

WORKSHOP ON PNG MICROFINANCE INDUSTRY FOR THE NEXT DECADE

Theme:

Service Providers to the Microfinance Industry

The MSME and Informal Sector – Policy and support projects

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Introduction

Thank you Chair, good morning ladies and gentlemen. I have been asked to address you on Micro, Small and Medium Enterprises (MSMEs) and the Informal Sector and policies and programmes to support them. If one includes smallholder agricultural production (for trade) within the informal sector, this sector provides the backbone of broad-based income and (largely informal) employment opportunities in PNG. The term informal 'economy' is now generally preferred to the term 'sector', but, as we are more familiar with the term informal 'sector', I'll stick largely to that today.

The informal sector comprises the bulk of micro-finance users. The commercial banks essentially service the formal sector, whilst the microfinance institutions service the informal sector. Micro enterprises essentially comprise the informal sector, without bank accounts, whereas small to medium enterprises fall in the formal sector, using the formal banking sector. There is, however, no clear delineation between the formal and informal sectors; with some enterprises falling in the middle ground, perhaps holding a bank account, or affiliated to formal organisations (like an agro-nucleus enterprise or cooperative) or even being a larger scale enterprise themselves but not registered or paying income tax. There are also some enterprises which move between the two sectors, sometimes graduating into the formal sector, and then slipping back into the relatively obscurity of the informal economy, perhaps when times are hard or form filling becomes excessive.

There is an implicit policy, including by some development partners, to encourage entry of micro-businesses into the formal sector, both to gain the benefits of formality, but also to contribute to the costs of a functioning State. However, that implicit policy has, at least until recently, not been well articulated, particularly in practical terms, either by government or development partners, with the costs of formality seeming to outweigh benefits for many small entrepreneurs. There is, however a renewed awareness over recent years of the role of the private sector as the driver of economic development, including that of the informal sector, with government and donors slowly aligning policies and programmes to respond to that priority, as expressed in the MTDS (2005-2010) and, for example, AusAID's 'Pacific 2020'.

Purpose Statement

The purpose of this presentation is to inform participants that the success of microfinance institutions (MFIs) will very much be determined by the effort government, including town and other sub-national authorities, put into successfully addressing the informal sector constraints.

Presentation Outline

I wish to briefly touch on the definition of informal sector and microfinance to help us see the link between them; the importance of the informal sector, government's support, the challenges posed and the way forward for the informal sector and the microfinance industry.

A. Informal Sector and Microfinance: Definition

Definitions of informal sector are varied. The informal sector is known by various names in different countries and the following are some of those used, some with negative insinuations; Black Market, Hidden Sector, Informal Economy, Informal Opportunities, Invisible Sector, Irregular Sector and Unofficial Economy, to mention a few. As stated, the informal sector is now widely referred to as the informal economy.

Informal Sector: the term informal sector refers to the sector wherein micro-business and income earning activities are generally unregulated. It entails economic activity that is neither taxed nor closely monitored by government; and is generally inadequately reflected in National Statistics, notably the Gross National Product (GNP). PNG's *Informal Sector (Development and Control) Act 2004* defines an informal business as one operating legally on a small scale, employing no more than five persons and not liable to pay (income) tax.

It is generally characterised by: -

- Relative ease of entry and generally unregulated;
- Small scale operation, usually family owned and with relatively few, largely family, employees;
- Limited capital and relatively labour intensive;
- largely traditional or self-acquired skills, rather than attained through formal training;
- Relatively competitive markets, although there may be cartels,

Microfinance: on the other hand, microfinance refers to the provision of financial services to poor or low-income clients, with any lending generally for micro-business rather than consumption purposes. It effectively means the provision of financial services to informal sector participants or micro-enterprises. It provides individuals and micro-enterprise with no access to conventional banking services, an opportunity for modest savings and credit provision. For some it may also provide an entry into the formal banking, as their enterprise grows in scale. Microfinance operates on lower cost arrangements, often entailing community and peer group pressure and a network of lower cost agents, or shared supervision. Microfinance provision and demand have been growing rapidly in PNG, although still only reaching a modest portion of the whole informal sector in some towns and provinces. (Other informal or semi-formal credit arrangements exist for households, often lending at usurious rates.)

