



Republic
of Palau



2022 ECONOMIC BRIEF

Republic of Palau

June 2022

Abbreviations

CURRENCY EQUIVALENTS

Currency unit: United States dollar (US\$)

ABBREVIATIONS

ADB	—	Asian Development Bank
AFPAC	—	Automatic Fuel Price Adjustment Clause
AML	—	Anti-Money Laundering
ATO	—	Australian Tax Office
BPT	—	Business Profits Tax
BSCC	—	Belau Submarine Cable Corporation
CARES	—	Coronavirus aid, relief, and economic security
CCSP	—	Civil Service Pension Plan
CFT	—	Combatting the Financing of Terrorism
COFA	—	Compact of Free Association
COVID	—	Corona Virus ID
CPI	—	Consumer Price Index
CPRO	—	Coronavirus Pandemic Relief Option
CRA	—	Compact Review Agreement

CROSS	—	Coronavirus One-Stop- Shop Relief Act
CSPP	—	Civil Service Pension Plan
CTF	—	Compact Trust Fund
DRP	—	Disaster Resilience Program
DSA	—	Debt Sustainability Analysis
EEZ	—	Exclusive Economic Zone
FAA	—	Federal Aviation Authority
FAS	—	Freely Associated States
FIC	—	Financial Institutions Commission
FMIS	—	Financial Management Information System
FPUC	—	Federal Pandemic Unemployment Compensation
FRDMA	—	Fiscal Responsibility and Debt Management Act
FSM	—	Federated States of Micronesia
GDP	—	Gross Domestic Product
GFS	—	Government Finance Statistics
GNI	—	Gross National Income
GSUSA	—	Graduate School USA
HLDP	—	Housing Loan Development Program
ICT	—	Information and Communications Technology
IMF	—	International Monetary Fund
JICA	—	Japan International Cooperation Agency
KASP	—	Koror Airai Sanitation Project
KSG	—	Koror State Government
LIBOR	—	London Interbank Offer Rate
MTEF-mod	—	Medium-Term Economic and Fiscal Model

NDBP	— National Development Bank of Palau	RPPL	— Republic of Palau Public Law
NIIP	— National Infrastructure Investment Plan	RUS	— Rural Utilities Service
NOAA	— National Oceanic and Atmospheric Administration	SEA-US	— Southeast Asia—United States (cable system)
OAE	— Open Access Entity	SOE	— State-Owned Enterprise
OEK	— Olbiil Era Kelulau	TIS	— Tax Information System
PBL	— Policy Based Loan	UCC	— Universal Commercial Code
PEFA	— Public Expenditure and Financial Accountability	VAT	— Value Added Tax
PEWA	— Palau Energy and Water Administration	VDS	— Vessel Day Scheme
PFI	— Public Financial Institution	WIOA	— Workforce Investment Opportunity Act
PFM	— Public Financial Management	WSIP	— Water Sector Improvement Program
PFTAC	— Pacific Financial Technical Assistance Center		
PGST	— Palau Goods and Service Tax		
PHA	— Palau Housing Authority		
PNA	— Parties to the Nauru Agreement		
PNCC	— Palau National Communications Corporation		
PPEF	— Pristine Palau Environmental Fee		
PPP	— Private Public Partnership		
PPUC	— Palau Public Utilities Corporation		
PSDI	— Private Sector Development Initiative		
PUA	— Pandemic Unemployment Assistance		
PVA	— Palau Visitors Authority		
RFP	— Request for Proposals		
RISES	— Recovery through Improved Systems and Expenditure Support		
RMI	— Republic of the Marshall Islands		

NOTE: Each FAS governments' fiscal year (FY) ends on September 30.



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Disclaimer

The views, thoughts, and opinions expressed in this economic brief are those of the authors and represent an independent assessment of the economic performance of Palau. This document does not necessarily represent the views of the government of Palau, the Graduate School USA, the US Department of the Interior, or any other organization, committee, group, or individual, real or implied.

Foreword

This brief, the fifth of its kind for Palau, has been developed to assist the Republic of Palau (RoP) in implementing the renewed terms of economic assistance under the Compact Review Agreement signed in September 2010 and approved and funded by separate acts of the US Congress in 2018. This brief has also been designed to assist the RoP in overall policy and economic management. It has been developed under contract with the US Department of the Interior's Office of Insular Affairs and administered through the Graduate School USA's Pacific Islands Training Initiative. The brief is intended to assess the RoP's economic performance and policy environment and to present a comprehensive set of economic statistics.

On behalf of Graduate School USA and EconMAP (Economic Monitoring and Analysis Program), the review was authored by Mark Sturton; Glenn McKinlay compiled the statistical data sheet. Additional inputs were received from Kevin O'Keefe and Jason Aubuchon. Special thanks are extended to: Hon. Kaleb Udui, Minister of Finance; Casmir Remengesau, Director of Planning and Budget; Muriell Sinsak and Limei Tesei of the Department of Planning and Statistics; and the many civil servants and business operators from the RoP, who supported the preparation of this brief and its statistical tables.

A digital copy of this review is available online at <http://www.econmap.org>.





1. Key Features in the Brief

Palau's economy is projected to decline by a three-year total of -23% in FY22 from FY19 pre-pandemic levels. Due to the impact of COVID-19, GDP contracted by -8.9% in FY20 and a further -13.1% in FY21, and is projected to fall by a further -2.7% in FY22 before recovery is anticipated. Without the positive support of the CROSS and US CARES Act mitigation programs, the economic impact would have been dire. In the tourism sector FY20, which had been projected to improve to 120,000 visitors from the weak performance in the late 2010s, actually fell to 41,674 in FY20 and to just 3,412 in FY21 due to the global pandemic.

Inflation is currently rising rapidly and projected to reach 13.7% during FY22. After many years of low inflation, prices began rising in 2021. As the global economy emerged from lockdowns, fuel prices increased in Palau. However, there was a lag before the utility prices changed and only a small increase of 0.5% occurred in FY21. However, by the end of the first quarter of FY22, these dampening effects had worked their way through the system and the CPI recorded an 11.9% increase. For the whole year an inflation rate of 13.7% is projected.

Mitigation programs including the CROSS Act and U.S. CARES Act proved highly effective. At the start of the pandemic Palau reacted quickly, passing the CROSS Act by the end of April 2020, and distributing the first financial support in May 2020. The combination of the use of Palau's internal savings, donor support

through the Asian Development Bank, and eligibility under the U.S. CARES Act enabled Palau to maintain momentum in the domestic economy by increasing household incomes, avoiding widespread poverty, and maintaining the social fabric.

Total financing needs of \$103 million or 44% of GDP will be needed to maintain government operations. With the impact of COVID-19 the fiscal position deteriorated rapidly. From a balanced position in FY19 a series of deficits are projected through FY23 until recovery is attained in FY24. Total financing needs amount to \$103 million or 44% of GDP to maintain government operations through the crisis.

External debt/GDP ratio is projected to rise rapidly to 92%. As a result of the pandemic the need for external borrowing is projected to rise rapidly in the short-term and the ratio of external debt to GDP to rise 92% by the end of FY22. While the increase in the debt/GDP ratio is projected to attain record levels, much of the increase is due to the decline in the denominator (i.e. GDP). After peaking in FY22, the ratio is projected to decline rapidly to 56% by FY25 when the economy recovers.

The SOE sector in Palau has underperformed, especially in the power and water sectors. The SOE sector is not large in Palau as compared to other Micronesian economies. However, it has underperformed and poses significant fiscal risk. Reforms are underway at the PPUC to enable full cost recovery tariffs in the power and water and wastewater sectors. If the proposed tariffs are implemented without political involvement, the sector is set for a brighter future.

The Public Financial Institutions sector, Social Security, and the Civil Service Pension Plan are currently unsustainable and pose a significant fiscal risk. A recent actuarial evaluation of SS incorporating recent awards of unfunded benefits, found that the system was at risk of collapse by the end of the decade. A reform process was initiated, and a national consultation process held in November

2021, to design a program of adjustments to ensure long-term financial sustainability. The recommendations of the group have been drafted into law and submitted to the OEK. The CSPP is in even more imminent risk of collapse, with a similar reformation process anticipated.

Palau has undertaken a series of important reforms to the environment for private sector development. Reforms have been enacted into law with a new Companies Act that creates a modern electronic framework. The Act includes improvements to the provisions for foreign corporations doing business in Palau and will ensure compliance with global Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) requirements. Palau has now joined the New York Convention on recognition and enforcement of arbitral awards and enacted the International Arbitration law, which will provide a means of resolution of disputes between foreign and domestic parties. Finally, Palau has developed a framework for Private Public Partnerships and issued a PPP policy statement. With graduation to high income status a PPP framework will provide a needed source of finance for investment and maintenance for infrastructure projects.

The economic outlook looks bleak until full recovery of the tourism industry is attained in FY25. After a successful vaccination program was completed mid-2021 Palau felt ready to revive the tourism industry. However, the major generating nations of Palau's tourism remained firmly closed. Based on the lack of visitors to-date and a bleak outlook for the remainder of FY22, a total of 7,000 visitors has been projected for the year. Looking forward a total of 41,000 visitors is projected for FY23 with 83,500 visitors for FY24, with eventual full recovery to pre-pandemic numbers in FY25.

Palau will continue to operate with fiscal deficits until FY24 when balance is restored. The implication of the slow recovery is that Palau will continue to run deficits through FY23.

If economic recovery continues to be delayed, Palau will either need to consider incurring additional debt or undergo a fiscal adjustment if the downturn shifts from a cyclical occurrence to a structural event and becomes entrenched.



2. Recent Economic Performance

Economic Performance

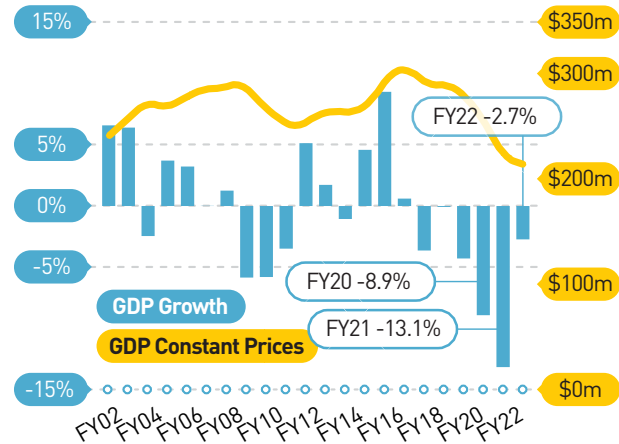
Palau's economic growth has been modest and has displayed considerable volatility. Palau's economic performance during the pre-COVID period FY00-FY19, was modest with economic growth trending at 0.5% during the period¹, see [Figure 1](#). Palau's low average growth during the period reflects high volatility between periods of strong growth in construction and the tourist industry against periods of substantial contraction. During the initial part of the 2000s through FY05 the economy grew by an average 3.4%, which reflected a combination of the construction of the Compact Road and tourism. This was followed by a period of contraction as these forces came to an end and due to the impact of the global financial crisis in 2008 and 2009; that is, overall GDP declined by an average -2.8% during FY05-FY10. After FY10 Palau underwent a tourism expansion phase growing by an annual average of 3.9%, which in turn came to an end in FY15 and the economy once again contracted by -1.9% per annum through FY19 as visitor arrivals contracted to a level only 5.6% above the FY05 level.

Palau's economy is estimated to have contracted by -8.9% in FY20 and a further -13.1% in FY21. FY20 was set to be a good year for the Palau economy as construction activity picked up pace, and in February the tourism industry was set to grow by 30% for the fiscal year. Then COVID-19 descended on

¹ Trends estimated using log-linear regression.

Figure 1: Palau real GDP annual growth, FY19 prices, (%)

Palau economy falls by 9 percent in FY20, and further 13 percent in FY21



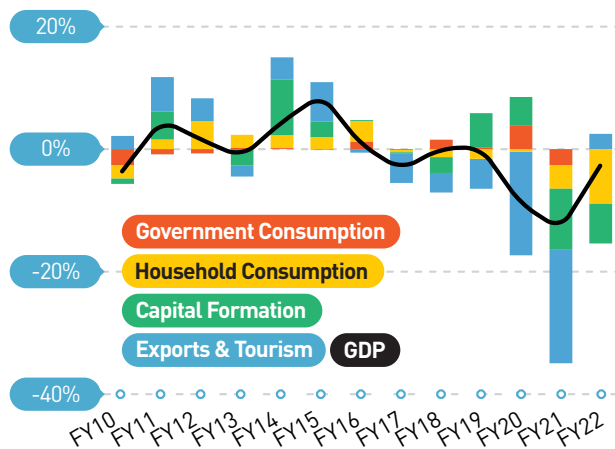
the world and international travel dried up and no further visitors arrived. GDP is estimated to have contracted by -8.9% in FY20 and to have fallen further by an additional -13.1% in FY21 as the full force of the collapse in the tourism economy was felt. The drop in FY21 reflects the virtual disappearance of visitors throughout the entire fiscal year and a reduction in the level of construction activity, but includes the positive impact of the mitigation programs: the CROSS and CARES Acts provisions (described below), see [Figure 2](#).

By the end of FY22 the economy is anticipated to have fallen by -23% compared with pre-COVID levels. Earlier estimates for FY22 had anticipated that the recovery would be well underway to regaining some of the lost ground. However, the current position (June 2022) suggests that visitor arrivals are not expected to show any signs of recovery until FY23. The issues with administration of the US CARES Act resulted in reduced benefits in FY21. However, these were reprogrammed

Economy is projected to fall by 23% by the end of FY22 compared with FY19.

Figure 2: GDE, contribution to growth

Tourism and investment main drivers of economic growth

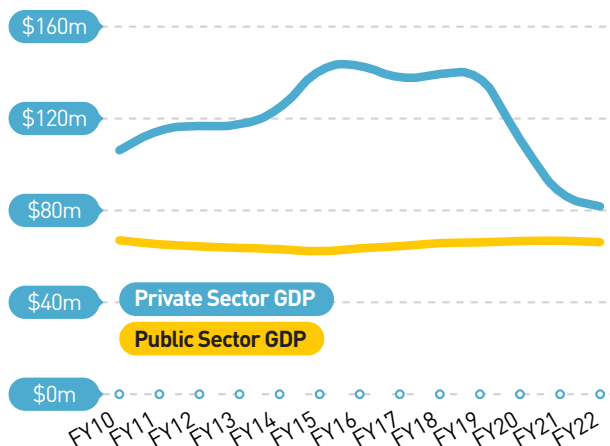


into FY22 and were higher than those paid out in FY21. Last, the construction industry is expected to contract further as projects in the pipeline are completed and not as yet replaced with new ones. GDP is now projected to fall -2.7% in FY22 and by -23% over the FY19-FY22 period.

Private sector experienced most of the impact of the pandemic and is projected to have fallen by -41% during FY19-FY22. Figure 3 indicates the impact of the COVID-19 pandemic on the private sector. While the public sector is projected to remain unchanged—thanks to donor financing to maintain basic services—the brunt of the impact of the COVID-19 pandemic fell upon the private sector. In FY20, a large reduction of -20.9% was experienced, reflecting the collapse of the tourist economy after the end of March and indirect effects on secondary industries. In FY21, a further reduction of -22.7% occurred, reflecting the full-year impact of the reduction in tourism with a further loss of -4.3% in FY22. Overall, a massive loss in output of -41% hit the private sector during the FY19-FY22 period.

Figure 3: Private and public sector GDP, constant prices, FY19

Private sector performance has been volatile and bore the brunt of COVID



Gross National Income per Capita

GNI per capita is projected to decline to \$13,265 in FY22 reflecting the impact of the COVID-19 pandemic while still remaining within the World Bank's grouping of high-income economies. The population of Palau consists of Palauans and a large number of foreign workers, mostly Filipinos. Since 1986, the Palauan component of the population has grown by 0.2%, after allowing for external migration, reaching 12,890 in FY15. The number of foreign residents has grown from 1,550 to 4,771 over the same period, reflecting the increased need for tourism-industry workers. GDP per capita rose by 0.8% per annum in the FY00-FY19 period. Gross national income per capita attained a level of \$15,799 in FY19, placing Palau in the World Bank's high-income group by exceeding the \$12,055 threshold. In FY21 GNI per capita is projected to fall to \$13,870 reflecting the impact of the pandemic while still remaining above the World Bank threshold. This has important implications for the eligibility of Palau for assistance from both multilateral and bilateral donors.

Employment

Early projections of job losses turned out to be less dire than original estimates with final figures indicating 1,692 jobs were lost compared with FY19. The labor market in Palau was comprised in FY19 of 5,539 Palauan workers and a larger number, 5,890, of foreign workers. In normal times the Palauan segment is close to full employment with excess demand supplied by foreign workers. During the FY00-FY19 period the Palauan segment had grown by an annual average of 0.3% with the number of foreign workers fluctuating with the demands of the economy, see Figure 4. Initial projections of the impact of the pandemic on employment suggested that a total job loss of up to 3,100 could be anticipated or 27% of the labor force. However, final employment data for FY21 indicates that 1,692 jobs were lost or 14.8% of the FY19 level. This unexpected result requires further explanation.

The impact of job loss has been mitigated by the private sector retaining workers in many cases on reduced hours to support recovery. Data on employment for the private sector indicates a loss of 1,540 jobs or a 23.6% decline of private sector employment since FY19. However, the Social Security records on

which these figures are based do not account for a reduction in working hours or reduced pay rates that tourism operators have used to offset lost revenues during the pandemic. On a full-time equivalent basis, the loss of private sector jobs would have been considerably higher than the figures imply. The resulting impact of the COVID-19 pandemic on employment thus turned out to be less dire than anticipated due to employers retaining workers on reduced hours to enable recovery and the impact of mitigation programs to offset the impact.

Inflation and Wages

Inflation in Palau has been historically low, but prices are rising rapidly reflecting increasing oil and food prices. Trend inflation in Palau has averaged 2.8% in the FY00-FY21 period and has generally been moderate. Inflation rose rapidly in FY08 reflecting the global financial crisis and rising fuel and food prices, see [Figure 5](#). After FY15 inflation was low, averaging 0.5% through FY21. As of the end of FY21 inflation was 0.5% compared with FY20, but the annual figure masked a set of underlying factors. While food prices increased by 1.2% as compared with a year earlier, the increase of fuel prices after the depressed levels at the start of the pandemic was exerting upward pressure on inflation. The transport component in the CPI recorded an average increase of 18% in the second and third quarters of 2021, but this increase was offset by a -13% reduction in electricity prices during the first and second quarters. However, electricity prices are based on a highly lagged formula, thus, the fall in prices reflected the fuel prices of several earlier quarters.

Inflation rises rapidly in FY22 reflecting international trends. In FY22, the global increase in inflation was felt in Palau and the CPI recorded an inflation rate of 11.9% during the first quarter of 2022 (year-on-year). The impact of rising fuel prices was now felt

Figure 4: Employment by Palauan and foreign workers

Before COVID employment in Palauan segment was stable with changes in demand for labor impacting the foreign workforce

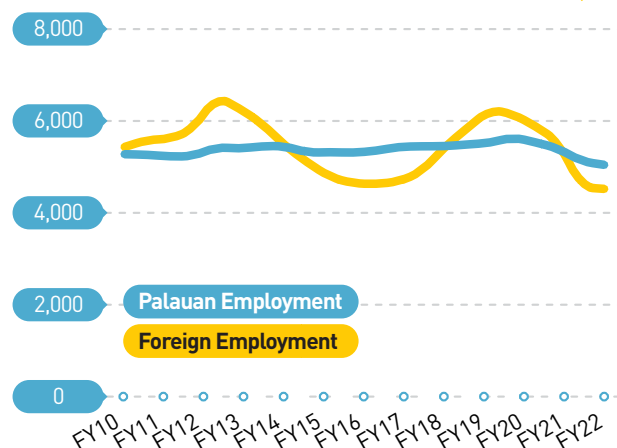
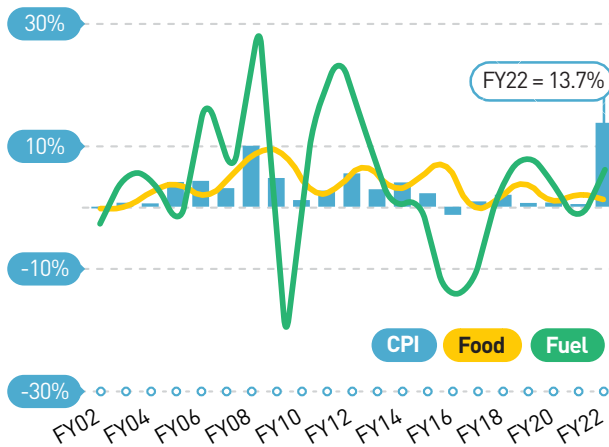


Figure 5: Consumer price index

Inflation is projected to reach 14% in FY22 as fuel and food prices increase rapidly

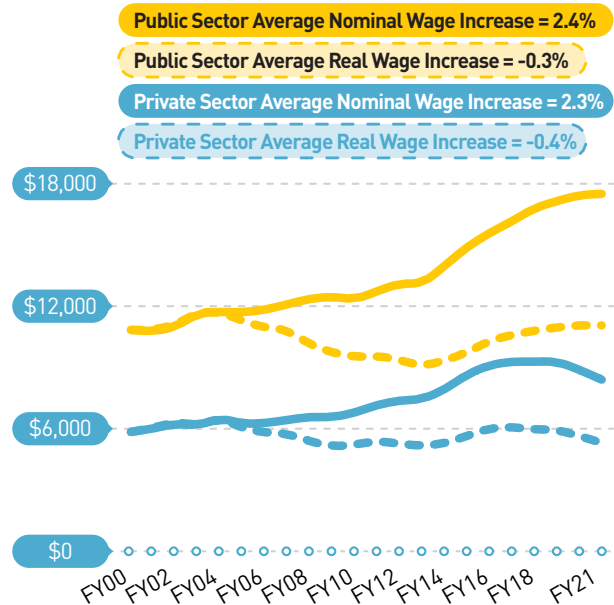


not only at the pump but also down through the PPUC tariff structure. Food prices were also peaking and recorded an average 13% increase in the last quarter of 2021 and first quarter of 2022. While some of the price increases reflect short-term effects following the recovery out of the pandemic, the more recent hikes, which are due to the Ukraine war, will be longer lasting or permanent as markets readjust from reliance on energy imported from Russia and grain shortages.

Real wages have declined in both private and public sectors with a considerable differential between the two. Nominal wages in the public and private sectors in Palau grew in the period of FY00-FY21 by 2.4% and 2.4% respectively. The public sector wages were 84% above those in the private sector in FY19 before the pandemic, see [Figure 6](#). Real wages declined marginally in the public sector by -0.3% per annum and by an average of -0.4% per annum in the private sector. In the near term the impact of inflation on real wages in Palau can be expected to be significant as the large imbalances between demand

Figure 6: Nominal and real wages, FY15 prices

Real wages improved after the tourism boom reflecting low inflation, but private sector wages fell during the pandemic. Public/private sector wage differential remains large



and supply work their way through the global economy. Citizen wages are 55% above non-citizen wages as a majority of Palauan workers are in the public sector and a majority of non-Palauans are in the private sector.

Inflation is projected to reach 14% during FY22.



3. COVID-19 Mitigation Programs and Donor Assistance

The CROSS Act provides support to the private sector to mitigate the impact of the COVID-19 pandemic. After the emergence of the pandemic Palau initiated a series of mitigation programs designed to assist both the affected private sector businesses and households during the period. In April 2020, the President of Palau signed into law the Coronavirus One- Stop-Shop Act (CROSS). A total of \$20 million was appropriated for an eight-month period through the end of January 2021. The law provided a variety of programs to mitigate the impact of the COVID-19 pandemic. These included an unemployment program for all those who lost their jobs, a temporary jobs program for a limited number of individuals, relief to the private sector through a loan program disbursed by the National Development Bank of Palau (NDBP), and a lifeline utility service program for low-income households.

CROSS Act extended through the end of FY21. By the expiration date of the CROSS Act at the end of January 2021, funds used on the program turned out to be considerably less than the \$20 million originally projected. Unused funds available at the end of this period enabled continuation of the program through the end of FY21 and a further extension under the FY22 budget. However, the structure of the program was altered with Palauans transferred to the temporary jobs program and foreign workers returned to their former employers. Foreign work force employees were expected to work 20 hours weekly at the minimum wage

of \$3.50 an hour, with a cost savings from the original \$400 per month to \$280.

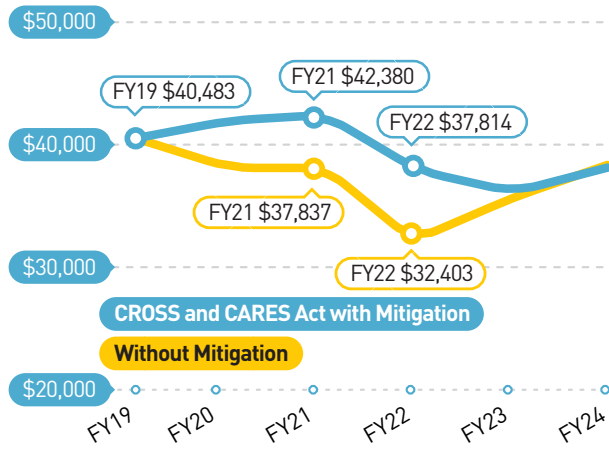
The US CARES program provided an important lifeline for Palauans who became unemployed due to the pandemic: In addition to the Palau CROSS Act, the citizens of the Freely Associated States were eligible for certain unemployment benefits under the US CARES Act through the end of 2020. These benefits were extended through March under the Consolidated Appropriations Act, and again through Sept. 6, 2021, under the American Rescue Plan Act. An original \$13.7 million was allocated to Palau in FY20 but fell to \$10.1 million in FY21 as administration of the program was halted due to irregularities in disbursements. In FY22 these issues were resolved, and Palau received an additional \$19.7 million after the conclusion of the programs in September 2022. The unemployment benefits were provided under two facilities: the Pandemic Unemployment Assistance (PUA) and the Federal Pandemic Unemployment Compensation (FPUC). The PUA provided \$397 a week for Palauans for an effective total of 79 weeks, taking into account the various extensions under US law. Under the FPUC, individuals were eligible for an initial \$600 per week through July 31, 2020, which was extended from January 1, 2021, at a reduced rate, allowing unemployed individuals to receive an additional \$300 per week.

Mitigation programs had large beneficial impacts on household incomes. Without the CROSS and CARES mitigation programs and unemployment benefits, household incomes could have fallen by -6.5% percent during FY19-FY21, which would have resulted in rising levels of poverty in both the Palauan and foreign sectors of the workforce, see [Figure 7](#). With mitigation based on both the CROSS and CARES Acts provisions, however,

Mitigation programs have large beneficial impact in supporting household incomes.

Figure 7: Household impact with and without mitigation

Household incomes fall by 11% between FY19 and FY22 with mitigation, and without mitigation by 19%



average household incomes are projected to have risen in FY21 by 4.7% percent compared with FY19. For FY22 while the CARES Act provisions have officially expired, the remaining unspent funds will enable the benefits to continue. This is a fortuitous development as unlike the United States where the recovery is well underway, in Palau it has yet to start and the remaining funds will continue to mitigate the impact. Overall, the magnitude of the coordinated government and donor response has been both timely and significant. The government and donor community should both take credit for rapid and apparently effective mitigation efforts.



4. Tourism Developments and Policy

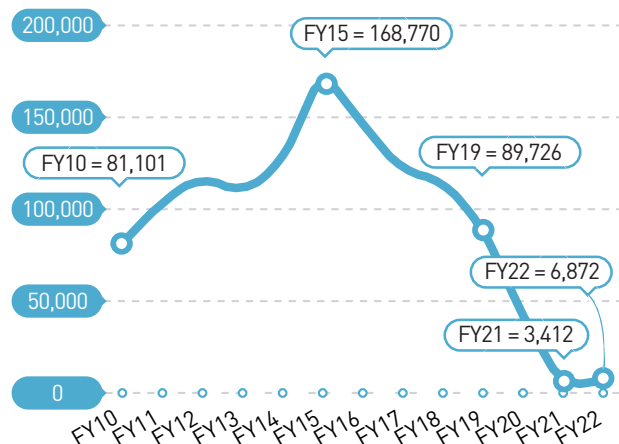
Tourism Developments

The rapid growth in tourism presented special challenges to Palau during the boom period.

In FY15, annual visitor arrivals grew by 34% and recorded a level of 168,700 visitors, an increase of 87,669 visitors above the FY10 level, see [Figure 8](#). From FY16 through FY19 the visitor numbers dropped in each consecutive year reaching a low point of 89,726 in FY19. The original increase in visitors was made possible by the large amount of excess capacity the nation had in tourism facilities; occupancy rates increased from 40% in FY10 to 63% in FY15. The majority of the increase occurred in middle-to-lower-grade establishments with an associated large increase in package-tour visitors, predominantly from China.

Figure 8: Visitor arrivals

After peaking in FY15 visitor arrivals decline to zero in FY21 and FY22 with impact of COVID



The tourism industry collapsed with the onset of COVID-19 and is not anticipated to recover until FY25.

Boom in the tourism industry encouraged new investment, but visitor numbers dropped, and occupancy rates fell to very low levels. In FY15-FY19, the drop in arrivals was strongly associated with a contraction in the Chinese segment of the market. However, there was also a significant reduction in the more traditional, higher spending tourists. The large increase in visitors and improvement in occupancy rates in the mid-2010s encouraged additional construction in hotel facilities just as the industry was undergoing contraction. The drop in arrivals through FY19, coupled with the additional largely unoccupied facilities led to a reduction in occupancy rates to 34% in FY19.

The rapid increase in visitors had a significant impact on government revenues, but the marginal gain from low-spending visitors was less than the average. As a result, the impact on the economy of the upswing was less than the visitor numbers would infer, and on the downswing the impact of the loss was dampened. The fiscal surplus rose significantly to 5% of GDP in FY15 as tourism boomed, taking the government by surprise, and was largely sustained through FY19 despite the reduction in arrivals and falling occupancy rates. The impact of the volatility of tourism on government revenues appears to have been less adverse than was anticipated: a favorable result.

Tourism collapsed as COVID hit but attempts to open a sealed corridor with Taiwan in early 2021 were unsuccessful. FY20 was set to be a better year with 120,000 visitors anticipated, but with the advent of COVID-19 that number dropped to zero by the end of March, even as 41,674 visitors were recorded for the fiscal period that began in October 2019. In April 2021 Palau instigated a “sealed corridor”

or “bubble” with Taiwan permitting travel between the countries and the potential of a slow recovery in the tourism industry. Initial uptake was slow with high costs of tours, restrictions on returning travelers in Taiwan, and hesitancy to travel while the COVID threat remained. As these issues were being resolved Taiwan experienced an outbreak in mid-May 2021 of the Delta variant effectively shutting down the corridor. As in the case of other isolated nations that tried to build a bridge to enable limited recovery in the tourism sector, all attempts proved short lived and unsuccessful.

Recovery in Palau’s tourism economy remains elusive. By mid-2021 Palau had largely completed a comprehensive vaccination program, safeguarded the health of the nation, and loosened its borders in July. While a limited handful of visitors arrived from the United States, including the US military, travel from Palau’s main tourism markets of China, Japan, Korea, and Taiwan remained effectively closed. In late 2021 and early into 2022 Palau underwent a period of rapid community spread of COVID-19, but the impact was contained with 6 recorded deaths. At the time of writing in June 2022 with the earlier waves of COVID largely dissipated, visitor arrivals remain largely nonexistent. China has adopted a policy of COVID-19 zero tolerance and is unlikely to reopen in the near term. The Korean market is showing some signs of reopening, but Japan and Taiwan continue to take a very cautious approach. In addition, lack of readily available airline routes or schedules to Palau, and the high cost of fuel and travel resulting from both the global economic recovery and the Ukraine war, indicate an elusive outlook for tourism recovery. A recent and on-going study by the ADB on the tourism sector indicated that Palau has a very attractive product to offer. However, when this will translate into a sustained recovery remains highly uncertain.

Palau needs a Tourism Master Plan to guide and regulate development as the industry recovers.

Tourism Policy

While the focus of tourism policy is currently on reactivating the industry, there lacks an articulated long-term vision. Palau has adopted a policy to attract high-value tourists but has limited resources/tools to implement the policy. As a result, tourist developments have been virtually unconstrained, and in an unregulated market, the economy has been subject to volatility and large swings in visitors. In 2015 Palau requested support from the ADB to assist with rationalization of the industry. The report endorsed the high-value concept and indicated the need for a comprehensive tourism strategy or master plan. This was further developed under a grant from the US Department of the Interior; however, that effort was limited to producing a Responsible Tourism Policy Framework. While the framework outlined important broad principles, it fell far short of a comprehensive strategy with specified and implementable actions. While the current focus is simply to reignite the industry, the critical long-term issues of the size, location, and type of industry Palau wants to attract remain unclear. The need for a tourism strategy or master plan thus remains unfulfilled. Until a comprehensive approach can be developed, Palau remains subject to the vagaries of market forces and development of an industry that is not of its choosing.



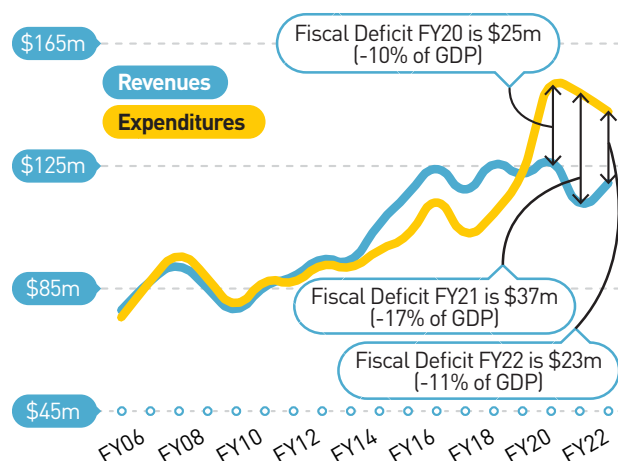
5. Fiscal Performance and Reform

The Fiscal Outturn

Palau has maintained a prudent fiscal policy while running surpluses during the tourism boom years. Between FY05 and FY13 Palau maintained fiscal balance between expenditures and revenue, see [Figure 9](#). During the global financial crisis of FY07 and FY08 fiscal balance turned negative, but the deteriorating position was largely contained. After the recovery in FY14 and reflecting the tourism boom years through FY18, the government recorded surpluses in each year, averaging 4.6 percent of GDP. By the period end of FY18, government deposits had risen to \$43 million, up from a level of \$9 million five years earlier. In FY19 as the number of visitor

Figure 9: Government revenues and expenditures

Palau generates large fiscal surpluses as tourism industry booms, but runs large fiscal deficits during COVID



arrivals fell to a level not seen since FY10, and the fiscal position tightened, the government ran a small deficit of -0.4 of GDP and cash deposits fell to \$31 million. However, despite the reduction in reserves, fiscal prudence during the boom years had established a significant cushion, which would come to serve the nation well during the onslaught of COVID-19.

Total financing needs of 50% of GDP are required to support the fiscal deficit during the COVID-19 crisis. With the impact of COVID-19 the fiscal position deteriorated rapidly. From a balanced position in FY19 this briefing note estimates a deficit of -\$25 million or -10% of GDP in FY20 rising to -\$37 million or -17% of GDP in FY21, as the impact of the pandemic was incurred during a full fiscal period. Not only did tax revenues decline reflecting the impact of the loss of the visitor industry but also Palau embarked on a series of mitigation programs requiring additional expenditures under the CROSS Act. Given that recovery of the tourism industry is not anticipated to get underway until FY23, a further deficit of -\$23 million or -11% of GDP is projected for FY22 and of -\$18 million or -7% in FY23 before full recovery is achieved by FY24. Total financing needs thus amount to \$103 million or 44% percent of GDP to finance Palau through the crisis. However, in addition to the national government's funding needs, Koror state has requested loan finance of \$15 million to support the state through the extended downturn now experienced due to COVID-19. Adding Koror state needs to those of the national government, total funding of \$118 million or 50% of GDP can be anticipated.

Total financing needs arising from COVID-19 could reach 50% of GDP in order to keep government open and sustain mitigation programs.

Available financing will not be sufficient to support government operations of both the national and Koror state governments through the projected recovery period. To finance the deficit Palau requested funding from the ADB to support the nation through the crisis. A series of loans were initiated: (i) a \$15 million facility under the DRP (Disaster Resilience Program) (ii) \$20 million under the CPRO (COVID-19 Pandemic Relief Option, and (iii) a further \$55 million under the RISES program (Recovery through Improved Systems and Expenditure Support), a Policy Based Loan (PBL), comprised of two subprograms. The first tranche conditions of the loan, subprogram 1 were met, and Palau received \$25 million of budgetary support in March 2021, which funded government operations through the end of FY22. The second tranche, or subprogram 2 of \$30 million required a further set of deeper and more demanding reforms. Palau has now fulfilled the conditions and is awaiting fund release after processing through the ADB's Board. Total funding from the ADB of \$90 million will thus not be sufficient to cover both the national and Koror state needs of \$118 million through the end of FY23.

Fiscal Responsibility and the RISES program

RISES program is based on the development of a Fiscal Responsibility Framework. Under an ADB supported technical assistance project in late 2018, a fiscal strategy was outlined for Palau. The core of the strategy was that Palau should adopt a fiscal responsibility framework for the implementation of fiscal policy. This was to form the guiding elements of the ADB RISES loan program, designed to assist Palau through the pandemic and establish a sound fiscal framework during recovery. The main elements of the RISES Program are:

1. Policy and legislative framework for public financial management
 - a. Fiscal Responsibility Law

2. Components of the FRDMA
 - a. Tax reform
 - b. Development of a Fiscal Strategy and preparation of the FY22 Economic and Fiscal Update
 - c. National infrastructure plan
 - d. External debt management law and policy statement
 - e. Social Security reform
3. Private sector reforms
 - a. Private public partnership framework
 - b. Arbitration law
 - c. Corporations law and registry

The elements of the RISES program are discussed in the following sections.

Fiscal Responsibility Framework

Standard principles of fiscal responsibility are extended for Palau. Many countries have developed a fiscal responsibility framework with New Zealand and the Cook Islands in the South Pacific being the prime examples. The standard set of principles has focused on (i) maintaining expenditures within revenues, (ii) managing debt prudently, (iii) predictability in the tax regime, and (iv) managing risk prudently. In Palau this list was extended to ensure a medium-term framework was adopted in budgeting, that capital assets and the COFA Trust Fund would be maintained in real terms, tax reform would include a VAT and equity between wage earners and businesses, and that adequate reserves and insurance would be maintained to cover cyclical and climate events. Last, the principles indicated that management of the SOE sector would be maintained on a commercial basis and that pension funds would be managed soundly without need for ongoing government subsidies or transfers.

Tax Reform

The tax reform bill was passed into law in September 2021. After a long history of attempts to modernize the tax regime Palau decided to place a major focus on tax reform as part of the RISES program. An earlier version of a proposed PGST bill under consideration in 2018 was resurrected, a new section on business profits added, and coupled with various revisions for recent developments, the bill was transmitted to the OEK by the president in January of 2021. The bill went through a series of hearings, state level townhall meetings and has been widely debated. An economic symposium was held in May supported by the Chamber of Commerce and the bill was passed into law in September 2021. The main features of the new law are:

1. A Palau Goods and Service Tax (PGST) at 10%,
2. **Excises taxes** to replace former import duties.
3. A Business Profit Tax (BPT) at 12%
4. Medium size business will remain on the **Business Gross receipts Tax** and small businesses will pay an **annual fee**.
5. Reform of the **Wages Tax** with zero rate collected on Palauans with wages less than \$15,000. Top marginal rate of 12%.
6. The **hotel-room occupancy tax** will be reduced to 10%.
7. Introduction of a nominal **carbon tax**.

The key challenge for successful implementation of the tax reform is the tight schedule requiring the reforms be fully ready for implementation by the end of 2022. In accordance with law a PGST Steering Committee has been created and initial meetings convened. A full-time tax advisor has been recruited to drive the process, and regulations are being drafted. Additional support has been obtained from the Pacific Financial Technical Assistance Centre to help



establish a modern tax administration with legal support in drafting of regulations and corrections to the original legislation. The Bureau of Revenue and Taxation will require implementation of modern business practices as well as training in the new tax regime and use of the software. The private sector will also need to prepare for the introduction of the new taxes, filing, and reporting. A review of the current Tax Information System (TIS), used for the legacy tax regime, has been undertaken with recommendations that it be upgraded with

extensions to enable a basic implementation of the reforms by the end of 2022. The Australian Tax Office will be supporting this effort to ensure that the proposed business practices will be reflected in the system code. However, the current TIS was not considered to be a robust system for long-term support of a modernized tax regime. A procurement process will be established, and an RFP developed to specify the long-term needs of the tax regime and modern tax administration. The most cost-effective qualifying solution will be selected.

The principles of Fiscal Responsibility

In November of 2021 the OEK passed, and the president signed into law the Fiscal Responsibility and Debt Management Act (FRDMA, RPPL No. 11-13). The principles of Fiscal Responsibility are defined as:

- A.** The government shall pursue its policy objectives in accordance with the following **principles of responsible fiscal management**:
1. Manage **operating expenditures** over the medium-term within operating revenues and in relation to the rate of growth of the economy;
 2. Manage net **capital and financial assets**, to achieve rising real national net worth over time;
 3. **Manage debt** prudently;
 4. Manage the **revenue regime** to best fit the structure of the economy, to provide for an equitable allocation of tax burdens, and to allow for predictability over time;
 5. Manage **reserves and insurance coverage** to offset cyclical volatility, the costs of natural disasters, and the impact of climate change;
 6. Manage the non-primary government public sector prudently including ensuring **State Owned Enterprises and Public Financial Institutions** are managed to deliver services on an effective and financially sustainable basis; and
 7. Manage **fiscal risks** and contingent liabilities prudently.

- B.** Notwithstanding sub-section A above, the Government may **depart from the principles** of responsibility provided the:
1. Departure is temporary;
 2. President states the reason for the departure;
 3. President indicates the period of time required to return to adherence to the principles; and
 4. Should any such circumstances arise which force departure from these principles during the fiscal year, they must be timely disclosed in accordance with the provisions of the FRDMA.

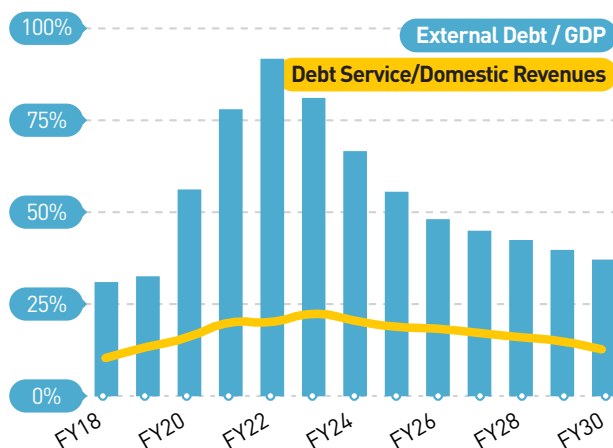


6. External Debt

External debt/GDP ratio is projected to rise rapidly to 92% of GDP to finance the impact of the COVID-19 global pandemic. As a result of the COVID-19 global pandemic the need for external borrowing is projected to rise rapidly in the short term (see [Figure 10](#)). External debt is expected to rise from a level equivalent to 31% of GDP in FY18 to 92% of GDP by the end of FY22. While the rise in the debt/GDP ratio is projected to attain record levels, much of the increase is due to the decline in the GDP. In FY21, revaluating the ratio based on the average level of nominal GDP in the FY16-FY18 period indicates the structural level of debt/GDP is about 22% lower. After peaking in FY22, the ratio is projected to decline rapidly to 56% by FY25 after the economy recovers. For a country of Palau's level of income, the

Figure 10: External debt and debt service, % GDP

External debt rises to alarming heights due to COVID financing



IMF considers a debt to GDP ratio in excess of 50%-60% as an indicator of debt stress. After the recovery Palau's debt is projected to decline slowly, but regular conduct of debt sustainability analysis (DSA) is still important.

While COVID-19 has been the main cause of the rapid rise in debt, Palau has also incurred significant debt for other reasons. While much of the rise in external debt, \$90 million, is due to COVID-19, Palau has also incurred significant debt for other purposes: the Taiwan HLDP loan of \$15 million for housing and subdivision, an additional ADB PBL for PPUC of \$10 million, and \$15.75 million for the second internet fiber project. In all, recent additional non-COVID borrowing totals \$41 million or 14% of GDP.

External debt service is projected to rise significantly but should not result in a high risk of debt stress. Debt service, that is, payments made to satisfy debt obligations, follows a similar but less extreme pattern. From representing 10% of government domestic revenues before the crisis in FY18, debt service, including SOE payments, rises to 23% in FY23 and declines thereafter as the economy recovers. Removing the SOE component from legacy borrowing, national government debt service is projected to stabilize at around 13% of domestic revenues in FY24. After a period where debt service has been a minor component of the national budget, it will end up consuming a significant but manageable proportion. While the level of debt Palau will incur is large by historical standards, it should not, given fixed low interest rates on many loans and the concessional nature of the debt, pose a high risk of debt stress. Return of growth in the economy, the tax reform initiative, and careful control of expenditures should enable Palau to maintain fiscal and economic stability in the years ahead without risk of debt stress.

The Fiscal Responsibility and Debt Management Act lays the groundwork for the management of external debt. The passage



External debt is projected to reach 92% of GDP in FY22 but to fall below 60% by FY25.

of the FRDMA has laid the groundwork and framework for the management of external debt with the establishment of an institutional capacity to monitor and assess the incurrence of new debt, and to conduct a periodic debt sustainability analysis (DSA). A debt management policy statement has been issued and outlines the framework for debt management. A debt management unit has been created and is being established to:

1. Provide technical review on every proposed borrowing and every proposed issuance of a sovereign guarantee, in particular, assessment of the various risks involved, terms and conditions of borrowing, and debt-servicing strategy;
2. Assist the minister of Finance to develop and maintain a debt management policy for consideration by the president;
3. Develop and utilize a project appraisal and approval framework for the assessment of loan-financed projects and to provide subsequent advice to the minister of Finance; and
4. Undertake a periodic DSA to support the debt management component of the Annual Economic and Fiscal update as set forth in the FRDMA and render its opinion or advice thereon to the minister.



7. Public Financial Management

Public Expenditure and Financial Accountability

PEFA provides a suitable measure of financial management that shows investors and donors that Palau is financially sound and well managed. The PEFA is a framework for the assessment of public financial management (PFM) developed by the World Bank and a group of international donors. It has been implemented in many countries and provides an objective yardstick by which countries can assess and improve their PFM performance. It contains 7 major areas of public financial management and 31 individual topics. The components of the RISES program and elements of the fiscal responsibility framework all feature prominently in the PEFA. As Palau graduates from developing country status to high income, it will need to show financiers and donors that Palau is a financially sound and well-managed nation. The PEFA provides a desirable and objectively verifiable method to assess reform efforts, which the nation can present to investors and rating agencies.

Update of Palau's former PEFA assessment will provide a useful tool to assess the impact of the PFM reforms under the RISES program. In March 2013, Palau invited the Pacific Financial Technical Assistance Center (PFTAC) to assist the nation in the preparation of a Public Expenditure and Financial Accountability (PEFA) self-assessment. The next stage in the PEFA process was for Palau to undergo a formal external assessment,

which was planned for 2019. However, due to COVID-19 the program was delayed and is now rescheduled for late 2022. With the assessment complete, Palau will then be eligible to request that PFTAC assist in the preparation of a road map to improve the PEFA score. With the various reforms initiated and underway as part of the RISES program, the PEFA exercise would provide an ideal means of assessment of Palau's improvement of PFM.

Financial Management Information Systems (FMIS)

New FMIS has been successfully implemented but first audit under new system is considerably delayed. The former FMIS used in Palau has now been replaced by the Tyler-Munis system utilizing funds provided from the Compact Review Agreement. The implementation program was successfully conducted mid-FY20, and the system is now deployed and operational; however, tidying up of data from the previous information system has taken time. The FY20 audit remains outstanding as it was delayed due to COVID-19 and the adoption of a new system. The FY20 audit due June 30, 2021, is now targeted for completion a year later and the FY21 audit is due to be completed by the end of 2022, which is six months behind schedule. The system is used by many US governmental agencies and will fulfill compliance with US government accounting standards. The system has a broad array of reporting options, which will require some time to learn and take advantage of.

New FMIS does not integrate GFS or performance budgeting management reports. The original intent was that the new system would provide statistics compatible with the IMF standard Government Finance Statistics (GFS) to support management and fiscal policy design. While some chart of accounts improvement was undertaken the new system essentially remains non-compliant with the GFS standard, which is

a PEFA component. GFS statistics can be compiled but require a separate data dump, establishment of correspondence tables, and development of routines to produce standard GFS tables. In addition to the GFS a similar integration of output/performance budgeting into the new FMIS would have been desirable. Thus, the new system has been successfully implemented fulfilling accounting needs but does not provide integration with either fiscal reporting or modern budgeting requirements.

Public Sector Payroll

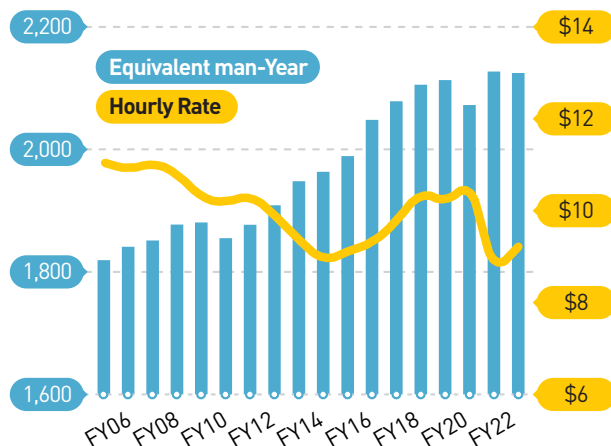
Government maintains tight control over the size of the civil service and payroll cost. An important component of PFM and fiscal policy is control over payroll cost. Recent trends in government payroll indicate a slight increase in equivalent person-years of 0.1% per annum between FY05 and FY22, see [Figure 11](#)². Hourly rates of pay (including benefits) have risen from a level of \$8.92 per hour to \$12.99, which is an average annual growth rate of 2.5%; however, once the cost of living as measured by the CPI is factored in, real government wages have fallen by an average annual rate of -0.1% (FY05-FY21). While the total cost of the government payroll (GFS) has risen by an annual average rate of 2.5%, payroll costs have fallen as a share of total expense, which has remained largely constant in relation to GDP. In effect government policy has been to keep tight control over payroll cost; however, other areas of expense have grown. While the reduction in payroll cost is a favorable outcome, the implicit increase in expense directed to other government entities and SOEs is a source of concern.

² The implementation of the new FMIS in mid-FY20 has generated some minor discontinuities in the series, and the data should be interpreted cautiously.



Figure 11: Government payroll: equivalent man-years and hourly wages

Government payroll (equivalent man-years) has been tightly controlled



8. State Owned Enterprise Reform

The SOE Sector

The SOE sector is small in Palau but poses significant fiscal risk. The SOE sector in Palau is smaller than those in other Micronesian economies. There are four major SOEs: the Palau National Communications Corporation (PNCC), the Palau Public Utilities Corporation (PPUC), the National Development Bank of Palau, and a more recent addition, the Belau Submarine Cable Company (BSCC). The provision of airport operations remains, however, a government department, as is the Post Office, and the port is owned by Koror State but operated by a private company under a 25-year concession. The operation and upgrade of the airport terminal has been restructured under a Joint Venture between the government, JICA and a private Japanese corporation.

The SOE sector in Palau has underperformed, especially in the power and water sectors. An assessment of the private sector conducted in 2017³ found a series of weaknesses related to the management and operations of the SOE sector. The report indicated that there was no legal framework to support the commercial operations of the sector, and unsurprisingly the sector had performed poorly. Board members were frequently political appointees and frequently lacked experience in the functions of the

³ Private Sector Assessment (PSA) of Palau: Policies for Sustainable Growth Revisited: A Private Sector Assessment for Palau, the Pacific Private Sector Initiative, Sydney, Australia, 2017.

SOE sector underperforms but adoption of full cost recovery tariffs currently under implementation in power, water, and wastewater will issue in a brighter future.

SOE. SOEs are not required to operate on a commercial basis and prices have been set at “affordable” rather than commercial rates. There is no monitoring mechanism of the sector and corporate planning was found to be weak. As a result, maintenance is often insufficient and excessively deferred, resulting in disruption of services and, ultimately, in higher capital costs.

Government is to consider enactment of the 2014 SOE policy statement into law to guide the operations and monitoring of the sector.

In 2014 the president issued an SOE policy with the primary objective that SOEs should operate commercially as successful businesses, which would allow them to recover all their costs, including the costs of capital. A set of policy principles was outlined to support the primary objective: These include specification of community service obligations (CSOs), appointment of qualified directors excluding political appointees, preparation of annual statements of corporate intent, business plans, performance monitoring, and benchmarking. Enactment of the SOE policy statement into law is part of the administration’s recently published Fiscal Strategy. However, management of the SOE sector without political involvement will require a significant departure from past practice.

Reforms in the utilities sector

POWER GENERATION AND DISTRIBUTION

PPUC engages with the ADB for a power sector policy-based loan to avoid insolvency.

PPUC is responsible for both power generation and distribution and, since 2013, the provision of water and wastewater services. In the power division PPUC has operated on a cash-flow basis well below cost recovery levels. Management results have been weak, and maintenance of plant has been deferred due to the weak financial position. In 2020 PPUC was reported to have been insolvent. As a result of the emerging crisis the ADB was requested to support a series of reforms through a policy-based loan, that is, Palau Public Utilities Corporation Reform Program. Subprogram 1 of the loan, entailing financing of \$5 million, contains four key areas: (i) tariff reform and adoption of full cost recovery, (ii) financial management improvements, (iii) corporate governance improvement, and (iv) market access for private sector participation in the development of renewable energy. The full cost recovery tariff has now been adopted, but there remain several weaknesses.

The automatic fuel price adjustment clause (AFPAC) is heavily lagged and needs reformulation.

The lagged structure of the AFPAC in the tariff has resulted in electricity prices being significantly out of alignment with international oil prices. As international oil prices rose with the recovery in the world economy after COVID-19, the AFPAC price adjustment still reflected prices before the oil-price hikes. The AFPAC needs revision to allow price setting to reflect current prices as well as for adjustment of over or under prior payments.

The current rate of subsidy to PPUC is not financially sustainable.

Given the recent rise in prices and subsequent large upward adjustment in the AFPAC, the FY22 budget incorporated a \$2.55 million subsidy to the



PPUC to offset the rapid price increase. In early 2022 an additional \$1.4 million subsidy was granted to PPUC to reduce the tariff to residential customers by \$0.10 per kW/hr for the consumption of the first 500 units. While the desire to offset the rising costs of living has been widespread in many countries, the current increase in fuel prices is likely to remain for the foreseeable future as the world oil market adjusts to a reduction in demand for Russian products and offsetting increases from other markets. As argued in other economies it would be preferable to provide a subsidy to low-income households and let them allocate the benefits to fit with their priorities. In Palau's case the large reserves built up from COVID-related borrowing from the ADB has provided a source of funds for the increased subsidies. In the longer term the current rate of subsidy is not sustainable and eventual adjustment will be unavoidable.

WATER AND WASTEWATER SERVICES

Water and wastewater services operate at significant loss and well below full cost recovery. In 2010 Palau initiated a Water Sector Improvement Program WSIP with \$15 million in funding from the ADB. The program was intended to (i) initiate the legal and policy framework for water sector improvement, (ii) establish an independent corporation for improved water services, (iii) adoption and achievement of full cost recovery in the sector, and (iv) effective public consultation. While it was recommended by the ADB that water services would be established as a new SOE, the delivery of water services, formerly provided through a government department, were merged with the PPUC. While the WSIP program was followed with increases in water tariffs, they were not sufficient to achieve full cost recovery, and PPUC continues to record a large operating loss. Based on the FY19 audit, revenues are about 56% of total operating costs.

Subprogram 2 of the PPUC PBL is focused on water services with a central target to

achieve full cost recovery. In mid-2022 the original ADB funded Palau Public Utilities Corporation Reform Program was extended through Subprogram 2 intended to focus on water and wastewater operations. The program, a policy-based loan, with further funding of \$5 million, was primarily intended for improvements in the water sector but also maintained support for corporate and financial management. The program entailed: (i) tariff reform with adoption of full cost recovery and subsidies for low-income households subject to regulatory oversight through the Palau Energy and Water Administration, (ii) enhanced financial management, (iii) enhanced corporate government, and (iv) provision for market access for private-sector participation in the energy sector. At the current time Palau is in negotiation for the provision of a power purchase agreement with a private contractor through a Private Public Partnership. The solar battery backup project will provide a significant portion of Palau's energy needs, replacing fossil fuel generation with renewables.

The original Koror-Airai sanitation project is nearing completion, but unfinished work requires an extension. The second ADB-supported program in the utilities sector, the Koror-Airai Sanitation Project (KASP \$28 million), entails substantial upgrading of infrastructure, and is due for close out in August after many years of delays. A second phase of the project, KASP II, was proposed to complete the remaining unfinished work (\$25 million) but was deferred due to cost implications. At the current time, funds are being sought to complete the remaining elements of the Koror system although the Airai section will remain incomplete.

Implementation of full cost recovery in the water division of PPUC, including debt service of the KASP, will require strong political will. As indicated in the discussion on the WSIP operating revenues represented 56% of cost during FY19 and indicate there is a long way to go to achieve full cost recovery.

However, once the debt service on the KASP and any future extension is taken into account, very significant increases in tariffs can be expected. In accord with the conditions of subprogram 2, PPUC has prepared the full cost-recovery tariff and a tariff petition has been delivered to PEWA. Public hearings are to take place on the new tariff before approval by the regulator.

ICT Reforms

Laying of new fiber optic cable connecting Palau to the internet backbone has significantly improved internet access.

Reforms in the Telecom sector have progressed positively with the creation of the Palau Submarine Cable Company, an SOE created to manage a new fiber optic link to the internet backbone and funded through a loan from the ADB. Palau has partnered with the SEA-US cable project linking Indonesia, the Philippines, Palau, and Yap to Guam, Honolulu, and the US mainland. Laying of the cable was commissioned at the end of 2017 and is now operational. ICT services had been very poor in Palau with some of the highest prices in the Pacific region resulting in a “repressed” market, that is, where demand was artificially low due to high pricing.

Moratorium on competition in the ICT market extended for 5 years. A key element of the ICT reforms was the passage into law at the end of 2017 of a Telecom reform bill supported by the World Bank. The new law enables competition in the marketplace and removes the monopoly and protected position held by the existing providers, including the Palau National Communications Corporation. The

law also creates a new regulatory office, the Bureau of Communications, in the Ministry of Infrastructure, Industries and Commerce, which will regulate the sector and issue licenses to potential new entrants. The original law provided a moratorium of up to 3 years on new entrants, but this has now been extended to 2025.

Palau embarks on second fiber project PC2.

In addition to the original cable project (PC1) BSCC is currently engaged in implementing PC2, a second fiber project to guarantee connectivity and provide redundancy should there be a failure or break in the initial cable. The PC2 project will involve a 110-km link with a large-capacity submarine optical cable that connects Southeast Asia and the U.S. mainland (Echo subsea cable system). Financing for the project stems from a series of sources, which include Japan (\$8 million in loans), Australia (\$7.75 million in soft loans), and US Compact and other grants (\$11.8 million).

Palau needs to complete the internet project and investment made in the two fiber projects of \$55 million with connectivity to the home/premises.

As a result of the two fiber projects, Palau will now have reliable high-speed access to the internet. However, the fiber connection only provides a trunk to the major telecom hubs in Airai and Koror and is yet to be distributed to the home/premises. After the initial boost to the internet experience in Palau resulting from PC1 in 2018, there has been little improvement in service or cost. The current infrastructure only supports relatively slow speeds through the antiquated copper system insufficient to support the uninterrupted internet-based calls that are now commonplace in the COVID era. PNCC has made an application under the RUS ReConnect Loan and Grant Program to replace the existing copper infrastructure with fiber to the home/premises. The RUS program is competitive and permits applications up to \$35 million but requires applicants to provide 100 Mbps symmetrical

ICT services have improved tremendously, but extension of fiber network to the home/premises is required to reap the benefit of large investments.



services. Should the application be successful Palau will be able to complete the original intent of the ICT project by providing coverage to nearly all parts of the nation.

Pricing of internet service requires review to bring down costs to the consumer. The second area of required reform is in the pricing of bandwidth to consumers, which remains high. There are two levels of price setting: (i) retail prices charged by ISPs (internet service providers) to the consumer and (ii) wholesale prices charged by BSCC to ISPs. Regarding the former the COVID era has not been conducive to greater competitiveness as PNCC has struggled to remain financially viable. However, as tourism and PNCC's market returns, downward adjustment is needed to encourage greater internet penetration and usage. At the wholesale level BSCC is a nonprofit organization with a mandate to price services that will lead to full cost recovery in the long run. The current pricing model entails a series of price bands per gigabit that is contracted for. An alternative mechanism would be for BSCC to apportion its cost across all ISPs according to their revenues from the sale of ICT products. Such a model has been considered in the FSM, which has a similar structure: a nonprofit open access entity (OAE) providing bandwidth to retailers. Under such arrangements BSCC financing objectives would be achieved, but, more important, the marginal cost of using BSCC's assets by ISPs would be zero, thus enabling considerable cost reductions to spread through the system.



9. The Financial Sector

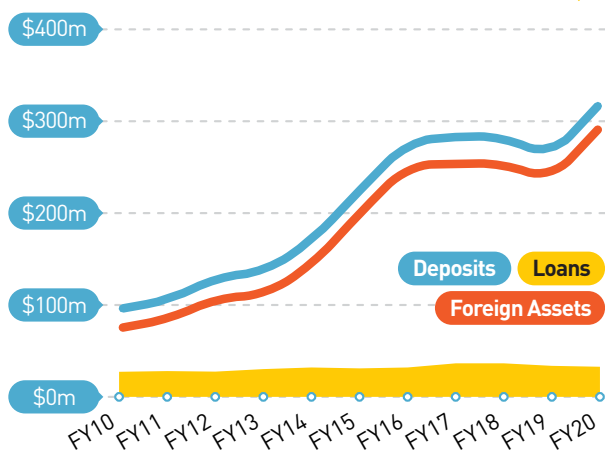
Banking

Deposits grew rapidly in Palau during the tourism boom years and after a period of stagnation rose rapidly during COVID-19. The deposit base in the Palau banking system (\$263.8 million in FY20⁴) grew very rapidly in the tourism boom period FY11-FY16, which reflected the booming economy, foreign direct investment, and land- lease purchases, see [Figure 12](#). After the peak in tourism in FY15 the deposit base stagnated and contracted in FY19 with the weak economy. However, in FY20 deposits grew rapidly in all sectors. Government deposits reached high levels

⁴ The Palau banking statistics are undergoing revision and reliable FY21 data is not yet available.

Figure 12: Commerical bank deposits, lending and net foreign assets

Commercial bank lending remains weak; funds invested offshore; deposit growth picked up during COVID



reflecting large yet-to-be-spent COVID-related borrowing. Both the private and household sectors recorded growth in deposits despite the massive contraction in the tourism industry. Households reflected the observed trends in other countries, that is large unemployment benefits and lack of consumption opportunities led to accumulated savings and deposits due to the uncertainty of the time.

Private sector credit remained low even during the COVID period as businesses had to cover fixed costs as sales disappeared.

While deposit growth has been rapid, lending performance to the private sector has been weak. Before the pandemic lending to the private sector in FY19 was \$33.7 million and represented only 12.9% of the deposit base, probably the lowest in the region. In FY20 despite the dire state of the private sector, credit to tourist operators remained subdued reflecting caution both from lenders and borrowers alike. The difference between the large deposit base and low level of credit is invested offshore in commercial bank foreign assets, which in FY20 stood at \$290.5 million.

Structural weaknesses have inhibited commercial lending in Palau, but it is hoped tax reform will encourage broader preparation of financial statements and access to credit.

The low rate of domestic lending reflects the perceived high risk of lending in Palau and a persistent perception of a “lack of bankable projects.” Overall, the inability of businesses to prepare credible business plans and financial statements, lack of collateral, the limited ability to use land as security, and inadequate provisions to secure transactions have inhibited development of the financial sector. Hopefully, the tax reform initiative, with the need to prepare tax returns after the introduction of the PGST and business profits tax, will provide a source of information for the support of loan applications. With limited opportunities, foreign commercial banks, coming under FDIC insurance and banking regulation, have preferred to invest their assets offshore in less risky and more secure markets.

Social Security Sustainability

Unfunded liability is not considered a useful singular metric to assess the financial position of SS sustainability. The accrued liability of the Social Security system at the time of the last actuarial report in 2020 was \$550 million. The value of the assets of the fund was \$112 million indicating an unfunded liability of \$438 and a funded ratio of 20 percent. This was a considerable apparent deterioration since the previous assessment conducted in 2018, which indicated a funded ratio of 35 percent. The reasons for the deterioration include different assumptions in the investment return that contributed 9 percent of the reduction, increase in longevity of 3 percent, and other differences of 3 percent. However, while the funded ratio provides an indicator of the resources needed today to meet SS liabilities, it is not considered a useful singular metric in a defined benefit system designed to meet a nation's basic pension needs in old age. A more useful measure is the curve of projected cash-flow balances accounting for contributions and benefits over the long term.

The Social Security system has undergone a series of increases in benefits and adjustments to maintain sustainability.

A set of three supplemental benefits have been awarded of \$50 each per month per beneficiary. The first was awarded in October 2014, the second in October 2017, and the third in April 2020. The second award was absorbed into the SS and accompanied with an increase in the contribution rate from 6 percent to 7 percent. The other two awards were unfunded and require an annual transfer from the national treasury. In FY19 \$2.1 million was transferred; in FY20 the transfer rose to \$2.8 million. In FY21 transfers were \$6.7 million. In FY22 \$2.0 million was included in the budget with the second supplemental to be funded from SS reserves. The original cap on wages of \$5,000 per quarter subject to SS contributions has now been abolished.



Recent actuarial evaluation of SS finds the administration is at risk of collapse, but reforms under consideration will ensure long-term financial sustainability.

Actuarial evaluation indicates SS is in a rapidly deteriorating financial position.

Until the recent actuarial assessment the conventional wisdom had been that the SS system was on an even, if not fragile, keel. The revised assumptions, especially concerning the need to incorporate the two remaining unfunded supplemental benefits into the evaluation coupled with a lower rate of return on investments, turned the outlook from cash-flow balance into a rapidly deteriorating financial position. Fortuitously, the ADB RISES program included the need for an evaluation of SS coupled with reform options and recommendations for changes in law as part of the program commitments. After the original evaluation was completed, a working group was created to develop suitable reforms to present to a wider audience at a participatory forum of stakeholders. In November 2021 a national consultative process was convened and attended by many members of Palau's leadership, including private sector representatives and other stakeholders. A set of reforms were thrashed out in two subgroups and in plenary were consolidated into a consensus.

A national consultative process crafts a series of reforms to place SS on a sustainable basis. These proposed reforms have been crafted into draft legislation and transmitted to the OEK. The consensus view was that the contribution rate should be increased from the current 7% to 9%, the retirement age should be extended to 65, and full benefits would accrue after 35 years of service. Pension benefits would be adjusted for inflation but slightly less than the full

increase in the CPI. The view was that SS should operate on an independent basis and without subsidy. Younger participants felt that the increase in the contribution rate was important to maintain the financial soundness of the system; however, this would involve sacrifice by the private sector. The results of these proposals and adjustments in spouses and dependent benefits were drafted into a reform bill that has now been transmitted to the OEK for consideration. **Figure 13** displays the outlook for SS both before and after the reforms. Without reform SS is projected to collapse by FY30.

Civil Service Pension Fund

With reforms of the SS underway, the Civil Service Pension Plan (CSPP) presents an even greater challenge. In December 2021 an actuarial evaluation and financial assessment of the CSPP was undertaken (Callund report). The findings of the assessment confirmed, as was already well known, that without reforms or injection of cash, the CSPP would collapse by the end of FY28. The Callund assessment indicated that CSPP had an accrued pension liability of \$219 million, and that plan assets

Figure 13: Social security fund investments, contributions and benefits

SS is projected to achieve financial sustainability after the reform process.

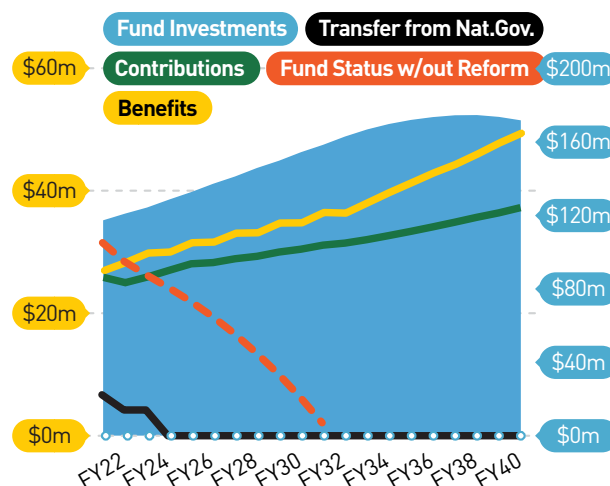
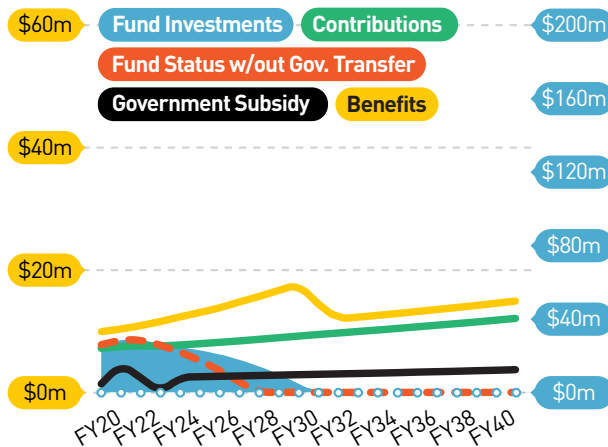


Figure 14: Civil service pension plan fund investments, contributions and benefits

CSPP will collapse in the near term without reform



of \$30.0 million were a mere 14 percent of liabilities. In the FY20 budget, and including the provisions of the CROSS Act, the government transferred \$4.8 million to the CSPP. In FY21 a further \$2.6 million was transferred, but no provisions were made for further transfers in FY22. **Figure 14** provides a projection of CSPP contributions, benefits, and asset streams based on the Callund actuarial assessment.

A similar reform process is underway for the CSPP as completed for SS. At the time of the design of the ADB RISES program the issue of the CSPP was discussed but felt to be overly complex for inclusion in the program. However, in the design of the ADB TA tasked to come up with options for SS, a similar evaluation and list of reform options for the CSPP was specified. SS reforms were to receive priority, and once complete, they would be followed by a similar exercise with the CSPP. As a result, the actuarial assessment has been completed, and the SS task force has switched focus to the CSPP.

Without reform the CSPP remains at imminent risk of collapse.



10. Private Sector Development

The World Bank's Doing Business Survey

The 2020 World Bank's "doing business survey" ranked Palau 145 out of 190 participants but the survey has now been discontinued. The World Bank's ease-of-doing-business survey has now been discontinued because an independent investigation found that senior World Bank officials had improperly influenced the results⁵. However, the survey provided a useful broad indicator and yardstick on the attractiveness of the business environment. The 2020 survey indicated that Palau ranked 145 out of the 190 countries surveyed, in the bottom third, which suggests there was considerable room for improvement. Although Palau fared better than the FSM and RMI, which were ranked 158 and 153, respectively, Palau was substantially below most South Pacific nations. Overall, Palau's scores are generally weak and ranked in the bottom third in: starting a business, dealing with construction permits, getting electricity, protecting investors, trading across borders, and resolving bankruptcy. The discontinuation of the doing business survey is unfortunate as it provided a means of assessment for many small economies. There is a need for a replacement, but until that time Palau would be advised to set up its own monitoring mechanism of self-assessment

⁵ "The World Bank's Doing Business Report", Congressional Research Service, October 29, 2021, Washington D.C.

Land Tenure

Land issues have long been identified as a significant constraint to private sector development in Pacific nations, and Palau is no exception. Land may only be owned by Palauan citizens and is owned by individuals, clans, and the government. A particular issue arises that foreign-owned financial institutions cannot secure mortgages on land or land leases in the event of default since foreign institutions are not entitled to ownership. In effect the only institution that can issue mortgages against land or land leases is the National Development Bank of Palau. Lease terms can be issued up to 99 years, and limited duration is not a problem. The lack of effective land-use planning in Palau is a serious weakness. This is especially so in a tourism-based economy, where land-use planning is the major means of effective implementation of policy and attainment of high-value tourism.

The Regulatory Environment

The reformed Companies Act has been passed by the OEK and the creation of an electronic Corporations Registry is slated for early 2023. Palau's regulatory environment is based on its constitution, customary law, and common law as applied in the United States and has no Uniform Commercial Code (UCC) or equivalent. An ADB Private Sector Assessment indicated that the former Companies Act was not suited to modern commerce, and the company registry functioned poorly. As part of the ADB RISES program Palau prepared legislation for a new reformed Companies Bill, which passed into law in September 2021 and creates a modern electronic framework. The reforms were completed with support from PSDI, the Private Sector Development Initiative. The key features of the new law include:

1. A standardized set of forms will be implemented for on-line filing by

A series of reforms in the private sector: new Corporations and Arbitration laws will establish a more secure environment for private sector development.

corporations. This will allow Palau to do away with outdated, bureaucratic formalities that formerly caused significant delays in completing incorporation.

2. The new law will ensure that Palau complies with global anti-money laundering / countering the financing of terrorism (AML/CFT) obligations.
3. The new registry will be a source of current, accurate information that will be available online to the public.
4. The Act contains more robust provisions for foreign corporations that seek to do business in Palau.
5. Provides a new framework to assist in classifying nonprofits into (i) charitable organizations formed for the public good, (ii) religious organizations, and (iii) other entities that are formed for the benefit of their members, such as chambers of commerce.

Creation of a centralized “one-stop shop” will assist in streamlining private sector applications to operate businesses. A large number of requirements, permits, and licenses are required for a business to be allowed to operate in Palau. Many of these problems will be reduced through centralizing the system into a “one-stop shop,” which has been recommended and adopted in many jurisdictions. The former finance buildings in Koror are being rebuilt for this purpose. Creation of the electronic corporate registry, and the administrative merger of the different agencies currently granting approvals into one office would greatly simplify the process. Finally,

Palau lacks a bankruptcy statute. The current system protects neither debtors nor creditors. The proof of debt is long and complicated, and legal practitioners are required. There are no systematic means by which debts can be discharged, and many individuals have no means of getting out of debt.

Palau accedes to the New York Convention on the Recognition and Enforcement of Arbitral Awards. Signatories to the convention benefit from participation in a recognized means of neutral dispute resolution. They also have the ability to enforce arbitral awards in the courts of other signatory countries. This makes arbitration an attractive means of dealing with disputes for foreign investors seeking a neutral, expert, and enforceable means of dispute resolution. In April 2021 Palau enacted the International Arbitration law, which enables commercial arbitration to take place in Palau between local and foreign parties who have voluntarily agreed to arbitration following a written arbitration agreement. The law sets out the parameters of the way in which arbitration may be conducted in Palau and deals with the relationship between arbitration and the court system of Palau. The reforms were completed with support from PSDI, and included information sessions with stakeholders from the business, legal, and judicial communities.

Foreign Direct Investment

Regulation of “front” businesses is a special issue in Palau’s foreign investment regime but has only been minimally effective. Palau operates an old-style foreign-investment board approach to FDI regulation, which imposes a range of bureaucratic restrictions and requirements. The law was amended in March 2016 to provide powers to the board to control “front” businesses: businesses owned by Palauans but operated by noncitizens. The original law, with a wide range of onerous requirements, was weakly enforced and encouraged the creation of fronts. However,

the issue of front businesses appears to be as widespread as before 2016; the new law, although incorporating wider powers, does not appear to have resulted in enhanced control, or improved quality or quantity of foreign investment. An evaluation of the pervasiveness and involvement of “fronts” in the economy would be a desirable, although subjective, first step toward change. The existence of law that is widely flouted undermines the process of law. A more rational approach that has the power to monitor the sector may be more beneficial than one which persistently fails to achieve its objectives.

Private Public Partnerships (PPP)

Designation as a high-income nation requires Palau to consider new vehicles for the financing of infrastructure. Palau has traditionally relied upon government for the procurement and operation of public infrastructure projects, including the operation of utilities currently under state ownership (SOEs). Infrastructure needs have to a large extent been financed through bilateral grant aid or loan financing from multilateral donor agencies. However, due to the designation as a high-income nation and the limitations on the incurrence of new debt (resulting from high indebtedness due to financing needs of COVID-19), the nation must develop new means and vehicles for the financing and operation of infrastructure. In response to these forces, Palau has developed a PPP policy statement with support from the PSDI. Adoption of the PPP policy statement by the president is also an important element of the RISES program.

A new PPP unit will be created in the Ministry of Finance to identify and develop PPP projects. A new PPP unit has been formally established in the Ministry of Finance but is not yet in operation. It will assist in the development of a PPP framework that will guide the development of PPP projects and procurement. The PPP unit has been



New Private Public Partnership policy and framework will provide a needed source of finance for investment and maintenance of infrastructure projects.

established alongside a debt management unit that forms a key part of the monitoring and loan appraisal process required in the Fiscal Responsibility Framework. The PPP unit will identify candidates for possible PPP financing for consideration by a PPP project Ministerial committee. Once the inception stage is complete, projects will be assessed for feasibility, and then approved by the president and, ultimately, by the OEK. After contracting and procurement, projects will be subject to monitoring by the PPP unit for fulfillment and delivery of outputs specified in the agreements.



11. Compact Issues

Compact Renewal

Near the end of FY10 Palau signed the Compact Review Agreement (CRA) with the United States. Subsequently the agreement was submitted to the US Congress, where it remained, for eight years, awaiting approval. During this period Palau received funding at the nominal level prevailing in FY09 through discretionary annual continuing appropriations. At the start of 2018, the U.S. Congress authorized and appropriated funds to finance the CRA, based on the total funds agreed to in the CRA less those expended on continuing appropriations during the intervening years. The funds, \$123.8 million, were provided as a lump sum to be allocated as determined by the original parties.

The terms originally specified in the CRA were for continuing current grant assistance, although at a declining level.

Additional resources were provided to support the Compact Trust Fund, infrastructure maintenance and capital projects. By way of a mutual agreement between the United States and Palau, the remaining funds have been mostly allocated in the spirit of the schedule outlined in the original CRA. It is understood that an additional allocation was diverted from lower priority uses and provided to support the Compact Trust Fund consistent with Palau's long-term intent to establish a perpetual fund.

A new feature of the CRA was the creation of an advisory group comprising five members: two nominated by each country

and one chosen by mutual agreement.

The purpose of the advisory group is to contribute to the long-term economic sustainability of Palau by recommending economic, financial and management reforms. Considering the success in Palau in generating improved information and statistical flows and also considering Palau's generally good performance in terms of fiscal accountability, the government may request that the advisory group's mission be more optimistically focused on promoting broader-based economic growth prospects for Palau. As of this writing, it appears the initial meeting of the Advisory Group may transpire as early as August 2022. The first two meetings should result in a mandated report to the two governments to be taken up in an (annual) bi-lateral consultation. While that meeting is specified to be held in June each year, the initial year will necessarily follow a revised schedule.

The Palau Compact Trust Fund

An enlightened feature of the original Compact was the creation of a trust fund.

The CTF was intended to provide \$5 million annually from FY99 to FY09 and then \$15 million annually for government operations through the Compact's fiftieth year in FY44; this approach differs from the Trust Funds created later for the amended Compacts with the FSM and RMI. Those sister Freely Associated State Trust Funds were designed to provide a perpetual source of fully inflation-adjusted distributions. Moreover, original projections were based on the CTF achieving an unlikely annual return of 12.5 percent. As it turned out, the CTF achieved a 7.47 percent return through FY09. This result was slightly better than the blended asset-allocation benchmark market rate of return of 7.32 percent over the same period; however, based on projections made at the end of FY09 the CTF would have failed by FY22, long before fulfilling the Compact objective of providing level funding through all 50 years (FY44).

Compact Review Agreement provides additional funds to shore up the COFA Trust Fund, but it is inadequate for establishment of a perpetual fund.

As a result of the required Compact Section 432 Review, an agreement was reached to renew the economic-assistance terms of the Compact, to reduce planned withdrawals and to deposit additional funds into the CTF over the period FY10–FY24. For the purposes of the Section 432 Review the forward projections for annual investment returns were made using a 5.5 percent growth rate. Using that rate of return, the \$293.3 million value of the fund at the end of FY18, including a CRA deposit of \$62.5 million near the end of the fiscal year, contemporary projections indicated that the CTF would achieve its original objective and persist well beyond FY44. Still, it should be noted this implies a continual decline in the real value of transfers over the remaining period of the Compact. Analysis that takes market volatility into account indicated a 5 percent chance the CTF would fail prior to FY44 and a 40 percent chance that the value of the CTF corpus would be on a declining path as of the end of FY44.

Post-FY24 Compact renewal

In the absence of any agreement to renew the Compact further funding in FY25 and thereafter will be provided from distributions from the Compact Trust Fund. However, there is some uncertainty over the continuation of many of the federal programs and services Palau currently benefits from that are provided through annual Congressional appropriations. The range of major programs in the Compact includes: Postal Services, FDIC, NOAA, Pell grants, FAA, education, health programs, etc., which are subject to periodic Congressional authorization and annual appropriations. While the shortfall



in distributions after FY24—assuming Palau treats the Compact Trust Fund as a perpetual fund-- is estimated at the time of this writing to be \$6.5 million, the range of possible loss of Federal programs may, in the worst case, add a further \$17 million or more to the size of potential negative fiscal adjustment.

Bi-lateral negotiations are underway with a strong potential for additional funding for a renewed period. The August 5, 2019, announcement by then US Secretary of State Michael Pompeo, "... that the United States has begun negotiations on extending our respective Compacts of Free Association with each country."⁶ was warmly welcomed by the leaders and people of each FAS. The announcement alleviated concerns about a fiscal cliff that would otherwise potentially prevail. Still, the offer that the U.S. government delivered to Palau in December of 2020 at the end of the prior administration was not welcomed by President Whipples. In meetings in DC and in public announcements the offer was described as inadequate as to level of economic assistance and problematic due to the apparent silence on the continuation of US Postal Service as part of a renewal package.

As of this writing, the U.S. has demonstrated the importance of the ongoing negotiations through the naming of a Special Presidential Envoy for Compact negotiations, Ambassador Joseph Yun. Palau has committed to present a counterproposal to Ambassador Yun and the U.S. government team in early August 2022.

⁶ Remarks to the press by Secretary of State, Michael R. Pompeo in Palikir, Pohnpei, FSM, following meeting with FSM President David W. Panuelo, RMI President Hilda C. Heine and Palau Vice President Raynold B. Oilouch; August 5, 2019; archived at www.state.gov.



12. The Economic and Fiscal Outlook

Projections of the economy are based on the GSUSA economic model. In this section a projection of the economy is made for the FY23-FY30 period based on an economic model, MTEF-mod, developed by the Graduate School USA. The projections form the basis for discussion and analysis of the economic outlook. Earlier projections had assumed that economic recovery would be well underway by mid-2022 and on a similar path to that currently being experienced in the South Pacific. However, the return to normal in the East Asian region has been below expectations and performance has shown that a conservative approach to the timing of the recovery is warranted. The focus of the discussion is on the implications of a delayed recovery on fiscal policy.

Full recovery of the tourism industry is not projected until FY25. After a successful vaccination program was completed mid-2021 Palau had attained a state of readiness for revival of the tourism industry. However, the major generating nations of Palau's tourism remained firmly closed. Based on the lack of visitors to date and bleak outlook for the remainder of FY22, a total of 7,000 visitors has been projected for the year, see [Figure 15](#). Looking forward, a total of 41,000 visitors is projected for FY23 assuming most markets recover by 50% and China remains closed. For FY24, 83,500 visitors have been projected by which time most markets would have recovered and China would start to move away from its zero COVID policy. However, this

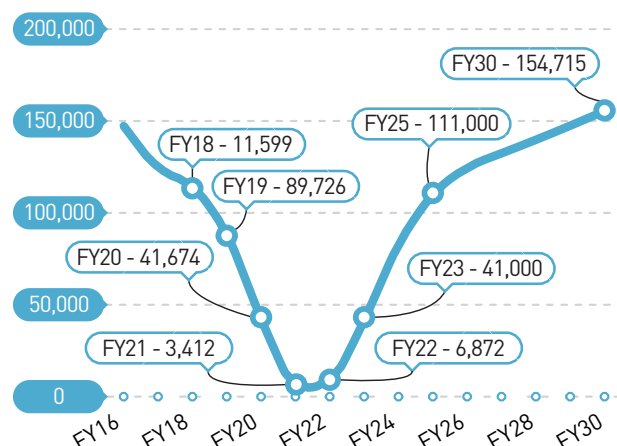
level is still below the FY19 level, which was itself well below trend. Eventual recovery is projected for FY25 with the number of visitors returning to 111,000, a level not far below the FY18 level.

After recovery from COVID-19 has been attained, the tourism economy is projected to return to normal levels of occupancy and profitability by FY30. While recovery from COVID-19 is assumed to have been achieved by FY25, the level of capacity utilization remains well below normal profitability levels. Based on the level of rooms in existence before the pandemic and assuming completion of plant under construction and no major closures, the level of visitors projected represents close to 40% of rooms available. The existence of significant capacity under-utilization suggests that operators will have significant scope and incentive for further expansion and the projections assume occupancy rates will rise to 50% by FY30. Coupled with modest further expansion in plant of 10% or an additional 220 rooms, total visitor arrivals of 155,000 are projected by the end of the decade; a level still below that attained at the height of the tourism boom in FY15.

Construction demand is projected to decline through FY25 but remain above pre-COVID

Figure 15: Visitor arrival projections: FY22-FY30

Tourism recovery is delayed until FY23 and only in FY25 is recovery complete



levels. Construction has traditionally had a large impact on the economy and the assumptions about major projects have a significant impact on the level of economic activity. After significant construction activity during COVID, the pipeline of projects is nearing completion and a reduction of 20% is projected for FY22, although still above pre-COVID levels. On-going projects include finalization of the airport Joint Venture, and the Surangel Superstore shopping mall in Airai. The One-Stop Shop building in Koror has now finally started and is the only new major project underway. Other major investments planned include: a new power purchase agreement for the supply of electricity to PPUC, the second fiber optic connection to the internet, and continued installation of the US radar surveillance system. While all these projects will have significant impact on the economy, the timing of implementation is uncertain, and they have not been included in the projections.

The outcome of the negotiations for the renewal of the Compact is presumed to be favorable. With the appointment of a special US envoy, negotiations between Palau and the United States are set to ramp up with the US intention to complete the negotiations before the end of 2022. Reflecting current sentiment in the United States and relations between the two nations, it is anticipated that the Compact will be renewed for a period of 20 years. The outcome of the negotiations is uncertain, but it has been assumed that an annual stream of budgetary grants (equivalent to the current \$15 million drawdown from the COFA Trust Fund) will commence fully at the start of FY25 and be regulated for inflation. This, it is assumed, will be supported with an annual flow of resources for capital investment equivalent to 30% of the current grant levels. With the current Compact Review Agreement expiring in FY24, it is assumed that the impact of these assumptions will commence in FY25.

Fiscal policy stance assumed to remain unchanged in FY23 with allowance for

inflation once recovery has been established.

The projections assume the provisions of the FY22 budget remain in force but that the earlier 10% reduction in appropriations is restored. Given the weak fiscal outlook, it is assumed that no increase in departmental budgets is allowed in FY23, but that the tax reform initiative is implemented on schedule. In FY24 a modest allowance for inflation is budgeted and in FY25, with the recovery well under way, expenditures are adjusted for the full impact of prior inflation including the recent surge. It is assumed that the government continues to finance the CROSS program at the revised rates for both the PVA temporary jobs program and unemployment benefits for foreign workers. Palauans formerly benefiting from the US CARES Act are assumed to be relocated under the CROSS Act but with 40 hours a week at the minimum wage. