The Challenges of Doing Business in Papua New Guinea

An Analytical Summary of the 2007 Business Environment Survey by the Institute of National Affairs
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Abbreviations

PNG  Papua New Guinea
PSA  private sector assessment
SOE  state-owned enterprise
Introduction

This report describes the results of a 2007 survey of 243 businesses in Papua New Guinea (PNG). Businesses were asked to provide their views on a wide range of issues that affect the way they do business, the factors that influence their investment decisions, and the relationship between the business community, government, and the public sector more generally. A similar survey, which provides a unique opportunity to compare how the business climate has evolved through time, was undertaken in 2002. The comparisons are especially interesting in light of the political stability of the past 5 years and the resource boom that PNG has recently been experiencing. In addition, a private sector assessment (PSA) analyzing the constraints to doing business in PNG was recently completed. The survey results provide further insight into PNG's business environment that complement the PSA as well as additional data against which to test its conclusions.

This summary highlights the main findings of the survey and should be read as a supplement not only to the full report, but also in conjunction with the recently completed PSA by the Asian Development Bank.

Summary of the Findings

The survey identified a number of concerns that impact the cost of doing business and the propensity to invest. The most important are:

• Political uncertainty: even though the previous government (2002–2007) completed its full 5-year term and the current coalition government retains many members who were in the previous administration, businesses still fear possible political instability.

• Business security: law and order problems impose substantial costs on businesses, with many respondents indicating that this had adversely affected their decision to invest or expand.

• Government regulations and policies: instability in laws, regulations, and rules that adversely affect businesses.

• Business–Government relationships: Corruption remains a considerable problem, as is the lack of consultation by the government before the promulgation of laws or regulations that affect business.

• Infrastructure and public services: the quality of infrastructure and services is poor and reported to have declined since the previous survey.

The Survey Sample

Every effort was made to ensure a representative sample. Of the businesses surveyed, slightly over half were PNG owned, about a quarter were foreign owned, and the rest were jointly owned. The sample consisted almost exclusively of formally registered businesses, 80% of which have been in business for at least 5 years. Nearly half of the businesses operated outside the main centers of Port Moresby and Lae. Forty-five percent of these were classified as large businesses, having a turnover of more than K5 million, and the other 55% were small- or medium-sized enterprises. About 20% of the respondents cater to both local and foreign markets.

The businesses surveyed were from 10 broad economic industry groups:

• agriculture, forestry and fisheries;
• building and construction;
• finance, business and investment;
• hotels, restaurants and bars;
• manufacturing;
• mining and quarrying;
• retail and wholesale;
• transportation and communication;
• utilities; and
• other services (e.g., gaming, hairdressing, etc.).
Methodology and Themes Surveyed

The survey was conducted between May and June 2007. It consisted of 26 questions grouped into the following themes:

- impact of political uncertainty on businesses,
- business security,
- effect of government regulations and policies,
- business-government relationships,
- effectiveness of government services,
- constraints to business and investment.

Political Uncertainty

Business is inherently risky. Investors and entrepreneurs commit capital and time in attempts to take advantage of commercial opportunities. Even in large developed countries, however, a significant number of businesses fail. In one sense, this is good because it encourages productivity and weeds out the inefficient. Nevertheless, when business risk, which in the first place is already quite considerable, is aggravated by political risk, the impact on investment is negative—investors will demand higher returns and shorter payback periods to reduce their exposure to uncertainty, and this lowers potential growth.

Furthermore, experience in many countries indicates that investors’ memories are long—when policy reforms are introduced, they do not immediately rush to invest. Rather, they adopt a wait-and-see approach to make sure that the changes are permanent.

During the 1990s, businesses in PNG experienced considerable instability arising from frequent changes in government, a breakdown in macroeconomic discipline, and erratic and frequent changes in policies affecting the private sector. This began to change in 1999, when the newly elected Morauta government introduced a wide range of reforms aimed at enhancing policy and political stability, including the Organic Law on the Integrity of Political Parties and Candidates in 2000. Notwithstanding these efforts, a breakdown in fiscal discipline in 2001 and early 2002 contributed to a weakening of business confidence, which may have served to undermine the Morauta government’s earlier achievements.

However, economic conditions in PNG have improved considerably since 2002, and the Somare government (2002–2007) was the first in PNG’s history to complete a full 5-year term. Moreover, following the 2007 elections, a coalition government with much the same composition has continued in office.

This period of continuity of government provides an excellent opportunity to assess the effects of greater political stability over the past 6 years and whether the business community has changed.

![Figure 1: Impact of Political Instability on Business](chart.png)
its investment behavior, or is still holding back, waiting to see if the improvement in the political climate is permanent.

