

TRADE OR AID? WHICH BENEFITS DEVELOPING COUNTRIES MORE?*

HELEN HUGHES*

1 Introduction

As Australians we are naturally concerned with our own welfare, but we also pride ourselves on our egalitarian outlook and we are very conscious of our unique geographic location as a neighbor to Asia-Pacific developing countries. Trade and aid are therefore important economic and political issues. We have pursued trade liberalization in our own interest and to give market access to developing (as well as other) countries, because economic theory indicates that trade is a powerful instrument of growth and not a 'zero sum game'. Self-interest and compassion have reinforced each other, so that from being one of the most protectionist industrial countries until the early 1980s, Australia has become one of the most open to trade.

We are a compassionate people, moved by the plight of the poor, conscious of transgressions against developing countries in the colonial past and of a responsibility to use wealth and good fortune to help those less advantaged. Australia was thus an early participant in the Western flow of aid to developing countries, and aid continues to attract political and community support. But giving aid is very difficult, because economic theory indicates that aid harms developing countries more than it helps them. Compassion and economics are in conflict.

This paper reviews the insights of economic theory into the effects of trade and aid on development. Australia's trade policies toward developing countries are followed by an analysis of Australian aid. Policy implications, particularly for aid to Papua New Guinea and the Pacific, conclude the paper.

2 Trade, Aid and Development

The return to, and acceleration of, globalization since World War II has underlined the power of the theory of comparative advantage. Trade increases the competitiveness of markets and puts pressure on governments to reduce regulation to enable gains from trade to be realized, reducing economic rents and opportunities for corruption. Trade requires national security and the rule of law. Trade liberalization leads to a demand for greater international capital flows and competitiveness in capital and non traded goods and service markets.

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Aid is dramatically different because it is an economic rent with negative effects. Milton Friedman anticipated the analysis of aid as damaging recipient countries (Friedman, 1963), but the principal exponent of the counterproductive aspects of aid was Peter Bauer (1966). Bauer saw fungibility as the most counterproductive aspect of aid. Even if aid is small in relation to budgets, it enables governments to spend on their own objectives rather than on projects or programs agreed with donors.

In small countries, where aid represents large components of budgets, it has been drained to build palaces, accumulate large personal accounts abroad and attack citizens and neighbors by Amin in Uganda, Bokassa in the Central African Republic, Mobutu in Zaire and Mugabe in Zimbabwe. The largest cathedral in the world in Cote D'Ivoire is the crowning example of fetish projects. Aid enabled Nyerere in Tanzania and Mengistu in Ethiopia to destroy their countries' economic and social fabric in the name of equality. All these aspects of aid are evident in the Pacific where aid per capita is the highest in the world.

TABLE 1
AID FLOWS BY REGION

	Total aid flows 1970–1999	Average annual aid flows per capita 1995–1999
	US Billion 1998 dollars	US 1998 dollars
Sub-Saharan Africa	416,600	22
India	85,000	2
Other South Asia	137,800	9
China	41,200	2
Pacific	49,300	220
Other East Asia	152,600	8
Caribbean	45,100	34
Latin America	111,700	10
Middle East and North Africa	282,600	15

Source: The Development Assistance Committee (1971–2002) *Development Co-operation Reports*, OECD, Paris.

Bauer elaborated the insights of neo-classical economics and anticipated developments in the theory of rents and institutional economics to explain that even when aid projects and programs have positive outcomes, aid has a negative impact overall.

Like mineral rents, aid flows lead to wasteful private and public expenditures, misappropriation and corruption. Mineral rents and aid appreciate exchange rates, making import substitution and non-mineral exports costlier. Mineral rents attract resources disproportionately to mining. Because aid flows to governments, it attracts investment to the public sector. Investment becomes unprofitable in agriculture and labor-intensive export industries. The expectation of mineral incomes and aid discourages the build up of foreign reserves and encourages fiscal and monetary irresponsibility, leading to inflation and capital flight, undermining private investment.

Waste and corruption at the top lead to crime on the streets, deterring business and investment.

Import substitution and other regulations increase the role of government, biasing the economy away from markets to the advantage of elites. Financial repression, price controls and other regulations follow. They are maintained by aid long after their high costs, lack of employment creation and contribution to fiscal and balance of payments crises become evident. Dirigiste regulations become the principal sources of patronage, intensifying the struggle for power, particularly in multi-ethnic communities. The large bureaucracies that implement dirigisme are a dead weight on society, but support the ruling elites with whom they share the spoils.

Countries rich in mineral or other natural resources that receive high net aid inflows are thus in double jeopardy as many Latin American, African and Pacific countries have shown, and East Timor is likely to prove.

Dirigiste economic management undermines the evolution of the institutions essential to growth and development (Kasper and Streit, 1998). 'Internal' institutions, such as civil and business morality, do not evolve from the clan loyalties characteristic of less developed societies. Modern 'internal' institutions such as respect for the rights of the individual are essential to savings, entrepreneurship, investment and rising output and productivity. They have often been ignored in economic analysis, but neo-classical Harrod-Domar models of economic growth do not work without them. 'External' institutions such as police, legal systems and economic rules for the conduct of an economy have become more clearly recognized as essential components of growth and development. In addition Bauer already saw in the 1960s that the adoption of Marxist 'development' rather than market economics (Lal, 1983) would create institutions that would not only retard development, but that, once entrenched, would be very difficult to reform.

