Removing barriers to investment and development

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One of the main aims of the Structural Adjustment Programs in Papua New Guinea has been the removal of barriers to investment and economic development, but while some progress has been made, much remains to be done. Regrettably, hardly any of the financing provided under the Structural Adjustment Program (SAP) has been used to remedy stark deficiencies in the country's physical infrastructure, such as transport, power and communications. The SAP's restrictions on public expenditure have led to declining levels and quality of public services. The SAP also failed to address the wholly backward land tenure arrangements that make it difficult if not impossible for investors to access land in most of the country outside the towns and old plantation areas. Moreover the SAP's many conditions left untouched the country's antiquated exchange control regime, inconsistently with the SAP's removal of tariff protection. At the same time the SAP's requirement for maintenance of tight monetary policy and high interest rates in a fruitless effort to stabilise the kina exchange rate has contributed to very high excess liquidity in the banking system.

The Structural Adjustment Program of 1999–2001, and in particular the World Bank's component, the Governance Promotion Adjustment Loan, sought to address the Government of Papua New Guinea's policy reform program in the following areas

- improvements to governance through enhanced fiscal transparency, improved budgetary and debt management and strengthening of 'oversight agencies' with respect to corruption
- public sector/service reform
- improved funding and delivery of health and education
- improved forestry management
- improved financial services, including banking, pension fund management and privatisation of PNGBC
- enhancement of the operating environment of business.

Only the last of these referred to the subject of this paper, removal of barriers to investment and economic development. The World Bank's loan agreement made no mention of specific measures other than—and illogically—the privatisation program (which of course reduces the public and expands the private sector without itself necessarily improving the investment climate). For, although necessary, privatisations like that of PNGBC will have no direct impact on the business climate, given that Papua New Guinea already had the adequate private sector banking services of Westpac, ANZ and Bank South Pacific (BSP) (which has now absorbed PNGBC).

What then are the main barriers to investment and economic development that were not addressed by the SAP?

My own perception is the hardly original one that the key problem areas are land, labour and capital—and that, of these, land is broadly unobtainable, skilled labour is of limited availability and not that cheap, and capital at least in the form of domestic loan finance is available but very far from being cheap, with the ANZ's Indicator Lending Rate still as high as 15 per cent and the commercial banks' weighted average lending rate still at 14 per cent in 2002 after being over 20 per cent for much of the period since 1997.

Other commentators have placed more emphasis on some other factors. For example, the Duncan and Lawson study on cost structures in Papua New Guinea concluded that 'law and order problems and the resulting security concerns are having the most adverse impact on the business environment and need the most urgent attention' (1997:1). This theme was elaborated by Chand and Levantis, who called for a 'big push' in terms of allocating resources to the agencies responsible for managing the crime problem—the police, prisons and courts (Chand 1998:42).

My own feeling is that law and order problems are as much an effect as a cause of Papua New Guinea's poor economic growth record, but that

Chand and Levantis are certainly right to call for more resources to be devoted to dealing with crime itself. It remains an extraordinary fact that the Royal Papuan Constabulary deploys no more policemen and women now than it did before independence in 1975 and that in real terms spending on the police is a fraction of what it was then. Amazingly, the Australian Capital Territory (ACT), which by Papua New Guinea standards scarcely has a crime problem, spends more on policing its 300,000 residents than Papua New Guinea does on its 5 million inhabitants!

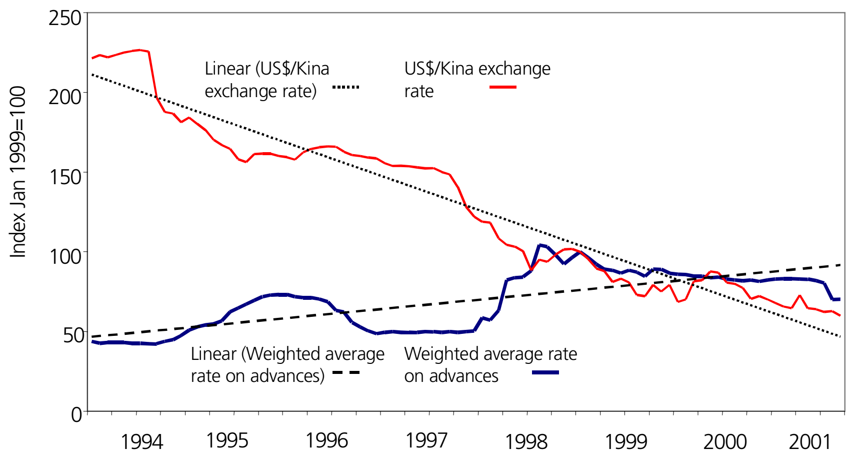
Capital should never be a constraint, and it is indeed super abundant within the PNG banking system, which has always been under-lent by reference to normal banking reserve requirements. Even with the Bank of Papua New Guinea's (BPNG's) exceptionally high Minimum Liquid Assets Ratio (MLAR) of 25 per cent, the banks have always had large excess liquidity—that is, they lend much less than they could—with a free reserves margin this year of over 20 per cent at the beginning of April. This means that the banks could have lent at least K5.6 billion instead of the actual K3 billion.[1]