The extent to which political instability harms businesses in PNG is shown in Figure 1. Fully 87% of respondents indicated that they were negatively affected by periods of political instability and uncertainty. Having almost the same number of respondents indicating concern in the 2002 survey suggests that the effect of unchanged government has yet to produce a positive response in the business community.

Furthermore, in the 2007 survey, businesses were asked how concerned they were regarding the stability of the political environment. Fully 76% indicated that they were either “very highly concerned” or “highly concerned” regarding future political stability (Figure 2).4

Business Security

A strong and effective legal system, contributing to a safe and secure society, is essential for a well-functioning private sector. Indeed, law and order is required to help ensure security over physical assets and, more importantly, of employees. Apart from the costs associated with theft, high crime levels deter business and investment by increasing insurance premiums, raising the cost of internally provided security (e.g., guards and security systems) and bringing up the costs associated with the employment of skilled labor from abroad. High crime levels can also impact adversely on the productivity of a business if employees are unwilling or unable to work night shifts.

A strong and effective legal system is required to ensure that property rights and business contracts can be readily secured and effectively enforced. Without a degree of certainty in the legal enforceability of property rights, security over ownership of assets will be diminished and the incentive to accumulate wealth and invest in productive capacity will be eroded.

Poor law and order in PNG has attracted considerable attention and debate over the past two decades, both in country and abroad. It has regularly been cited as a major constraint to business activity and investment. The 2007 survey provides an opportunity to assess

*The survey was conducted before the 2007 election, which could have heightened the respondents’ concerns over political instability.
whether the situation has improved in recent years, or whether it remains one of the foremost constraints faced by businesses.

Participants in the survey were asked to indicate the extent to which law and order problems have affected their businesses. Fully 87% indicated that they were “fairly concerned,” “highly concerned,” or “very highly concerned” by issues of crime and security (Figure 3).

The costs of dealing with crime are substantial. Figure 4 shows the security costs to business as a percentage of turnover. While 57% of businesses reported that their security costs as a percentage of sales were 1%–10%, 16% of firms reported that security costs constituted 11%–50% of sales. On average, the security costs as a percentage of sales were 5.8% in 2007 compared with 4.6% in 2002.

Not only does the poor security situation affect the costs and the productivity of PNG businesses, but it also negatively affects investment decisions. Figure 5 shows how the decision to invest or expand operations has been impacted by crime. Over half the respondents indicated that the decision to invest or expand their business had been either very highly or highly affected by the chronic state of law and order. There had, however, been a small improvement from the 2002 survey.

The 2007 survey confirms that PNG’s law and order situation remains a serious issue for the business community. While, at best, there may have been a marginal improvement in businesses’ perceptions of the law and order situation since the 2002 survey, the responses indicate that the direct costs to business (in terms of internal security costs) have increased.

Over the medium to longer term, many underlying causes of PNG’s law and order problems can only be addressed by increased employment and income-earning opportunities, and by a more general reduction of poverty. However, the economy’s capacity to sustain high rates of employment growth through productive investment is constrained by the current law and order problems. Hence, a more effective law and order policy that encompasses the three tiers of policing, prosecution, and detention is urgently needed.

The fundamental requirements for a secure law and order environment are (i) a strong police force that successfully apprehends offenders so that criminals are aware that they will be apprehended...
for committing a crime; (ii) solid legal processes and institutions to successfully bring convictions to offenders; and (iii) punishment that fits the crime and jail sentences that are served in full.5

**Government Regulations and Policies**

Stable policies, rules, and regulations as well as simplicity and certainty of their application are fundamental prerequisites for a sound business and investment environment. Frequent changes in rules and regulations raise the costs of compliance, make businesses vulnerable to predatory officials, and generally increase the costs of doing business. A number of questions were asked of the respondents to gauge the extent to which changes in rules, policies, and regulations are a concern for the business community in PNG.

Overall, apprehension was high not only with respect to future changes, but also regarding retrospective changes to rules and regulations. The latter issue is of particular concern to investors because an investment decision is based on cost calculations of the existing pattern of rules and regulations—if these change and raise the costs of compliance, investments that might have previously been profitable become less so, which could result in some wrong investment decisions.

Figure 6 indicates that on average, 70% of businesses were “very highly concerned” or “highly concerned” about the stability of rules, policies, and regulations. Importantly, there has been no significant easing in the level of concern recorded in 2007 compared with 2002. Overall, businesses remain worried about the stability of the “rules of the game” imposed by the government. The perception of risk of doing business in PNG impacts negatively on investment.

A closely-related question asked respondents whether they feared retrospective changes to rules and regulations, an issue which is central to the credibility of the regulatory and policy environment faced by businesses. If investors are concerned with retrospective changes to rules and regulations, they may apply a high-risk premium to the financial assessment of new investment.

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proposals and other operational matters. This risk premium could mean the difference between a new investment going ahead or being abandoned.