Despite the mounting confirmation of the validity of Bauer's thesis, his views have been ignored in favor of a 'vicious circle' of underdevelopment that argues an inability to save combined with foreign exchange deficits, that create 'two gaps' that can only be filled by aid. On this basis, Western countries could never have developed. External capital can accelerate development, but only if it is invested in open, market economies so that it produces outputs at internationally competitive prices. Aid flows to governments have been dominantly invested in public sectors in closed economies. But elaborating the 'two gaps' enabled the World Bank to lead the aid industry to provide more than \$2,500 billion (in 1998 dollars) of aid, with at least another \$1,000 billion (in 1998 dollars) in concessional loans, to developing (and transitional former European Communist) countries during the past 50 years. Unfortunately, there is no evidence that these flows fostered growth, development or poverty alleviation.

2.1 Trade, Aid and Growth

At the end of World War II, China, India and East and South Asian countries were the poorest in the world with only 10 per cent of the industrial countries' per capita income in 1960. Latin America was relatively advanced, with 40 per cent of the industrial countries' per capita income (Table 2).

The last 50 years support Bauer's hypothesis that the relationship between aid and growth is inverse. Sub-Saharan Africa was the largest aid recipient between 1970 and 1999; it had the slowest rate of growth (Tables 1 and 2). Pacific and Caribbean islands – the largest per capita aid recipients by a considerable margin – have been among the slowest growing economies. Aid has kept in power incompetent and dysfunctional regimes that are responsible for the world's poverty (Bueno de Mesquita and Root, 2002). India and China became growth leaders when they moved toward markets despite low aid. Aid advocates argue that unless countries adopt and implement growth-oriented policies, aid will not be effective (World Bank 2002a), but Bauer and the theory of rent indicate that aid can delay adoption of growth policies and have damaging effects even when countries turn to them. Recent research supports Bauer. The hypothesis that aid works in countries with pro-growth policies (Burnside and Dollar, 2000) has been shown to be invalid (Easterly, Levine and Roodman, 2003) It is not surprising that the most rapidly growing countries have had little aid.

Only the East Asia and Pacific region is catching up to industrial countries. Taiwan and South Korea turned from destructive dirigiste, inward oriented industrialization when the United States Congress, appalled by the corruption that aid was encouraging, ended budget aid and substantially reduced civilian aid. With Hong Kong and Singapore they became the 'Tigers' of development. Thailand, Indonesia and Malaysia followed to some degree. China has grown strongly since it opened its door ajar to the world in the 1980s, though overall its growth is not as high as official figures indicate (Rawski, 2001). Other East Asian countries and the Pacific Islands have fallen behind (Table 6 below).

TABLE 2
*PER CAPITA INCOME OF DEVELOPING COUNTRIES AS A PERCENTAGE OF
INDUSTRIAL COUNTRIES' PER CAPITA INCOME*

	Population	Per capita Income	Per capita income as a Share of industrial Countries' income		
	1998 Millions	1998 US Dollars	1960 Percent	1980 Percent	1998 Percent
Developing countries					
Sub-Saharan Africa	470	1320	15	10	6
India	975	1,750	10	6	8
Other South Asia	330	1,410	8	6	7
China	1,240	3,120	9	7	15
Other East Asia	585	4,890	14	16	23
Latin America & Caribbean	500	5,800	40	36	27
Middle East & North Africa	360	4,340	26	28	20
Industrial countries	836	21,480	100	100	100

Source: Maddison (2001). For China the 1998 per capita income, in spite of Maddison's care, appear to be more representative for the East Coast than for the country as a whole.

Bauer considered that aid enabled the Congress Party to maintain socialist policies that severely retarded growth in India (Bauer, 1966, p. 49). When the United States cut food aid to India in 1965 because the US Congress was appalled that its aid had permitted the development of an atom bomb, India began to reform agriculture to feed itself, thus taking the first steps toward a market economy. But it was not until it was faced by bankruptcy in 1991 that India turned to markets.

In spite of the relative decline of Sub-Saharan Africa, Latin America and the Middle East and North Africa, there have been marked gains in developing countries' living standards. During the last 50 years their population more than doubled to 6 billion, but population growth rates have now fallen in most countries with a demographic transition that first reduced death rates and then fertility rates. Except in Sub-Saharan Africa, where an HIV/AIDs epidemic exacerbates poverty, the expectation of life rose markedly for most people, indicating improving standards of nutrition, housing, education and health.¹

Absolute poverty remains a severe problem, but after rising steeply after World War II, it has been declining both as a percentage of the population and in absolute terms during the past 20 years to 465 million people in 2000. Opening economies to trade has been the major factor in reducing absolute poverty globally. In Sub-Saharan Africa, however, the numbers of absolutely poor people have doubled to 362 million, and in the Middle East and North Africa and Latin America they have also risen in the last 20 years (Bhalla, 2002).

The arguments that growth does not lead to poverty alleviation, that economic multipliers are biased against low income earners and that globalization (trade and commercial capital movement) hurts the poor are not supported either by economic theory or empirical evidence. Openness to trade is essential to, and stimulates sustained growth that is always marked by increasingly productive employment that leads to poverty alleviation. Equally importantly, poverty can not be reduced without growth (Fields, 1989). Institutional theory elucidates why the attempt to alleviate poverty directly, without a growth context, is a self-indulgent delusion. Without personal security, equality before the law, property rights, functioning markets and macroeconomic stability, investment can not take place and productivity and earnings can not rise. The most positive results of such direct poverty interventions as rural development and micro finance are limited (Lele 1975, Morduch, 2000).

Substantial middle and upper middle income groups have emerged, but in most developing countries they are thwarted by dirigiste policies that limit personal freedom and economic opportunities. Many millions seek to emigrate for opportunities denied at home, creating pressures that are threatening liberal immigration policies in the West (Hughes, 2002). Exploiting economic and political frustration, extremists foster revolution at home and abroad, creating networks of terror.