So, with K2.6 billion not being lent even at the 25 per cent MLAR, and K11 billion available but not being lent if the MLAR were a more normal 10 per cent, clearly domestic capital is not a constraint in Papua New Guinea despite the best efforts of BPNG and the government (Curtin 2002a).

However, domestic loan financing is not cheap at over 14 per cent per annum. This is because Papua New Guinea's interest rates have always been and remain too high, due in part to excessive concern over the exchange rate. As shown in Figure 1, continually rising interest rates have not stemmed the depreciation of the kina although, whenever interest rates have been allowed to fall, the kina's decline certainly accelerates. Even so, keeping interest rates high while the kina still keeps falling prompts the suggestion that perhaps the economy could have done better with lower interest rates without necessarily suffering any faster decline in the exchange rate. For one needs to remember that cost of finance is a critical factor in the investment decision—and that, whilst foreign borrowing would nominally be cheaper than borrowing in kina, the horrendous exchange risk increases the real cost of such borrowing well above even the kina cost for all except wholly export based projects like gold, oil and palm oil.

The effect of the declining exchange rate on effective interest rates has seldom been spelt out. For the record, the current rate paid by a PNG borrower on a loan of US$100 million in 1992 at 8 per cent is now 32 per cent. The loans provided by the World Bank and the other SAP lenders in 2000 at 7 per cent

Figure 1 **Interest rates and the exchange rate**



on average are already in 2002 costing the PNG government an effective interest rate of 10 per cent on the original kina value of the SAP loans. Thus PNG policymakers should perhaps reduce their efforts to attract even more general purpose financing from foreign lenders and encourage foreign investors to access the domestic capital market, and in addition encourage national investors by reducing their costs of borrowing, since borrowing from PNG banks does not of course incur the foreign exchange risk posed by a falling kina. Both foreign and national investors could well reap handsome foreign exchange gains if they invest in export opportunities. East Sepik's Allan Bird, 'Mr Vanilla', is a great example of just what can be done.

It is worth recalling the great classical economists' perception that money is a veil, obscuring the unchanging values in the real economy. The continuing fall in the kina certainly creates costs for some (mostly those fixated like the government on foreign loans) and benefits for others (exporters), but sooner or later the prices of steaks, beer and petrol in Papua New Guinea catch up with what they were before in, say, Australian dollar terms. In general, internal prices in Port Moresby expressed in Australian dollars differ no more from Australian prices than they did when the kina and the Australian dollar were at par in 1975 and again in 1995. For example, petrol in Port Moresby at around K1.80 per litre currently costs about the same when expressed in Australian dollar as a litre of petrol in Canberra.

Moreover, it is arguable that all PNG governments have been too concerned to please those leaders seeking only to invest in real estate in Cairns by striving to keep the kina up, whereas a policy of cheap money at home whatever the decline of the kina would have done much more for the cause of investment and economic development in Papua New Guinea. Not only that, ceasing to worry about the kina's exchange rate as a policy target would enable the dismantling of the BPNG's relatively limited but still irksome exchange controls, which have a significant nuisance value for new investors but have not succeeded in discouraging the notable capital flight that has occurred since 1994.

Finally, all too many commentators follow the IMF line on the importance of limiting the fiscal deficit to not more than 2 per cent of GDP without grasping that of course that deficit ratio is consistent with any level of public spending and revenue. The IMF's view however is that not only should the deficit be constrained—and probably we all agree on that—but also that the absolute level of recurrent public expenditure should be subject to a ceiling and that, even if additional financing were to be raised by the government, this should be offset by reductions in its domestic financing (see Curtin 2000a). Yet it would be feasible to retain the IMF's 2 per cent level of deficit–GDP ratio even if public expenditure were say 50 per cent higher than the 2002 Budget level of K3.5 billion (now worth only A$1.58 billion).