Once again, the majority of businesses (62%) were either “very highly concerned” or “highly concerned” over the possibility of retrospective change to rules and regulations (Figure 7). Furthermore, reduction in the level of concern between the 2007 and 2002 surveys was marginal.

A question regarding the likelihood of policy changes with changes in government explains much of the concern regarding political instability. Respondents were asked to indicate the extent to which they agreed with the statement that rules and regulations changed as government changed (Figure 8). A significant majority agreed that rules likely changed when governments changed.

In addition, when asked how burdensome government regulations were, a great majority indicated that compliance is a major problem from the perspective of fees, complexity, and processing time (Figure 9).

When asked whether the cost of compliance with government regulations affected investment decisions and increased the cost of doing business, again, the majority of respondents answered in the affirmative. Furthermore, nearly half of the respondents indicated that they had abandoned investments because of compliance difficulties (Figure 10). When these responses are considered in conjunction with concerns over political uncertainty and the stability of rules and regulations, it seems that the combination of all these factors is having a marked negative effect on investment.

**Business–Government Relationships**

In well-functioning business environments, business–government relationships are collaborative. Ideally, governments consult with the business community before embarking on policies or regulations that impact the costs and performance of business. Similarly, businesses refrain from seeking special favors, and are open to government concerns.
In PNG, a weak relationship exists between the private sector and the government. When asked to rank their overall working relationship with the government and bureaucracy, 39% of respondents indicated that the government was “highly unhelpful” or “very highly unhelpful,” while another 30% indicated that the government was “fairly unhelpful” (Figure 11).

Furthermore, a significant number of respondents indicated that they were negatively affected by corruption among officials (Figure 12). Sixty-seven percent said that they had been affected by corruption, with 40% stating that they had either been “very highly affected” or “highly affected.”

On a follow-up question regarding the frequency of irregular payments to government officials, just under 40% of respondents indicated that such payments “always,” “mostly,” or “frequently” occurred (Figure 13). By contrast, about 34% of respondents said that they “seldom” or “never” made such payments.

**Infrastructure and Public Services**

Another set of questions inquired about the effectiveness of infrastructure and public sector services for respondents’ businesses. The quality of the business environment depends largely on the effectiveness of supporting services and infrastructure such as water, telecommunications, electricity, ports, roads, as well as the courts and the legal system. As in other countries, these services are provided in PNG by a mixture of public and private suppliers. The recent PSA for PNG and other economic reports have consistently found that infrastructure and supporting services have limited availability and are often of poor quality.

The perception of the overall efficiency, effectiveness, and quality of government services is very low, with over 80% of the respondents rating them as fairly poor or worse (Figure 14).

Furthermore, businesses perceive little improvement since the 2002 survey. On a scale of 1 to 6, with 1 being “never efficient” and 6 being “always efficient,” businesses in all sectors of the economy rated government service provision as being largely inefficient (Figure 15).

The respondents were also asked to rate the quality of particular infrastructure and other services (Figure 16). The ratings showed a significant level of dissatisfaction with virtually all the items included in the questionnaire. Overall, roads and bridges were ranked the poorest, followed by telecommunications and postal services, electricity, and water and sewage.
While finance and banking services, which the private sector primarily supplies, received the best ranking, these services still received a below-average rating.

With regard to telecommunications services, it should be noted that this survey was undertaken before the impact of the entry of Digicel had been fully absorbed by the private sector. Anecdotal reports over the last 12 months suggest that there has been a quantum improvement not only in the quality of the privately-supplied telecommunications services, but also in those services provided by PNG Telikom.

This lesson—that competition is good for both the public and the private sectors—has far-reaching implications for government efforts to improve service delivery supplied by state-owned enterprises (SOEs), which center around efficiency improvements and using public–private partnerships to reduce costs. The effectiveness of both measures will also be improved by ensuring that there is competition.

The private sector supports the aim of improving these services. In a separate question, 70% of respondents agreed or strongly agreed that major reforms in the delivery and quality of government services are needed.

Of the government services included in the questionnaire, the court system is generally regarded as effective and efficient. Over 60% of respondents indicated that they had confidence in the judiciary and in court decisions.

**Constraints to Business and Investment**

As part of the survey, businesses were asked to rank 22 potential constraints according to their impact on the business environment. Respondents were asked to rank constraints on a six-point scale ranging from “not a problem” to “extremely problematic.” Figure 17 shows the ranking of the constraints that the respondents identified as posing the most important problems for doing business in 2007. The major impediments to doing business in 2002 are also included for comparison.
Consistent with other responses to the survey, businesses reported that the most significant problems were “law and order,” “corruption,” and “political uncertainty.”

Among other major issues identified as significant impediments to business and investment were “access to land” and “land compensation claims.”