3 Australian Trade Policy

¹ The expectation of life is the best indicator of living standards. It is highly correlated with GDP growth. The UNDP Human Development Index (UNDP 1998-2002) is too deeply flawed to be a useful indicator of living standards as Castles (1998) pointed out. Castles' critique led to some improvements in the Index, but it still has a long way to go before it can be taken seriously.

Australia has become one of the most open industrial countries, particularly when other industrial countries' quota restrictions on imports of labour intensive goods are taken into account. Australia's negligible protection for agriculture contrasts with the \$US245 billion agricultural protection in the European Union, Japan and the United States is estimated to cost developing countries (World Bank, 2002b).

TABLE 3
AVERAGE APPLIED TARIFF RATES FOR MANUFACTURES IN INDUSTRIAL COUNTRIES (PER CENT)

	Australia	United States	European Union	Canada	Japan
Manufactures	5	4	5	5	2
Textiles, clothing, footwear and leather	17	10	9	14	6
Motor vehicles and components	7	2	4	3	0

Source: Productivity Commission. Averages are unweighted and exclude tariffs on items not imported, but include zero tariffs.

3.1 Residual Protection in Australia

Protection in Australia is largely limited to clothing, textiles, footwear and leather (TCFL), motor vehicles and components and sugar.

TCFL tariffs are still 25, 15 and 10 per cent (with some items at 5 per cent or less).. Quotas were eliminated and tariffs were reduced in the early 1990s, halving tariff collections, though they are still more than 10 per cent of the price of imports (Australian Bureau of Statistics, 2000). The Productivity Commission's Review of TCF Assistance Position Paper recommends the reduction of tariffs, as anticipated (Productivity Commission 2002a) to 17.5, 10 and 7.5 per cent in 2005, then reducing most of these to 5 per cent in 2010 and maintaining this level of protection to at least 2015. Handsome current budgetary support (Strategic Investment Program) is to be extended for another eight years albeit at a declining rate. The Commission clearly hopes that even with this degree of protection "further adjustment out of labour intensive standardized TCF" will continue to take place (Productivity Commission, 2003).

Clothing has a relatively high share of consumption of low income earners, who thus bear a disproportionate share of TCFL protection (Gresser, 2002). The protection of clothing also has unfortunate employment effects. 'Outwork' provides incomes for immigrant women. Low wage 'sweat shops' employ migrant women whose husbands and fathers do not permit them to learn English. In an open, flexible labour market both these groups could earn higher rates of pay, have control over their own pay packets and become integrated into Australian society.

Imports have almost 40 percent of the TCFL market, compared to 29 per cent for other manufactures (Productivity Commission data). Over 80 per cent of TCFL imports come from developing countries. (Australian Bureau of Statistics, 2002).

Motor vehicles and components have a tariff of 10 per cent, to be reduced to 5 per cent in 2010. The industry has been allocated \$4.2 billion from 2006 to 2015 through the Automotive Competitiveness and Investment Scheme and is to receive \$150 million for research and development. The current 3 per cent revenue duty protection imposed under a Tariff Concession System is to be removed.

Tariffs also bear most heavily on low priced vehicles and hence on low income earners. The labour force in motor vehicle production also has a high migrant component, but it is dominantly male, unionized and hence shares in the rents created by protection.

Sugar remains significantly protected, preventing small marginal producers from moving to more productive farming and other occupations.

Australia has low non-tariff barriers. Quarantine restrictions with minor exceptions arise from genuine quality and safety concerns. Australia's dumping measures in force, new cases initiated and new measures imposed have fallen. Service imports are also relatively free. The Productivity Commission's (and its predecessors') information has made a considerable contribution to the transparency of Australian protection and hence to its reform. Commonwealth and State budget subsidies and tax concessions and the total cost of protection are modest (Productivity Commission, 2002a).

Developing countries have a high share of Australian imports, with the clothing share between 80 and 90 percent despite high import tariffs. Developing countries have a more than 50 per cent share in several other categories and a nearly 40 per cent of all merchandise imports (Australian Bureau of Statistics, 2002).

It is impossible to judge to what extent remaining TCFL and motor vehicle tariffs restrict imports and market penetration from developing countries. Both are growing with Australia's increasing integration into the world's economy. Australia is also a clothing, textile and footwear and motor vehicle exporter. Several Australian firms, specializing in design intensive clothing, textile and footwear products, have invested abroad to operate in world markets. Most of the gains of reduced protection, however, do not accrue within industries but are economy wide. It is futile to conjecture how imports and exports, and hence employment, will be affected when remaining tariffs and subsidies are reduced. The outcomes depend on demand and supply elasticities for thousands of products at home and abroad.

3.2 Regional Trade Arrangements

GATT/WTO weakness in accepting regional and trade diverting arrangements with the Treaty of Rome with its Common Agricultural Policy, leading to the formation of the EU and later NAFTA, undermined the GATT/WTO system. A proliferation of bilateral trade diverting arrangements, such as the EUs' with North African countries, followed. Regional and bilateral trade diversion arrangements introduced lists of inclusions and exclusions that the GATT/WTO - MFN Rounds were at pains to end. The Doha Round is grounded in trivia and seems unlikely to result in the liberalization of trade in agriculture which is the principal remaining area of trade barriers. Australia is being forced to look to bilateral negotiations, particularly in the light of US plans, slow though they may be to come to fruition, for extending NAFTA to Latin America and thereby threatening Australian agricultural exports to the United States. To-date,

Australia has been able to avoid trade diverting agreements. The Australia New Zealand Closer Economic Relations arrangement is free trade (plus free capital and labour movement) and so is the Australia-Singapore agreement. It remains to be seen whether negotiations with Thailand and the United States will succeed in avoiding trade diversion.

