Microeconomic policy in Papua New Guinea: the factor markets

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'GETTING prices right' has become a cliché of development economists to the point where it tends to be dismissed by policymakers in developing countries. Yet while it is not the whole story, it is certainly an important step in facilitating economic development. In Papua New Guinea, there are many examples of distortions to economic incentives. As discussed in a recent monograph[1], perhaps none are so debilitating as the distortions that exist in its factor markets.

Background

The diversity in the country—languages, distances, topography, political structures—makes economic policy formulation and implementation very difficult. Yet Papua New Guinea is generally regarded as having carried out successful macroeconomic policies since independence. Inflation has been kept under control, the currency has been reasonably stable and convertible, and monetary policy has been effective in limiting credit expansion to targeted limits. Fiscal policy has not been quite as successful. The tax base is still narrow, government spending has tended to exceed internal government revenue, and budget deficits would have been much larger if direct budgetary support had not been received from Australia. (On the other hand, the support has encouraged deficit-creating expenditure, or made revenue measures unnecessary.)

While macroeconomic policies have, in general, achieved their stabilization objectives, economic growth in Papua New Guinea has been disappointing. Real per capita gross national product (GNP) has shown little growth despite the impact of large mining developments at Panguna on Bougainville and Ok Tedi. With the closing of the mine in Bougainville, because of land disputes and secessionist pressures, per capita income declined in 1989 and a further fall is expected in 1990.

The success of macroeconomic policy has helped to provide a suitable climate for economic growth, but is not sufficient of itself to ensure that such growth actually occurs. A country may have a stable price level and a freely convertible currency, but growth can be stifled if there are large distortions in factor and product markets. That is, reforms in microeconomic policies are also needed.

Factor market distortions

In Papua New Guinea there are substantial distortions in markets for land, labour and capital. By examining these markets in turn it can be seen that distortions necessarily result in inefficient use of the country's resources and therefore lower national economic welfare.

Land

The Papua New Guinea people have a special relationship with their land. This is especially so in agriculture, but access to mineral, oil and gas are often determined by attitudes to land use.

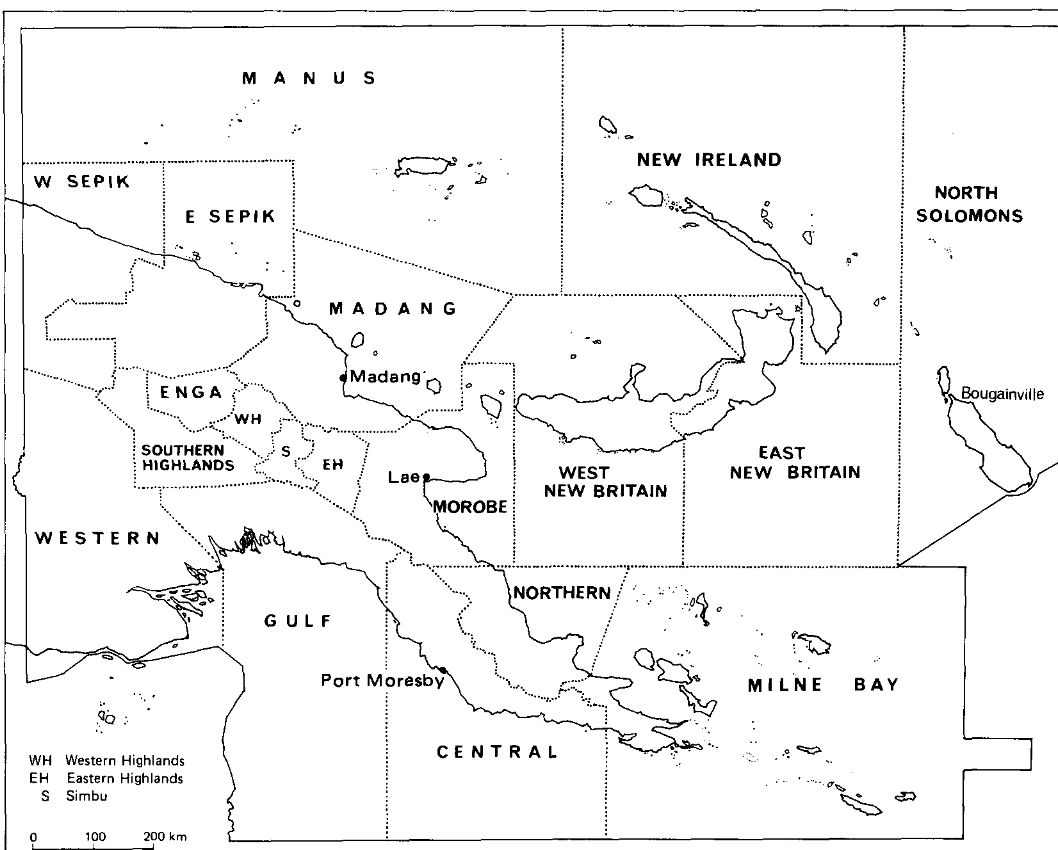
As 85 per cent of Papua New Guinea's population live in rural areas, the efficient use of land is critical for their economic well-being. The land market is very constrained and underdeveloped. Yet 97 per cent of the land is held in customary (clan) ownership. Two-thirds of this is unsuitable for major agricultural development because of topography or lack of drainage, while most of the remaining third is used at relatively low levels of intensity.