Microfinance is not static, nor tied to established mechanisms. It must be attuned to the country and culture in which it operates. New arrangements to reach small savers and borrowers are being introduced, with microfinance institutions often at the forefront. These particularly involve the use of mobile phones, which are much more widespread than formal bank accounts in most developing countries, and also enable lower income households more accessible ways to access and manage money, and move away from cash, for example in South Africa using credit cards with low ceilings and Eftpos facilities in small village stores. However, micro-enterprise and micro-finance, as with business generally, do not operate in isolation, and are dependent upon suitable business and investment conditions to be able to develop.

From the definitions, we can see the direct and clear link between the informal sector and microfinance.

B. Importance of the Informal Sector

Informal sector activities are found in every economy, from the least to most developed countries. Gauging its scale is hard, but in many developing countries, surveys have estimated that it provides markedly greater employment than the formal sector, particularly in the rural sector and for women. According to the World Bank (2006), the informal economy in Africa was estimated to have provided 42% of GDP in 1999/2000 and

41% of GDP in Latin America, whilst a survey in Thailand in 1994 found the informal sector making up the majority of the overall workforce and almost the entire agricultural workforce.

The informal sector provides opportunities for relatively unskilled people to earn incomes, and, together with the wantok system, provides a social safety net, including against loss of formal employment during business downturns. Whilst in the past the informal sector was widely perceived as a temporary phase in development, it's now recognised that it can be a major, vibrant and entrepreneurial part of the economy, which is also here for the long haul. According to the industrial pyramid in every economy, there are only a few large enterprises at the top, with a larger number of medium enterprises, and at the bottom a very large number of informal sector or micro enterprises. Many governments of developing countries now recognise the informal economy as a critical generator of employment, poverty alleviation, and broad-based economic growth. A vibrant informal sector can increase poor people's opportunities, security, and empowerment.

Poor rural infrastructure and services, and lack of economic opportunities in rural areas in PNG have been pushing people towards our towns. However, whilst wide access to land and resources in rural areas have enabled rural households to secure food and some income, the urban informal sector in PNG has so far provided fewer opportunities than in many developing countries, partly as a result of outmoded restrictions by town authorities on informal trade, and lack of facilities provided, skills and awareness of the range of opportunities generally developed in Asian informal economies.

A survey in 1995 of PNG's urban workforce¹ found 13% earning incomes through the informal sector, but an astonishing 18.5% surviving principally through crime (including prostitution), indicating that opportunities and incomes in both the formal and (legitimate) informal sectors were inadequate. Considerable urban growth has occurred in PNG since 1995, including growing numbers of vulnerable households, including street kids, and the recent economic growth and modest formal employment growth have made little impression on these burgeoning numbers.

Whilst the informal sector is criticised (fairly or unfairly) for being untidy and disorganised, providing a haven for crime, not paying tax or fully contributing to the cost of running the State, and unfairly competing with the formal sector in some products, it must be given the attention it deserves for the following glaring reasons:

- i. The formal sector has been, and remains, completely unable to provide the level of needed employment for PNG's fast growing population, especially considering PNG's dual economy, with its large projects (including prospective LNG) providing limited broad-based employment;
- ii. The informal sector provides greater employment opportunities at relatively low cost per job - It is credited with generating the majority of employment with over 85% of the PNG populace involved in the rural and urban areas, combined;
- iii. Women play a key and leading role. 63% of women were found to be involved from the 2001 CIMC study.

So, assuming the right conditions and impediments to legal informal sector activity are removed:

- iv. Rural-urban migration can be reduced
- v. law and order problems addressed
- vi. poverty reduced
- vii. a large portion of school leavers (or those never attending) can be absorbed, at least in the interim
- viii. opportunities provided for other unemployed/under-employed, including the vulnerable

Restraining

- ix. the growing income disparity in PNG society

¹ Levantis T, ANU/INA 1998

- x. the pressure to participate in criminal activities, including prostitution, and hence also a factor in the spread of HIV/AIDS. Crime is encouraged by limited employment and adequate income earning prospects, combined with poor law enforcement and deterrent, but in turn constitutes a major constraint upon business and investment, especially for smaller businesses, including agriculture.