APEC is a largely political construct justified by the colorful shirts of its annual leaders' meetings. Promises of tariff reductions by 2010 by industrial members have enabled Australia to extend the motor vehicle reform timetable from 2005 to 2010. TCFL producers will no doubt seek the same extension. Developing members' trade liberalization bears no relation to the 2020 APEC target. It is too distant to be of use to countries with reform in mind and distant enough for those that do not intend to liberalize.

3.3 Preferences for Developing Countries

Industrial countries' tariff reductions were marred by 'voluntary export restraints' on imports of labour intensive goods from developing countries. In clothing and textiles these were systematized in successive international Multifibre Agreement (MFA). GATT took over the MFA so that in 1995 it became the WTO Agreement on Textile and Clothing. Whereas most other 'voluntary export restraints' were eroded, the GATT intervention succeeded in perpetuating the MFA structure to this day. Under the Uruguay Round clothing and textile tariffs and quotas are to be phased out by 2005, but progress toward this target has been negligible.

In 1961, Raoul Prebisch, as Secretary General of UNCTAD, led developing countries to seek exemptions from GATT rules on 'infant industry' grounds. Only half weaned from protection and feeling guilty because of their barriers to imports, industrial countries gave in to these so that Part IV of the GATT in 1965 exempted developing countries from MFN and reciprocity rules. Australia, with high protection levels and unconvinced of the benefits of trade liberalization, supported the developing countries' drive to damage themselves at the initial and subsequent UNCTAD and other conferences.

Although it was strongly argued that the GSP (General Scheme of Preferences) was not likely to help developing countries (Johnson, 1967), preferences continued to be used by industrial countries to assuage their guilt about their continuing protectionist barriers against developing countries. Following the 'voluntary export restraint' structures, the GSP tariff reductions and import quota limits were listed by product and exporting and importing country with complex rules of origin. Thousands of officials found employment in allocating and policing quotas in importing and exporting countries. Importing firms were the principal beneficiaries.

Australia, guilty because of its high protection, was the first country to introduce preferences to developing countries – the Australian System of Tariff Preferences (ASP) - in 1965. Other industrial countries followed, with the EU eventually superimposing controls in Brussels on members. The European Economic Community's Lomé preferences for small African, Caribbean and Pacific (ACP) states were particularly destructive. Tying the Pacific Islands into the Lomé scheme provided economic rents for Fiji landowners, but was not as damaging as for Africa, although the

‘infant’ Solomons Islands tuna fishery was severely handicapped by the European “delinquent parents” rules of origin (Grynberg, 1998).

By 1985 the severe frictions created by the ASP with developing countries showed that the ASP, far from encouraging developing country export growth, had high administrative costs for Australia, and for Australian importers, created friction with neighbors and was ineffective for developing countries (Hughes and McLucas, 1985). Almost 20 years later, these conclusions have been underlined by several studies (Sapir and Lunberg, 1984, Whalley, 1990). The most recent, by Ozden and Reinhardt (2002), covering US preferences to 154 countries from 1976 to 2000, shows that preferences delay trade liberalization in exporting countries.

The 1985 ASP reform introduced a flat tariff preference of 5 percentage points for all products and all developing countries, without quota restrictions and with simple rules of origin. Some high income developing countries have subsequently been removed from eligibility, but otherwise this uniquely non-discriminatory system with low transaction costs for governments, importers and exporters has operated since 1985 in marked contrast to the torturous GSP schemes continued by other industrial countries.

Australia and New Zealand signed a preferential import scheme - SPARTECA (South Pacific Regional Trade and Economic Co-operation Agreement) - with the Pacific states in 1981. Subject to simple rules of origin, all goods from the Pacific Islands enter Australia and New Zealand duty free. A quota on sugar imports to Australia is the only quantitative restriction. SPARTECA resulted in Australian investment in clothing production in Fiji although the bulk of clothing from Fiji is now exported to the United States. But as Australian clothing tariffs drop, Fiji will become exposed to greater competition. Without SPARTECA greater competitiveness would have been encouraged from the start. A Japanese electric harness factory for motor vehicles in Samoa is the only other SPARTECA engendered firm in the Pacific.

UNCTAD has a high investment in the GSP because it is the only one of its many proposals that has been adopted. UNCTAD has never shown any interest in its effectiveness, but it has proposed that the GSP should be extended by removing tariffs altogether on industrial country imports from ‘least developed’ countries. The WTO Ministerial Conference in Doha in November 2001 declared that duty and quota-free market access was to be pursued for products from less developed countries. Only 0.2 per cent of all Australian imports come from ‘least developed countries’ although tariffs are only an issue for TCFL and motor vehicle products and only for other than SPARTECA countries. The Productivity Commission predictably found that the proposal has little merit (Productivity Commission, 2002b). The less developed countries that already export clothing to Australia - Bangladesh, Burma, Cambodia and Nepal – could have some, albeit, low benefits from a zero tariff. But exports from Fiji would be likely to fall if Bangladesh became eligible for a zero tariff, illustrating the way preference systems distort investment and result in trade diversion.²

² The Productivity Commission unfortunately failed to note the literature that suggests that preferences to developing countries are counterproductive and to show why least developed countries, in spite of very low wage costs, are failing to take advantage of Australia’s low and zero tariffs.

4 Australian Aid to Developing Countries

Taxpayers in the West transfer more than \$US50 billion annually through multilateral and bilateral agencies and by contributing substantially to NGOs that operate in developing countries. Australia is necessarily a small aid contributor, with 3 per cent of total global aid flows. Compassion drives the transfer of taxpayers' funds to developing countries, but aid also takes into account Australia's commercial and strategic concerns (Jackson Committee, 1984)³.