This public spending ceiling results in a much less than feasible level of public spending. The IMF's ceiling derives from the quaint notion that there is some definite fixed limit on Papua New Guinea's absorptive capacity, irrespective of the availability of cheap offshore financing sufficient right now to double the Public Investment Program (PIP). For example, I have just done some work for the East Sepik provincial government, namely a feasibility study of a new power station for Wewak to enable the Starkist tuna factory project to proceed. ESPG has successfully procured a US$7.7 million loan from Korea's Exim Bank at just 2.5 per cent per annum and a grace period of ten years (enough time for the present government to be back in power!). Any number of similar projects exist that could attract export credit financing on the same soft terms without in any way causing strain in terms of absorptive capacity. The ten year grace period removes one source of strain on the budget, and the fact that the power project enables an export processing project to proceed means that in any case foreign exchange and tax will accrue sufficient to cover interest charges. The government's preference for the program loans of the SAP, which provide general support for the balance of payments and the budget without being tied to specific projects, has led it to neglect the very large sums available from the even more concessional terms available for project financing from OECD export credit agencies like Korea's Economic Development Cooperation Fund.

Ross Garnaut (see, for example, 2000) is perhaps the godfather of this preoccupation with the deficit rather than with the abysmally low level of public services in Papua New Guinea. Most other commentators on the PNG economy have equally failed to accept that the real cost of investment is increased when there is a dearth of the quality public services needed for any successful private sector business operation. In particular, while the World Bank and some others do express plenty of concern over deficiencies of all public services in general, and of higher and technical education, law and order, and infrastructure in particular, nearly all seem perversely united in agreeing that in aggregate the present level of public spending on these services is too high and should be reduced. Given that they already take up exceptionally high proportions of total spending, the scope for redistribution within the total is severely limited (although there would be room for large cuts in the Prime Minister's own department). Yet, as I showed in Curtin (2000b), Papua New Guinea's ratio of aggregate public expenditure to GDP is well below the norm in OECD countries and, given its low GDP, the outcome is a derisory level of public services.

To provide some further perspective on the real level of public services in Papua New Guinea, a glance at the ACT's latest budget is once again instructive. Whereas, after years of neglect by Australia's AusAID and outright attacks by the World Bank, Papua New Guinea's total spending on tertiary education in 2002 is less than K100 million (A$45 million), the ACT spends A$70 million on just the Canberra Institute of Technology. All studies of human capital formation have shown the extraordinary tax benefit governments derived from increasing the number of graduates in the labour force. I myself have shown the marginal tax rate in Britain on graduates' higher incomes *vis-à-vis* non-graduates' is over 50 per cent (Curtin 2000b). Thus, if spending on tertiary education in Papua New Guinea were increased by say K100 million per annum, producing an extra 1,000 graduates per annum above the present 1,000 or so, the tax yield on their incremental incomes would be of the order of K50 million per annum for their working lives (average tax of K50,000 per annum on average graduates' extra incomes *vis-à-vis* non-graduates'). And if those working lives are only 20 years, the total profit to the budget would be K1 billion per cohort of graduates, a gross undiscounted return of 250 per cent.

This example reflects my view that, apart from the land issue, the greatest barrier to a higher level of investment and economic development in Papua New Guinea is the shortage of human capital, that is, skilled manpower. However, I have to admit to being a voice in the wilderness. All economists think they understand the calculus, but when it comes to human capital they all think that the highest returns accrue to primary schooling, with its higher initial rate of return. But that implies that one travels fastest in cars equipped only with first gear rather than in those with 3rd and 4th gears (because first gear is where the rate of acceleration (that is, rate of return) is highest, see Curtin and Nelson 1999). The World Bank's education economists spent 30 years advocating cuts in tertiary education because of their inability to understand that the 'best' rate of return is that equal to the opportunity cost of capital, and that the rate of return on primary education is the infra-marginal rate.[2] In Papua New Guinea, the World Bank's 1996–97 SAP succeeded in securing cuts in budgetary allocations to the University of Papua New Guinea and Unitech of up to 50 per cent—hence the complete absence of journals and new books, to give one example many will know from their own experience.

Using the World Bank as representative of the standard international agency view that public spending and the public sector are both too large (see World Bank 1999), that view fails to accept the cost of public sector failure to private sector investors. Duncan and Lawson (1997) emphasised the costs to investors of inadequate policing to investors, but Chand's paper in this collection concentrates on what he calls 'deficit bias', implying excessive commitment of government to expanding Papua New Guinea's actually pathetically deficient public services.