By contrast, macroeconomic issues embodied in exchange rate instability and high interest rates that were ranked among the most problematic issues in the 2002 survey were not reported as major problems in 2007. This reflects the greatly improved macroeconomic situation in PNG over the last 5 years.

The ranking of issues in this section tracks closely the constraints identified in the other parts of the survey, providing a good consistency check of the overall accuracy of the answers to the questions.

The respondents indicated significant problems in all the areas investigated. Concerns regarding political stability remain despite an extended period in which the government has been in office. The business community appears to have little confidence in the ability of the government to supply services and remains highly dissatisfied with the quality of services available.

Corruption is viewed as a widespread phenomenon, which is consistent with the finding that when rules and regulations are pervasive and are changed frequently, public officials are able to extract “irregular payments” from businesses.6 Law and order problems continue to weigh heavily on businesses, amounting to the equivalent of a significant tax on profits. Investment decisions have been affected by the difficulty of complying with rules and regulations imposed by various government departments and agencies.

The survey responses clearly show that investors in PNG have long memories, so that the political stability of the past 6 years has had less impact than might have been expected.

The business community follows ministerial reshuffles and changes to the heads of key government departments and agencies closely. It may also believe that the underlying political dynamic that has led to political instability in the past has not been addressed by reforms such as the Organic Law on the Integrity of Political Parties.

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An overwhelming majority of those surveyed indicated that law and order should be the prime focus of policy.

The binding constraints to growth identified in the PSA for PNG closely mirrored the issues identified in the survey. The most important constraints in the PSA are:

- High risk resulting from a high crime rate; lack of transparency in government; unpredictable changes in government policy; a weak commercial legal framework, including a poor collateral system; and an uncertain and complicated land leasing system.
The Challenges of Doing Business in Papua New Guinea

- High transactions costs resulting from the government intruding in every area of the economy through ownership and regulation, which raises costs and weakens competitiveness.

- Poor infrastructure, especially road infrastructure, which has been described as a massive and pervasive problem in PNG. Inefficient SOEs provide poor, high-cost service and crowd out the private sector.

- Underdeveloped financial markets with low lending and high interest rates.

These conclusions are to a large extent confirmed by the business survey and highlight the need for reform. Although in the short run the natural resource boom has changed the economic landscape in PNG and growth and investment have been strong, ensuring that growth spills over to the rest of the economy requires broad-based reform. Many countries that have experienced growth from natural resources fail to sustain the expansion once commodity prices decline, as they inevitably do.

The current boom provides PNG with an opportunity to broaden its economic base and provide for sustained growth in the future that relies not only on natural resources but a more diverse range of economic activity. Failure to remove the bottlenecks, target public expenditure on priorities, constrain corruption and other handicaps to broad-based reform. Many countries that have experienced growth from natural resources fail to sustain the expansion once commodity prices decline, as they inevitably do.

Policy Reform

The conclusions of the survey and the PSA lead to similar policy recommendations. The most important of these are:

- Vigorously promoting competition by eliminating SOE monopolies. The dramatic reduction in calling costs and expansion of services as a result of the partial opening up of the mobile telephony market to competition illustrates the benefits of having new entrants in sectors that have been monopolized. Generally, policies should be directed at reducing costs and improving service, instead of protecting incumbent SOEs.

- Promoting public–private partnerships to increase investment and improve productivity in infrastructure and service provision.

- Modernizing the legal system to better meet the needs of modern commerce and reflect the realities of PNG. Initially, the Companies Act and the companies registry require reform, and should accommodate rural and community organizations.

- Simplifying the system of licenses, regulations, and taxes which raises the costs of doing business. This will especially help small- and medium-sized enterprises.

- Promoting financial market development by reforming the collateral framework, establishing a system for credit information, and promoting access to financial services in rural areas.

- Formalizing private and public sector consultation mechanisms to arrive jointly at a consensus regarding reform initiatives and priorities. This will entail strengthening the ability of representative private sector organizations to analyze policy options.

- Providing robust and adequately-funded independent mechanisms for addressing crime that have a tangible deterrent effect on criminal activity, including public (and private) sector corruption.

- Vigorously pursuing public sector reform, including the right-sizing of institutions and staffing levels to meet the needs and priorities of the business community. In many cases, this entails cutting back on waste and excessive overheads and staffing. In other cases, it involves increasing staffing levels or providing more specialist staff to eliminate bottlenecks in areas such as migration and work permits, as well as longer term issues related to education, training, infrastructure, and contract oversight.

This report summarizes the results of an extensive survey of the business community on the challenges of doing business in Papua New Guinea. It finds that despite some improvement in the business environment, progress since a similar survey was conducted in 2002 has been disappointing. Many of the issues identified then still have a negative impact on investment and entrepreneurship. To ensure that the current resource boom is translated into sustainable prosperity, substantial reform is needed.

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