The last 20 years have seen a change in the relative efficiency and effectiveness of multilateral and bilateral aid. The Australian aid agency - formerly AIDAB, now AusAID - has developed from a rump of the Department of Territories to a team of professionals, standing at arms length from, but within, the Department of External Affairs. Close parliamentary oversight has brought growth and equity objectives to the fore. A cycle of design, implementation, monitoring and evaluation guides projects and programs so that AusAID has become one of the most efficient of the bilateral aid agencies. In contrast, multilateral aid agencies, notably the IMF and the World Bank, with neither shareholder nor democratic parliamentary oversight, are dominated by their own institutional interests, so that they fulfil Bauer's expectations that aid undermines, rather than promotes, development.

More than half of Australian aid goes to country programs, with global (multilateral) programs next. Humanitarian relief is a small but essential component despite the extreme difficulties of delivering such aid (Hughes, 2003).

TABLE 4
AUSTRALIAN AID FLOWS: 1998-99 TO 2000-01

	1998-1999		1999-2000		2000-2001	
	\$million	Percent	\$million	Percent	\$million	Percent
Country programs	858	56	902	51	907	55
Global programs	485	32	256	14	561	34
Humanitarian relief	(109)	(7)	(89)	(5.1)	(88)	(5.4)
Multilateral banks	(231)	(15)	(12.)	(0.6)	(314)	(19.3)
UN and international	(105)	(7)	(110)	(6.3)	(111)	(6.8)
NGOs and community	142	9	156	9	171	10
NGOs	(102)	(7)	(110)	(6.3)	(122)	(7.5)
Other	43	3	435	26	16	1
Total	1529	100	1749	100	1623	100

Source: Commonwealth of Australia, (2002).

4.1 Aid Flows to International Financial Organisations

³ The Simons Committee (1997) in contrast, suggested that Australian aid should be solely guided by poverty alleviation, without, however, indicating how such an objective could be achieved in practice.

It was initially argued that Australia could participate in aid to large countries and to distant regions through international financial organizations. The colonial connotations of conditionality could be avoided, it was thought, if international financial organizations provided an umbrella for policy dialogues with developing countries.

Bauer foresaw that many factors that would make conditionality unworkable. Experienced professionals working within mainstream economics could disagree on the appropriateness of policies for a given country at a given time. External advice, without in-depth consideration of a country's own institutional framework and political support for change, was doomed to failure.

Undaunted, the World Bank and the IMF claimed responsibilities for conditionality, with the Bank concentrating on microeconomics and the long term and the IMF on macroeconomics and the short-term. They undertook country monitoring and research to inform conditionality. The Asian Development Bank and the other regional banks accepted IMF-World Bank leadership.

Some conditionality advice has been sound, but much has been subject to continuing debate within and among donor agencies, and some has been misleading or simply wrong. More importantly, the IMF and the World Bank did not insist that their conditionality be implemented, continuing to transfer funds to meet their own internal organizational objectives even when their advice was ignored. The exceptional aid recipients in East Asia imposed their own strong pro-growth policies, ceased to need aid and stopped being IMF and World Bank customers.

Project conditionality initially had some meaning for 'hard hat' capital and foreign exchange intensive projects which could be closely monitored. For program lending, which fungibility made into budget support, conditionality was meaningless. Short term IMF credits to balance budgets and balances of payments could be tied to specific performance conditions, but as the IMF extended its lending, its conditionality became as loose as the World Bank's. When helping 'the poor' directly by 'soft' projects and programs in rural development, education, health and governance became the fashion, monitoring became difficult even in those countries that had previously sought to control aid spending. Fungibility came into its own, countries used the aid for whatever they fancied, and provincial and local as well as central governments, were able to steal from 'grass roots' projects designed to help the poor.

Australia has averaged \$200 million a year for the past 5 years for development bank contributions. The development banks earn \$US3.3 billion annually by investing grant donations in money markets before disbursing them (Meltzer *Report*, 2000, p. 73) adding them to the interest payments they earn on loans, so that they, and the IMF, have large annual incomes which make them independent of their shareholders' views. IMF and development bank Governors' annual meetings are ceremonial and Boards of Directors week to week defer to managements. Networks of contractors, including academics and project and program implementing firms, provide support for the international financial organizations. The World Bank alone currently has over 46,000 commercial contracts (World Bank website <http://tenders.dmarket.com/>).

The international financial organizations (and some bilateral donors) predominantly use loans to transfer capital to developing countries. These loans are used to establish credit with international commercial lenders. Foreign capital accelerates development if it is used productively, but if the economic environment is not competitive, borrowing,

whether public or private leads to unsustainable debt. The expectation that loans rather than grants would impose accountability was not, fortunately shared by the Australian Treasury, so that loans have played a negligible role in Australian aid.⁴ The accountability of loans proved to be an illusion. Countries that wasted grant aid, wasted loans just as egregiously.