1 F.G. Jarrett and K. Anderson, *Growth, Structural Change and Economic Policy in Papua New Guinea: Implications for Agriculture*, Pacific Policy Paper 5, National Centre for Development Studies, Australian National University, Canberra, 1989.

Property rights to land are transferable only for the 3 per cent of alienated land (that is the land held by the government or assigned to private individuals after alienation by the government from customary ownership). Rights to the 97 per cent of the customary land involve more complex patterns of transfer. The rights to customary land use in Papua New Guinea are determined on the 'as graun' principle. This principle provides the person who first cleared and used the land with rights over that property. These use rights are shared with, and inherited by, the person's descendants. The rights to use are often contingent on continued residence. Prolonged absence may place land rights in danger of loss. Hence, some Papua New Guineans, fearing that loss, often return to their own plais from time to time.

There are some similarities in land transfer systems between Papua New Guinea and Africa. In both cases, fire is the original means used to clear land and the Maitre Du Feu (Master of Fire) was regarded as the original proprietor and rights to land use accrued to his descendants. If there were no descendants, then in Africa, the tribal system through the hereditary chief provided a vehicle to transfer title of land. Such a vehicle does not exist in Papua New Guinea where agreement on land transfer has to be achieved more by consensus than fiat. Generally, the proprietary interest rests with a land holding group, and individuals within that group have limited rights of use, although there is considerable variation in the precise nature of these arrangements. Prior to independence, the Australian Administration accepted the

Papua New Guinea



importance placed on land and introduced legislation—much of which is still in force—to reserve customary title to unalienated land. Inter alia, the legislation aimed to register communal rights to land once group ownership had been established and looked to convert tenure from customary ownership to individually registered titles.

Unfortunately, the legislation has not achieved many of its objectives. As a result, the government in 1990 is using funding from the World Bank and the Australian International Development Assistance Bureau (AIDAB) to introduce a Land Mobilization Program (LMP). The purposes of the project are to create an inventory of unleased alienated land, to support attempts at the registration of customary land, to decentralize certain administrative functions, and to strengthen the Department of Lands and Physical Planning (the central department responsible for land use and land transfer decisions).

The impediments to land use in Papua New Guinea will inhibit economic development. Some of these impediments result from bureaucratic delays in transfer. Others are based on attitudes towards land ownership. These attitudes are coming into increasing conflict in a society that is becoming more monetized, where intermarriage between different land owning groups is occurring (thereby blurring customary land transfer patterns), and where migration to other parts of Papua New Guinea weakens village attachments.

A secure land title is also essential for farmers who wish to use land as collateral for borrowing from financial institutions. To help provide such security, various instruments have been developed recently. One is the lease-and-lease-back arrangement, whereby clans lease their land to the government which then leases it back to the clan enabling it to be used as collateral. Another is the Clan Use Agreement which involves a non-permanent right to a portion of the clan's land. Nonetheless, lack of secure permanent title is still an impediment to borrowing for long-term development purposes.