Most of the people involved in the informal sector are the *unbankable*, people who do have any access to formal banking services, which MFIs are being introduced to serve. PNG’s informal sector participants can be profiled in the following manner;

Profile of Urban Informal Sector Participants (from a survey of 5 urban centres) in Papua New Guinea

Women are the majority	63%
Married	68%
With children	77%
Average age	33 years old
Education	
No Formal	32%
Grade 1-6	41%
Above Grade 6	27%
Self-employed	77%
Informal Sector is sole source of income	69%
Average Income/week	K60.50
Incomes >K251/week	22%
Average household size	7 members
Participants for >6 years	50%
New Participants (<1 year)	17%

(Source: INA 2001 – CIMC PNG Informal Sector Study)

C. Government Support

In recognition of the importance of the informal economy and the need to provide more legitimate economic opportunities, including in the urban areas, the Minister for Community Development, Dame Carol Kidu, championed the passage of the *Informal Sector (Development and Control) Act* in 2004. The Act was designed to free up long-standing constraints for the informal economy, including by urban authorities, whilst still requiring the sector to comply with standards, for example urban zoning, orderliness, health and hygiene. Unusually, the Act was passed in the absence of an overarching informal sector policy, leaving the Act as de-facto policy. There was clearly a need for a supportive policy framework, consistent with the MTDS, to enable suitable interventions, including programme support, to assist the development of the informal economy. As such in 2006 the National Executive Council (NEC) endorsed a framework for an integrated approach to developing a National Policy on Informal Economy as a Poverty Reduction Strategy.

Since 2004, although some urban authorities have provided some support to informal sector development, most have either done nothing, usually constrained by funds, or continued to impose heavy restrictions on its operation, continuing to see it as an unsightly activity, imposing costs and harbouring criminal elements. The urban sector has certainly not yet met a fraction of its potential or the diversity prevalent in Asian cities.

Recently, the late Mr Mike Manning was engaged by CIMC to help to finalise a Draft National Policy on Informal Economy, based upon a framework prepared by the Informal Sector Task Force. Last Tuesday, 26 August 2008, a National Consultation Workshop was organised by CIMC, which brought in stakeholders from all provinces, including town authorities, for their input on the draft policy for the informal economy. Their comments are currently being incorporated into the draft policy, intended for consideration by Cabinet later this year. It is hoped as a result of this wide participation, and feedback from an informal sector survey (commissioned by IFC during 2007) that there will be a strong sense of ownership of the new policy, necessary for its subsequent successful application.

D. Challenges

Although we now have the Act and a draft policy currently under review, there still remains much to be done. According to the 2001 Informal Sector Study conducted by teams in 5 urban centres, the following were identified as critical constraints to the development of the informal economy:

- i. Restrictive Laws and Regulations and overzealous enforcement of those laws/regulations
- ii. Negative Attitude to the Informal Sector (although conflicting views were found)
- iii. Lack of information and baseline data on the Informal Sector, to assist in planning sector support
- iv. Inadequate marketing, financial, technical, training and other support – including transport and market facilities, micro-credit/finance, etc.
- v. Uncoordinated institutional support
- vi. Cultural and gender issues,
- vii. Macro-economic impediments

Informal sector participants in a 2007 Survey of the Informal Sector in 19 centres (commissioned by IFC²) found access to market and transportation problems as the main obstacle (51%), followed by access to loans (12%), and then crime/theft and disorder (10%).

Constraints cannot be addressed in isolation from each other. Successfully addressing one impediment will have little effect, if another overarching constraint still exists. They need to be addressed as a whole, by respective authorities, including support from the private sector and wider community. Whilst participants in the 2001 study identified access to credit as critical, experience of both credit and the capacity for repayment was limited, so adequate awareness and training were also clearly required.