The Paris Club was formed under the Chairmanship of the Bank of France to enable the industrial country donors to ‘forgive’ the debt of low income, mainly African countries. The IMF and the World Bank could not continue their country operations by their Articles of Agreement once borrowers ceased to service their debt. IMF and World Bank staff therefore devised the Highly Indebted Poor Countries (HIPC) scheme in 1996 to pay the delinquent countries’ debt service out of the interest paid by prudent developing country borrowers, with additional contributions from donors such as Australia. The HIPC scheme is extremely labour intensive for IMF and World Bank Staff, with detailed and prolonged conditionality arrangements for the 41 qualifying countries. By July 2002 debt negotiations had only been concluded for 26 countries (World Bank 2002c) and even for these countries, the outcome of intensified conditionality has been negligible. Uganda, one of the HIPC countries regarded as a model of compliance with conditionality, is fighting over diamond spoils in the Congo while rebel child soldiers rampage on its borders. *The Economist* concluded a skeptical account of this donor’s darling by quoting the Ugandan comment: “At what point do we stop thanking the guy (Yoweri Museveni) for not killing us?” (1.3.2002). Wars and civil insurrections continue to rage, elites continue to exploit their citizens, but the IMF and the World Bank are able to continue to operate in HIPC countries.

The results of 20 years of debt forgiveness were predictable (Harper, Hughes and Gregg 1999). Forgiveness has been used for new and higher borrowing. By 2,000, the HIPCs were more highly indebted than in the 1970s. During 1996 –2000 the HIPCs received 70 per cent of aid flows to low income developing countries although they only accounted for 30 per cent of their population (Easterly, 1999). Although Australia has no aid related debt,⁵ it has been bullied by the NGO Jubilee 2000 campaign (World Debt, 1999) and the IMF and the World Bank into contributing more than \$50 million to the IMF-World Bank HIPC cause during the past three years.

Australia’s participation, by its membership, in the IMF’s operations in middle income countries is also questionable. The IMF has helped to fill Bauer’s expectation that aid would lead to escalating budget and balance of payments deficits. Conditionality became farcical. Countries followed imprudent policies that favored monopolistic crony capitalists, inflation that magnified poverty and currency overvaluation. International investors were encouraged to ignore project and sovereign risk. Domestic investors saved abroad, borrowing in foreign currencies, often with government guarantees. When egregious mismanagement ultimately led to devaluation and crises, the IMF, supported by development banks and bilateral governments, came

⁴ The Simons Committee recommended that Australia move from grants to loans. This suggestion received a very poor hearing in the seminars held on its Report (1997) and from practitioners familiar with the low income countries’ debt situation. It was not adopted as Government policy.

⁵ A \$A4 billion commercial debt, largely relating to export financing and support for IMF ‘rescue’ packages is owed Australia by developing countries.

to ‘rescue’ government and private borrowers and commercial international lenders. Private debt was transformed into public debt that has to be paid by, mostly low income, taxpayers. The IMF and the World Bank failed to read the warning signs before the 1997 financial collapse in East Asia in spite of large resident staffs and frequent ‘missions’. They misdiagnosed the problems and with their “rescue” made it possible for South Korea, Thailand and Indonesia to avoid taking the measures necessary to return to growth paths, so that five years later their economies are still struggling with deep economic flaws (McLeod, 2002). The IMF, despite its denials (Rogoff, 2002) has clearly created a major moral hazard in international capital markets.

The IMF is proposing to extend its reach of operations by creating a scheme by which countries could be preselected for bankruptcy. Several are queuing up to be the first to be declared bankrupt.

‘Contagion’ is used to justify the IMF’s rescues. When a debt crisis threatens, careless lenders fear that this time they will perhaps have to pay for their greed. They run for cover and threaten world wide capital market collapse. Media are mobilized to put pressure on industrial country governments to support the IMF so that taxpayers once again come to the rescue, mainly in developing countries, but to the extent that rescue packages carry lower than market interest rates, also in donor countries.

Concerned, if not alarmed, by the international financial organisations’ increasing detachment from their supposed objectives, the United States Congress in 2001 appointed an Advisory Commission, chaired by Allan Meltzer, to consider their future. The *Meltzer Report* (2002) is a devastating critique of the IMF and the World Bank. It judged that “neither the World Bank nor the regional banks are pursuing the set of activities that could best help the world move rapidly toward (a world without poverty) or even the lesser, but more fully achievable, goal of raising living standards and the quality of life, particularly for people in the poorest nations in the world”. The Meltzer Commission recommended a radical downsizing of the World Bank and the other regional development banks and a shift of focus to the lowest income countries (*Meltzer Report*, 2000, p. 55). It was equally critical of the IMF. It recognized the IMF’s creation of moral hazard in world capital markets and recommended a radical downsizing that would make the IMF a “quasi lender of last resort” and “stand by lender to prevent panics and crises... To the extent that IMF lending is limited to short term liquidity loans, backed by pre conditions that support financial soundness, there would be no need for detailed conditionality (often including dozens of conditions that has burdened IMF programs in recent years and made such programs unwieldy, highly conflictive, time consuming to negotiate, and often ineffectual” (*Meltzer Report*, p.7).

The IMF and the World Bank used their formidable resources to prevent the US Congress and other parliaments in industrial countries, including Australia, from following up the Meltzer Report. For once the IMF and the World Bank achieved their objectives.

4.2 *The Australian Country Aid Program*

Australia is fortunate in being able to focus much of its aid on East Asia for this is the region where growth was most rapid and poverty alleviation hence most effective, and

where commercial and strategic considerations have high returns. In rapidly growing countries, as AIDAB-AusAID professionalism increased, aid became efficient and effective. Australian aid to individual countries, even to Indonesia, are a negligible proportion of total aid flows, so that Australia has to accept national policies as given, but until the early 1990s, the economic environment was conducive to growth so that Australian aid could have positive returns.