Credit

The institutions for providing financial capital in Papua New Guinea are relatively few in number and the banks, both publicly and privately owned, exercise a dominant position. There are six commercial banks that accept deposits and make advances. One of these, the Papua New Guinea Banking Corporation, is government owned and accounts for almost half of all banking business. Three of the banks are largely subsidiaries of Australian banks with some local equity, while two are 51 per cent owned by a Papua New Guinean government agency but are affiliated with major European banks. The Agriculture Bank of Papua New Guinea provides a wide range of credit with its advances weighted towards agriculture. It does not accept deposits. The funds advanced are largely derived directly from the Central Government, or from international financial institutions such as the Asian Development Bank and the World Bank. Interest rates and repayment provisions on loans from these sources often involve a concessional element.

There are other comparatively small financial institutions such as hire-purchase and leasing companies, savings and loan associations, and merchant banks. A few non-mining private companies operating in Papua New Guinea are quoted on Australian stock exchanges and have access to capital markets in that country. The mining and petroleum companies, most of which are multinational, tend to rely on overseas sources of funds for investment purposes.

The banks in Papua New Guinea, particularly the Agriculture Bank, are under directions from the Bank of Papua New Guinea (the central bank) to lend to smallholder farmers at concessional rates. In 1981, the Agriculture Bank's loans to agriculture were provided at interest rates ranging from 5–11 per cent at a time when the weighted average interest rate charged by commercial banks was 15.6 per cent. The much higher transactions costs per kina of loans to smallholders makes the effective subsidy greater than the gap between those interest rates. One loan officer suggested that, on average, at least a further 10 per cent should be added to the interest rate for agricultural loans to cover the costs of transactions in rural areas.

The pressure to extend concessional credit to smallholder agriculture is often based on equity and efficiency arguments. It is maintained that because many farms are small, farmers are therefore poor. Cheap credit is one way in which they can be assisted to break out of the vicious circle of poverty and dependence on the high-priced informal credit market. It is also maintained that the free market would provide too little credit to agriculture because of its risky nature, without facing the question: 'What is too little in an efficient resource allocation sense?' Neither argument is robust. By 1984, coffee producers had received almost a quarter of the Agricultural Bank's total loans and these averaged Kina 68,500. Cocoa producers had received 20 per cent of all loans, with an average value of Kina 57,400. A smallholder could not bear the burden of such loans, even at concessional interest rates.

They were also highly concentrated in a few provinces (Western and Eastern Highlands for coffee and North Solomons for cocoa).

On efficiency criteria, if agriculture involves more risky investment and society is risk averse, relatively less should be invested in agriculture. It is a misuse of scarce resources to place them in areas where the risk of loss is substantially higher than in other areas and the misuse will be reflected in high default rates. Moreover, the apparently high interest rates on commercial loans may reflect high risks and high transaction costs. However, a monopoly position possessed by a local money lender where the size of the market will support only one lender may contribute to excessive credit costs.

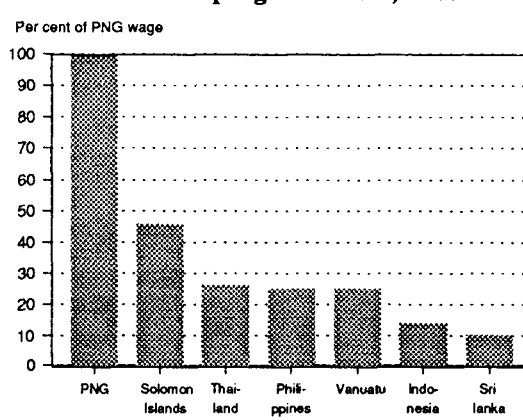
The concentration of lending to particular commodities, such as coffee and cocoa, and to particular provinces is understandable. If any bank is forced by government to provide credit at concessional rates to a particular group, it is rational for the bank to offset these losses by concentrating on high-profit customers. These are, in effect, cross-subsidising the concessional loans, especially if the bank is supposed to be operating in a quasi-commercial way. Even 'development banks' are expected to follow some conventional commercial criteria in their lending policy. If they do not, then the ultimate demise of the institution is not long in coming. The world history of subsidized credit schemes for smallholder agriculture is replete with failures. The ones that have been successful have been characterized by a great deal of local knowledge and control where the risk of default can be minimized. The Australian model of a head office and regional branches would seem inappropriate for Papua New Guinea. Alternative institutions using post offices, trade stores and processing firms as agents for lending would appear to offer better prospects of making loans accessible to the smallholder sector.

The 1989 Budget recognized the impediments to capital formation in agriculture by introducing a number of measures designed to foster rural savings and to improve the rural credit market.