Almost all Papua New Guineans claim to be landowners, and indeed they are, but only *collectively*, since they may not as *individuals* freely buy, sell or otherwise dispose of their land. There is a clear difference, all too often overlooked by some anthropologists, between say buying, owning, and, when one chooses, selling a car, without reference to third parties, and 'owning' land that one has not bought and may not sell. There is no doubt that landowners in Papua New Guinea may have some rights of ownership, extending to entitlements to build homes and to the output from identified trees and gardens, but those rights generally do not extend to disposal of existing, or purchase of new, trees and gardens. Moreover, merely registering customary land holdings does not of itself create individual tenure, by which in this chapter is meant the right to buy and sell land like any other commodity.

> [individual land ownership] confers a number of definite rights: principally the right to use the land, the right to exclude others from its use and enjoyment; the right to transfer it by sale, lease, or gift; and, perhaps most notably the right to receive income from the property independent of use. This particular combination of rights—use, exclusion, alienation, and income—does not occur in any Papua New Guinea society (Harding 1973:107).

Curtin (2002b) sets out the case for establishing individual land ownership in Papua New Guinea. After distinguishing the differences between that and Papua New Guinea's existing system of communal land ownership, it examines the claims that the latter has not held back economic development, and shows that the output of Papua New Guinea's exported cash crops, which are mainly produced by smallholders using communal land, has not kept pace with population growth, and that production of food has at best grown no more rapidly than the population. The paper cites experience in other countries like Egypt and Kenya that indicates land reform can be successful in raising productivity in the rural economy, and provides evidence indicating that tenure issues do much to explain the very low level of bank lending to agriculture in Papua New Guinea.

At less than K200 million in 2000 and 2001, credit for the rural sector provided by the commercial banking system is a small proportion—less than 10 per cent—of total bank advances in Papua New Guinea, and certainly out of line with the size of the rural sector (which comprises 80 per cent of the country's total population). Bank lending to the agricultural sector has declined from K350 million in 1994 to K165 million in 2001, despite the increase in total lending over that period from K1.16 billion to K1.75 billion. Thus, just as land is scarce in Papua New Guinea, despite its abundance, there is also an evident scarcity of money for agriculture, despite the banking system's large lending capacity.

Were collateral available in the form of land titling and a market in land, requiring alienation from unsuccessful borrowers to successful, the banks would no doubt lend more of their available, but unutilised, K10 billion for agriculture. The BPNG might well then be able to lower the liquidity ratio, since, unlike most of the banks' present lending, which is concentrated on importers, loans to the rural sector would relieve the country's balance of payment constraint by reducing food imports and raising exports.

The lack of collateral not only holds back Papua New Guinea's agricultural sector. Bank lending for housing is less than K100 million, around 7 per cent of total bank lending, compared with nearly 50 per cent in Australia. Introducing individual land tenure could quite quickly lead to modern home construction not only in the burgeoning squatter settlements in Papua New Guinea's towns but also in its many villages, led initially perhaps by retirees from the urban areas. That in turn would stimulate the construction industry, which at present accounts for only around 3 per cent of GDP, and which is both labour intensive and relatively reliant on local materials.

The German development agency, GTZ, has acted on de Soto's ideas (2000) by sponsoring large-scale registration of illegally built homes in the largest slum in the world's most crowded city, Cairo, as a first step towards upgrading both housing and infrastructure. The residents of Ezbet Bakhit will be able to buy the land they occupy, and thereby gain access to credit, as well as start paying local council taxes (Drummond 2001). Perhaps the National Capital District Commission (NCDC) could make a start by granting title to the residents of Two Mile and Erima. It would certainly help to transform their lives and make those settlements much less of a haven for rascal gangs.

Conclusion

The papers presented all gave excellent accounts of the Structural Adjustment Program. On the strength of those, you are now equipped to visit a certain country as a policy analyst. Guess which country is referred to.

It has the highest average tariff rate in the world. More than half the population cannot vote. Vote buying and electoral fraud are widespread. The country has never recruited a single public servant through an open process. Its public finances are in deficit, with loan defaults that worry investors. It has no competition law, and does not acknowledge foreigners' copyrights. In short it is doing everything contrary to the advice of the IMF, the World Bank and the WTO.

Which country?

The USA in 1880 —with acknowledgments to Ha-Joon Chang (*The Guardian Weekly*, 27 June 2002:14).

So for sure it is way too early to give up on Papua New Guinea, and maybe in 120 years time your grandchildren will be grateful for your trailblasing.

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Notes

1 These calculations assume no relationship between a bank's lending and its liquid assets, but these tend to increase together, so total potential bank lending in Papua New Guinea is even larger than the amounts indicated in the text.

2 Elementary economics teaches that profits are maximised when marginal revenues equate with marginal costs, NOT when the distance between the margins is largest, as contended by the World Bank's economists (and many others).