TABLE 5
*COUNTRY PROGRAMS EXPENDITURES BY REGIONS
AND SELECTED COUNTRIES 1998-99 TO 2000-01*

	1998-1999	1999-2000	2000-2001
	\$ million	\$million	\$million
Pacific	436	403	439
Papua New Guinea	(315)	(280)	(312)
Pacific	(121)	(123)	(127)
East Asia	323	396	364
Indonesia	(81)	(91)	(93)
East Timor	(4)	(59)	(30)
Philippines	(53)	(53)	(55)
Vietnam	(58)	(59)	(59)
China	(38)	(39)	(39)
South Asia	53	54	54
Bangladesh	(21)	22	21
India	14	13	15
Africa	35	35	36
Other	48	51	52
Total	858	902	907

Source: Commonwealth of Australia, (2002).

In contrast, aid has enabled the Philippines to pursue counterproductive economic policies that would have completely destabilised the economy but for workers' remittances from abroad. China has achieved rapid growth, albeit not with equity, but Australia's contribution to China is very small; we can not be blamed for the Chinese Government's imperviousness to conditionality. Giving aid is much more dubious to Vietnam where growth is more limited and largely accrues to urban (Communist) elites, with no sign of the micro- or macroeconomic reforms the country desperately needs. The situation is even more difficult in Laos, Cambodia and Burma where domestic policies severely repress local populations and hinder growth and development. Every dollar of aid enables governments to avoid change. In East Timor aid and mineral rents signal difficulties. Australia has tried to do its best in these circumstances by picking projects with direct returns to poor people so that some resources – whether from budgets or from Australian aid – are devoted to improving living standards.

South Asia, being more distant, receives a smaller proportion of Australian aid. More far sighted strategic thinking with regard to the balance of power in Asia may consider it a matter of some concern that democratic India receives less aid than China or Bangladesh.

Australia's aid experience in Africa has underlined how difficult it is to give aid effectively. Australian commercial interests claimed that Australia had expertise in dry land agriculture in Africa and the Middle East, but bitter experience proved that it was not transferable to developing countries.

4.3. Aid to the Pacific

The Pacific is Australia's close neighbourhood and area of strategic concern. It is regarded internationally as our sphere of responsibility. The large volume of Australian aid makes it the testing ground for Australia's aid efficiency and effectiveness. Unfortunately, it is also a testing ground of Bauer's thesis. In the Pacific aid has not only failed to foster development. It has contributed to the region's slide into chaos.

TABLE 6
PACIFIC ECONOMIC INDICATORS

	Land Area Km ²	Population '000s 2000	Density People/Km ² 2000	Annual population Growth % 1970-2000	Annual real GNP Per Capita Growth % 1970-2000	GNP Per Capita ⁽⁸⁾ US\$ purchasing power Parity 2000
Papua New Guinea	463,000	5,200	11	3.7	0.6 ⁽⁴⁾	2,180
Fiji	18,272	812	44	1.9	1.6 ⁽⁵⁾	4,480
Solomon Islands	28,530	447	16	3.9	-0.6 ⁽⁶⁾	1,710
French Polynesia	3,265	235	72	3.7	(NA)	23,340
New Caledonia	19,103	213	11	3.2	(NA)	21,820
Vanuatu	11,880	197	17	4.6	-0.3 ⁽⁷⁾	2,960
Samoa	2,935	170	58	0.6	0.8 ⁽⁷⁾	5,050
Micronesia Fed. States	702	118	6	3.3 ⁽¹⁾	(NA)	2,000
Tonga	699	100	143	0.5	2.6	1,660
Kiribati	690	91	132	2.8	-1.2	950
North Marianas	477	70	68	(NA)	(NA)	12,857
Marshall Islands	181	50	36	2.9 ⁽²⁾	(NA)	1,600
Cook Islands	240	21	88	0.0 ⁽²⁾	(NA)	5,000
Palau	458	20	23	(NA)	(NA)	9,000
Wallis & Futuna	274	20	14	(NA)	(NA)	2,000
Nauru	21	12	571	(NA)	(NA)	5,000
Tuvalu	26	11	423	1.6 ⁽³⁾	-1.4 ⁽⁶⁾	1,100
Niue	259	2	8	(NA)	(NA)	3,800
Tokelau	10	1	100	(NA)	(NA)	1,500
Pacific average				3.4	0.6	

Notes: (NA) data not available or vary by more than 25 per cent among sources

⁽¹⁾ 1980-2000; ⁽²⁾ 1981-2000; ⁽³⁾ 1983-2000; ⁽⁴⁾ 1973-2000; ⁽⁵⁾ 1968-2000; ⁽⁶⁾ 1967-2000; ⁽⁷⁾ 1979-2000

⁽⁸⁾ Purchasing power parity for the Pacific is not derived directly but from econometric estimates based on 'like' countries; it is only applicable to urban, not to subsistence rural areas. The high purchasing parity per capita incomes for French Polynesia and New Caledonia reflect the high salaries of the French 'metros' employed in the public service.

Source: Compiled from World Bank data, except for Cook Islands, Wallis and Futuna, Nauru and Tokelau which are based on the *CIA Factbook* which has the best data set for the small islands.

Although the share of aid going to Papua New Guinea and the Pacific Islands has been declining, it is still nearly half of Australia's country aid and Australia is the leading donor in the Pacific's large aid flows. But the economies are failing (Table 6). *The Economist* (22.2.03) asked whether the Solomons was the Pacific's "first failed state". Throughout the Pacific, and in Papua New Guinea particularly, aid and mineral rents have led to economic stagnation, waste and corruption by elites and crime by the 'raskols' who have been denied jobs and a decent way of life. Warlordism in the Papua New Southern Highlands and the Solomons is a signal of dangerous decline. A culture of armed violence is spreading throughout the Pacific.