Microfinance Institutions in PNG

- a) ***Access to start-up capital*** - Access to micro-finance for start up capital is widely identified as one of the major impediments. This was again echoed strongly at the recently held National Consultation Workshop on Informal Economy Policy organised by CIMC. The 2001 study highlighted that participants have very little access to credit, in particular from formal institutions. Whilst micro-finance outlets and numbers of accounts and transactions have been expanding rapidly in recent years, with support from development partners – including PNGSDP - and formal banking institutions, there still remain relatively few micro-credit and savings schemes operating in PNG to meet the many and varied demands of informal sector participants.
- b) ***Access to savings institutions*** – Although many micro-enterprises provide very low incomes, and little opportunity to save, informal sector participants do endeavour to save for household needs and for future investment, and some earn well above the average and are in a stronger position to save significant amounts (e.g. in the 2001 survey 8% earned more than K500 per week). So, apart from the

² IFC Informal Sector Survey 2007, INA January 2008

need to access credit for start-up capital, informal sector participants also need to save their earnings securely for future needs, including against possible rainy days and away from prying hands, preferably earning interest to counter the seepage from current higher inflation rates.

If more than 85% of the population is in the informal sector, we can safely assume that virtually that same percentage has no access to formal credit or saving arrangements, although various customary saving arrangements are known to operate, especially involving women's groups. Papua New Guineans are not renowned for saving habits, often spending earnings as soon as received. This lack of a saving culture is understandable considering limited traditional mechanisms, notably the short storage life of most of PNG's traditional foods, resulting in times of plenty and times of shortage. Traditionally saving was replaced by reciprocity, whereby surplus was exchanged, with the capacity to call up dues when required. Nevertheless some PNG societies did traditionally have savings mechanisms, including the traditional accumulation of shells and pigs and other wealth prior to major MOKAS, for example, and the accumulation for weddings and various customary events. Formal mechanisms and training need to be reinforced to enable micro-enterprises to save for future investment and other needs, and to nurture businesses for the long term, rather than draw down capital or sell out for short term income. Similarly, there is the need to encourage maintenance of agricultural tree crops, to provide long term sustained yields.

The potential from 85% of the population in the informal economy is considerable if adequately supported. With a high risk of theft, poor infrastructure and lack of retail outlets in rural areas, there is limited incentive to earn cash incomes above a minimum target level. Digicel has demonstrated that formal business is willing to take a challenge and target PNG's rural communities, and provide rural services, income and job opportunities. Improved communications, including telecommunications is critical to rural economic development. Mobile telephony itself provides immense opportunities for informal sector businesses, as highlighted in the January ICT workshop co-hosted by INA at UPNG, with vegetable, fish, flower producers and traders, for example, detailing the advantage of placing and receiving orders and monitoring safe delivery of produce by phone.

Considerable further opportunities for micro-businesses and households will become available with the use of mobile phones transmitting data, including for mobile banking, , including in rural areas. More details of these opportunities will be highlighted in an October workshop on mobile banking which the INA will be co-hosting. The mobile phone effectively removes the handicap of inaccessibility to established bank branch networks, or even the mobile banks being developed in Fiji and Solomon Islands. It even stretches the network of 'barefoot' microfinance agents, but utilises the same principles of lower costs community based networks.

- c) ***Special licenses by Bank of PNG*** - the current microfinance institutions operating in the country are operating on special licenses issued by the Bank of PNG. The need for appropriate licensing arrangements and oversight will be critical for the longer term development of the microfinance industry in PNG, along with adequate linkages for those seeking to 'graduate' to the formal sector
- d) ***Fundamental Pillars in Business*** – Business success is based upon adequate capital, skills including sound management, having the right products and being able to market them successfully and profitably as well as suitable operating conditions (law and order, market conditions etc). The microfinance institutions cannot take on the role of supporting all aspects, but they can work closely with informal sector participants, local authorities and training institutions to help identify suitable conditions for micro-entrepreneurs to operate and thrive on their own, or through group marketing arrangements, including helping identify alternative products and markets, so that the level of

competition is not excessive in the current narrow range of products. Gaining some economies of scale and reducing individual overheads, through affiliations with larger enterprises, including through agro-nucleus enterprises, has recognised advantages, including in the management of credit and savings.

E. Way forward

As a way forward for microfinance institutions, I make the following recommendations;

- i. **Address constraints identified** - Firstly and most importantly, it is absolutely imperative that the wider needs of the informal sector must be given the utmost and coordinated attention (by government, local authorities and wider stakeholders) if the microfinance institutions are to be successful in fulfilling their role effectively. That means the constraints as identified in the 2001 and 2007 surveys, referred to above, must be adequately and promptly addressed by respective authorities;
- ii. **Microfinance governance** – more specific institutional arrangements might need to be established through the Bank of PNG to ensure effective longer term support and oversight for the microfinance institutions. Clearly, the informal sector is not a short term arrangement, but will provide a major economic and social function long into the future, so institutional support (by the authorities as well as the private sector) should recognise this and respond accordingly;
- iii. **Microfinance Institutions Association** – if it's not in place already, an association could be formed for Microfinance Institutions, as with the Bankers' Association, with some public financial support, able to promote the skills and other needs of the microfinance institutions and their clients.
- iv. **Attention on the business fundamental pillars** – Microfinance institutions, whether set up by commercial banks or as cooperative-type entities, have a strong interest in the success of their clients' enterprises. Their clients have less capacity than the banks' clients to access training, market and other support. Monitoring and supporting their clients' needs and capacity will remain a greater function of the micro-financing organisations than the formal sector institutions. The micro-finance providers therefore need to be ready to review existing policies in the light of changing needs, capacity and opportunity in a fast evolving market, including the use of new technology (including mobile phone banking, use of village-based financial outlets etc)
- v. **Set up a separate Authority** - since the informal sector comprises more than 85% of the populace of this country, there is the need for an effective coordinating institution in government focussed on the needs of the informal sector, as there is in other countries like India where they have a separate ministry known as the Ministry of Micro, Small and Medium Enterprises. This needs also to be constantly seeking to knock down the bureaucratic and other institutional barriers for informal sector participants to 'graduate' to the formal sector, including simplifying business registering, operating a bank account, and ultimately paying taxes (apart from VAT). The steps to formalisation or partial formalisation should be simplified and sped up, as far as practical, including through use of new technologies
- vi. **Government must actively dialogue with the private sector** to iron out the impediments to business and investment, whether by large or micro-entrepreneurs, at the national, provincial and local levels. Mechanisms which exist, such as CIMC's informal sector, commerce and services and agriculture sector committees, should be utilised fully and reinforced, whilst others which have become moribund, like the valuable National Working Group on Impediments to Business and Investment, should be restored. Such mechanisms for dialogue are needed at provincial and district levels, to ensure community needs are met, and help oversee the effective utilisation of the considerable District grants now available, which are fundamental to restoring local infrastructure and services, needed by micro, small and medium enterprises and the wider community.

F. Conclusion

When one talks about *microfinance institutions*, one is essentially talking about *informal sector* participants, who comprise the majority of PNG's population, and form its current and potential client base. The potential is immense, and whilst security for credit cannot be provided through land, but rather by long term savings and business performance, building up the credibility of the micro-enterprise, as well as possible community peer group pressure, greater community awareness of business and new technologies and markets can open up opportunities. The potential can, however, be greatly enhanced by government and town authorities taking their infrastructural, law and order and other responsibilities seriously and government and the wider community, including micro-finance institutions, seriously addressing the marketing, training and other needs of the informal sector and small and medium enterprises.

Business of any scale entails risk and some element of choice. Risks cannot be eliminated, but in PNG there is considerable room for them to be considerably reduced. Microenterprises are more jeopardised by risk than larger and more diverse businesses. They also need to be aware of the level of risk and require firm guidance on those risks and the responsibilities when considering borrowing for a new enterprise.