Labour

As well as an Australian model in the financial capital market a further vestige of the Australian administration is the wage fixing system. Papua New Guinea's Minimum Wages Board (MWB) meets triannually to determine minimum wages as well as wage rates for a range of skilled and semi-skilled labour. For the urban areas, wage determination has been essentially based on a 'needs' concept, with indexation based on movements in the Consumer Price Index (CPI). Since 1983, the indexation has been only partial. In rural areas, the determination of wages has been influenced more by a 'capacity to pay' principle. Urban minimum wages doubled in real terms between 1972 and 1976, as a MWB determined 'follow on' decision, after the establishment of the Bougainville mine with its high expatriate labour-determined wage rates, but have been maintained at the 1976 level in real terms by indexation. Rural minimum wages, on the other hand, have changed relatively little in real terms and have been less than 40 per cent of the urban minimum level since independence. In other words, urban wages have usually been 2.7 times rural wages.

Figure 1 **Wages in manufacturing, Papua New Guinea and other developing countries, 1987**



Source: Jarrett, F.G., *Papua New Guinea: economic situation and outlook*, International Development Issues No. 6, AIDAB, AGPS Canberra, April 1990.

Wages in Papua New Guinea are much higher than wages in comparable developing countries (Figure 1). The relatively high wage rates in Papua New Guinea do not reflect high labour productivity. They result in a crowding-out effect on other budget outlays in the public sector. The slight increase (6 per cent in the period 1977–86) in the numbers employed in the public sector, has been associated with a more than 10 per cent increase in real wages. In the private sector, high unit labour costs are reflected in decreased profitability and competitiveness and have restricted the growth of investment and employment.

These excessive wage rates may well generate greater inequities and production inefficiencies than the distortions in the land and financial capital markets. Even though the analysis of labour market statistics in Papua New Guinea needs to be treated with some caution because of 'the parlous state of statistical information', certain inferences can be made.

The labour force (defined as those in wage employment plus those actively seeking wage employment) represents only approximately one-tenth of the population (citizens 10 years old and over). Almost 80 per cent of the population are in agriculture. There are also substantial differences between male (17 per cent) and female (3 per cent) participation rates in the labour force. Moreover, there are very high unemployment rates (defined as those seeking employment as a percentage of the labour force) in both rural and urban areas.

In the 1980 Census, recorded unemployment amongst females in rural areas was estimated at 53 per cent. In the urban areas (Port Moresby, Lae, Madang) unemployment rates were particularly high for the 15–19 years old group, ranging from 20–30 per cent. In some of the Highland provinces, Simbu for example, unemployment rates in the 1980 Census were over 30 per cent. The high unemployment rates among the young in the cities contributes directly to the 'rascal' problem of maintaining law and order.

As well as the inequities resulting from high urban minimum wage rates, there are inefficiencies. As credit is subsidized and wage rates are higher than they should be, producers will combine inputs to substitute relatively cheap capital for relatively expensive labour at a time when Papua New Guinea's factor endowment would suggest the input mix should be such as to conserve capital. For example, there will be an incentive to adopt capital intensive rather than labour intensive technologies that will have the potential for labour displacement. High urban wages also increase marketing costs for farmers, including smallholders, as they enter the monetized society.

In summary, the distortions in the labour market in Papua New Guinea, as a result of high minimum wage rates, reduce output and employment. They are inequitable in that they raise the incomes of those lucky enough to get jobs, but they induce urban unemployment and contribute to the law and order problem.

Conclusion

The Central Government of Papua New Guinea faces difficult problems in effecting reforms to these factor markets. Deep-seated attitudes towards land are likely to be slow to alter. Hence, more innovative alternatives than formal alienation of titles need to be found so that land can be used more efficiently in production and as collateral for loans. Credit markets will continue to be characterized by very high transaction costs for smallholders in rural areas, so, again, innovative methods for providing low-cost banking services outside the towns need to be sought, since urban commercial banking methods are inappropriate and will survive only with the help of distortioning subsidies. In the labour market, a gradual erosion of real urban wages is needed to increase the opportunities for employment and to reduce the incentives for excessive numbers of young people to move to the towns in search of well paid jobs.

Difficult though these tasks are, the need is there for microeconomic policy reform, especially with the economy under stress as a result of the closure of the Bougainville copper mine and the associated loss in export earnings and government revenue.