The Pacific is rich in agricultural land, timber, fish, minerals and tourist attractions. Traditional agriculture sustained high levels of nutrition and leisure. Initial successes of cash crops indicate that the Pacific is no less endowed with entrepreneurs than other regions. But communal land ownership - that has not permitted economic development anywhere in the world - has strangled agricultural development. Women work hard to maintain subsistence and cash crops but male underemployment is vast. Aid has enabled the Pacific to maintain welfare and statist policies that strangle local urban private sector development, allowing expatriates to exploit state created monopolistic rents. Labour market rigidities and protectionism result in 40 per cent unemployment in urban areas. Population growth hence exceeds economic growth. Public infrastructural development - notably in transport, health and education, has stalled and even gone into decline. Destitution is avoided by clan support which, however, undermines saving and business development. Remittances from emigrants have rescued the Cook Islands, Samoa and Tonga.

The macroeconomic effects of aid flows have followed Bauer's hypotheses like textbook expositions (Chand 2002). Government expenditures have anticipate revenues with escalating deficits supported by bilateral aid and loans from the World Bank and the Asian Development Bank that provided a base for commercial borrowing and external debt. The loans have not been invested productively, so that debt repayment has become a problem. Politicians and bureaucrats, including the police and military, and their associates in firms contracting for public works, form the core of the urban elites that dominate Pacific societies. They have absorbed the bulk of budget expenditures.

The IMF, the World Bank and the Asian Development Bank have made no effort to analyse the cause of the Pacific economies' difficulties or to impose conditionality. Loan disbursement has been suspended or slowed from time to time, but subject to mild injunctions, lending continues, and exacerbates, dismal economic performance. Politically constrained not to be seen as a colonial 'big brother', AusAID has been unable to give economic advice let alone impose conditionality on its grants. AusAID tried to follow the Jackson Committee's recommendation to move from budget to project aid for Papua New Guinea, but the distinction is meaningless. For example, by paying for 85 per cent of road maintenance in Papua New Guinea, Australian aid in effect remains budget aid. Pacific governments, moreover, add Australian grants (and other grants and concessional loans) into their budgets as revenue! Australian aid funds

are thus openly spent on the recurrent expenditures of Pacific governments without the controls to which all other Australian taxpayers' expenditures are subject.

5 Conclusion

As an open country, Australia is fortunate in being a neighbour to the Asian region that opted for trade openness and growth. Absolute poverty has declined markedly. Yesterday's developing countries have become trading partners. But aid played little if any role here.

Australian aid to Asian developing countries has been so small that it can only be evaluated in terms of specific projects and programs. AusAID, closely monitored by Parliament, has become a leading bilateral aid agency, ensuring the efficiency and effectiveness of bilateral aid projects and programs. But worldwide aid has failed to foster growth and development. Indeed, as Bauer predicted, aid has harmed development and has been inversely related to it. The World Bank's and the IMF's organisational self interests have worked, again as Bauer predicted, against the findings of economic research and analysis, to foster developing countries' indebtedness in the name of aid. Australia should work with the United States to bring the IMF, the World Bank and the Asian Development Bank under control by reducing their size and hence the damage they do to developing countries. To increase the effectiveness of Australian aid, Australia should move from multilateral to bilateral aid channels.

Aid flows to the Pacific underline the counterintuitive economic finding that aid damages recipients. After 30 years of substantial aid flows (\$US49 billion or nearly \$A100 billion in 1998 dollars), the Pacific, because it adopted counterproductive economic policies, has not only failed to improve living standards but is descending into chaos. Australia's national security interests are threatened as drug and arms traffic increases and the dangers of terrorist infiltration through and in the Pacific mounts. By 2025 when Papua New Guinea's population alone is expected to be 10 million, deep poverty, the danger of a rogue state and floods of refugees across the Torres Strait could become a reality.

The barriers to growth and development can only be overcome by the Pacific societies themselves, but Australia has dual responsibilities not to make reform in the Pacific harder than it need be and to ensure that Australian taxpayers' funds are spent prudently. Economic theory indicates that the best, and perhaps the only way, to help Pacific economies to reform is to suspend aid flows. United States' curtailment of aid to Taiwan and South Korea enabled their reformers to set them on the path to becoming East Asia's 'Tigers'. Such a policy may be deemed too harsh. Even partial solutions that continue aid will require fundamental changes in the way that Australian aid operates. They will also require an understanding of the economic theory that explains why so much of aid is counterproductive, just as the theory of comparative advantage had to replace a protectionist outlook before Australia could adopt trade reforms.

The principle of mutual obligation (that governs domestic welfare) is needed to master conditionality if aid is to reflect the sovereignty of recipients as well as responsibility to Australian tax payers and stop retarding growth and development. All aid projects and programs need to take the form of mutually agreed sequenced payments, subject to monitoring by Australian and the recipient country teams, with

disbursement subject to audited accounts. Such conditionality would require a mandate to AusAID to become involved in strategic economic development issues as well as in project and program management. It would also require greater co-ordination with the Department of External Affairs, the Department of Defence and the Treasury.

Pacific islanders should also increasingly access the Australian labour market, as the Jackson Committee recommended in 1984. Remittances contribute more effectively to growth than aid. Australia should not, however, drop character, skill and English language migration qualifications that other migrants have to meet. It is essential to our relations with the Pacific that we should not create an under-class of unskilled, welfare dependent Pacific migrants. European experience with such migration has been, and is, disastrous. Education, training and keeping out of police records in the Pacific would be encouraged if opportunities in the Australian labour market became evident. Not only would remittances follow, but some migrants would return to the Pacific to start businesses.

Low returns on Australian aid can be shrugged off. We can afford one and a half billion dollars a year to maintain political goodwill with developing countries. But aid damages developing countries, notably in the Pacific. The time for a debate on aid is long overdue.

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