an increasing disincentive in terms of promoting either equitable growth or diversification of the economy. In 1989 the first treaty on Development cooperation set out a timetable for the phasing out of budget aid and phasing in of project (later programme) aid. Interestingly the proportion of government expenditure going to key sectors of education, health and infrastructure was higher during the period of Budget aid than when programme aid was introduced¹⁰.

During the period before and immediately after independence there was an intense debate about the direction that the government should use its expenditure there was a heavy emphasis on distribution and a relatively lower emphasis on economic and growth issues. However changing circumstances including the financial crises of 1990, 1994 and 1997, the Rabaul volcano, the el nino drought of 1997-8 and the Asian crisis led to a realisation that PNG had to concentrate more on economic growth¹¹. It remains a major challenge today.

This submission fully recognises the importance of Australian aid and its crucial importance to PNG. PNG is grateful for the continued support that Australia has given. Nevertheless it is important that some aspects be looked at again in the interests of redefining that relationship.

The first common complaint about Australian aid is that it is "boomerang" aid. A large proportion returns to Australia either in the form of equipment and supply purchases or through employment of Australian consultants. It is ironic that one of the goals of the aid programme is to increase capacity in PNG and PNG consultants are not allowed to tender for AusAID projects. Recently there has been some movement towards use of PNG consultants as counterparts but the lead consultants have to come from Australia or New Zealand. The private sector would like to see eligibility of PNG consulting firms for AusAID contracts.

In the opinion of the private sector one of the major weaknesses in PNG has been middle management both in the public and private sectors. Most Australian aid personnel are attached to the PNG government as advisors¹². This is not an effective use of staff and it is recommended that both governments recognise the need for good middle managers to help rebuild the discipline (especially financial) and capacity of the public service. There is a need to re-introduce good office practices and record keeping, restore stability and develop again an institutional memory. Australian aid should provide necessary middle management for reasonably long-term contracts because of the need for new staff to learn the systems and methods of PNG.

The private sector also believes that service delivery through the existing government system is unlikely to improve and that the unwieldy Organic Law on Provincial and Local Level Government (OLPLLG) is a major constraint to progress. It believes that future delivery should be concentrated on the private sector and NGOs. It believes

¹⁰ Ibid p23

¹¹ See for instance Bart Philemon; budget speech for the supplementary budget in August 2002 p8 and other government statements.

¹² E.g. Successive police projects.

that the proposed National Road Authority and the ADB funded SSSPP are models for the future and that the Australian aid programme should give even greater emphasis to alternate delivery mechanisms.

The Trade Relationship

Clearly PNG has to improve its economic performance and one of the ways that this can happen is by encouraging greater export production. PNG also needs to diversify its export base and the private sector fully supports the government's "trade led recovery" policy. It believes that Australia can help to some extent by assisting more in the identification and promotion of potential exports (including tourism). The first thing that PNG needs is a massive and on-going publicity campaign about its potential and to dispel the very bad reputation that it has in Australia and (when they have heard of it) the rest of the world.

Australia can start by re-examining its general perception of PNG as enunciated by the Department of Foreign Affairs - does PNG really warrant a "warning status" for travellers? Is it really the most dangerous posting that Australian diplomats can have? PNG has to play its part but Australia can help change the image that its people have of PNG by some subtle changes in the way that the Australian government approaches and even describes PNG.

Australia has already engaged ACIAR (Australian Centre for International Agricultural Research) in helping identify and promote research into various agricultural products. It could help further assisting in carrying out a large scale study on potential agricultural markets and the probability of PNG being able to enter these markets thereby helping prioritise PNG research and development expenditures.

Australia should also re-examine some of its quarantine procedures to ensure that they are really necessary to protect it from disease and not a non-tariff barrier to trade (e.g. importation of frozen prawns). Other Pacific countries are allowed to export their taro crop to Australia but PNG is not given the same privilege. Where there are real quarantine worries Australia should increase its assistance for remedies for the potential pest and disease threats such as a satisfactory and effective treatment for fruit fly.

It is important to note that Papua New Guinea's largest trade partner is Australia. It is also a significant market for Australian goods, services and technology. On the other hand, Australia remains the largest portfolio investor in Papua New Guinea and the source of the largest bilateral aid for that country. Papua New Guinea without a doubt is an important neighbour to Australia and Australian economic and security interests. Papua New Guinea is to Australia as Mexico is to the United States. If Papua New Guinea's economy caves in, it will significantly affect the Australian economy and its investment in PNG. PNG matters in the scheme of Australian relationship with the Pacific.

Migration and Short Term Employment

For whatever reason Australia accepts migrants and even short term workers from the rest of the world (including the rest of the Pacific) but not from PNG. It may be

because PNG itself feared a brain drain or because Australia did not want to encourage a drain from PNG. It has not worked because the elite are already following the market place wherever their talents are saleable and PNG has airline pilots in the Arab emirates, doctors in Australia, scientist in North America and many PNG business people and politicians have quietly assumed permissive status in Australia.

It is time that this part of the relationship was re-examined. There would be immense short term benefit to PNG by allowing seasonal workers into Australia wherever there was a need. It is understood that there is a large influx of Fijian labour into Australia during the fruit season. PNG is closer and has a larger unemployment problem that would benefit from such a scheme. Papua New Guineans are known for remitting monies back to their home provinces and money earned in Australia would probably find it way back to families in PNG.

There is also the educational aspect of short-term migration and Papua New Guineans would benefit greatly from the experience in the outside world as well as picking up new skills. Exposure to Australian communities and social environment has the potential to develop social links that would be beneficial to both peoples.

There should be a scheme created to facilitate this as an arrangement between the governments of Australia and Papua New Guinea. This can be specifically supervised by government agencies in both countries. Such an arrangement could enhance cultural and economic relationship between the two countries and could lead to the creation of a free trade zone, which could be extended to other Pacific countries. This would be of immense mutual benefit to both peoples.

Of interest is also the fact that there are an increasing number of marriages between Papua New Guineans and Australians. This means that their children would have claims to both countries through family ties and hence an emergence of strong cultural ties. Papua New Guinea and Australia should grant each other reciprocal immigration rights. Papua New Guineans should not need to have entry visas to visit Australia and vice versa. Currently Australians travelling to Indonesia do not need an entry visa. Australia gives similar rights to other countries but not Papua New Guinea.

The authors believe that these are the sort of things that will help improve the relationship founded on mutual respect with long-term benefits for both countries and peoples.

The General Relationship

The private sector believes that the relationship between PNG and Australia needs to be improved. It does not and never has recommended re-colonisation or any change in PNG's sovereignty. However it believes that the relationship has not worked as well as it could over the last 25 years. This is probably a natural outcome of the growing of a new nation and the attitude of a departing "father" as Minister Brown referred to it in a recent speech.

The private sector would like to see this relationship nurtured more through intellectual and cultural exchanges and dialogue. It believes that there are some

serious mis-conceptions in both countries about the other's capabilities and intentions. PNG needs to shed its prickly pride and sensitivities and Australia has to leave its patronage and superiority behind as both strive to improve the relationship on a more even and open basis.

Both countries are part of the Pacific region and will always be. Problems in PNG will inevitably affect Australia and vice versa, already the drugs-for-guns trade flourishes across the borders. If PNG declines further there could be increases in many types of illegal activity e.g. a large stash of hashish found buried on one of the outer islands in the early 1990s. The potential for HIV/AIDS to cross national borders has to be controlled in both countries. It is gaining epidemic proportions in Papua New Guinea and Australian assistance in this area is very important for both countries.

Potentially Australia's security can be easily affected by social or political instability in Papua New Guinea. Australia's complacency could risk its own sovereignty being drawn into PNG's internal conflicts. The possibility of transnational criminals and fanatical terrorists using PNG soil to get access to Australia cannot be underestimated. Currently Papua New Guinea's land and sea borders do not have effective surveillance and is therefore open to people smugglers and drug traffickers.

The oft reported problems in the Southern Highlands are an example of the possible outcome for a large part of the country. It is by no means a likely outcome but it will require a concentrated effort along the lines already started by the Minister, Sir Peter Barter to keep the restoration of law and order and services flowing back into the province.

The growing of a special relationship between Australia and Papua New Guinea has the potential to lead to more intellectual cooperation between the two countries as PNG strives to plot its destiny and come to grips with its many problems.

Mel Togolo
President
Business Council of Papua New Guinea

Mike Manning
Director
Institute of National Affairs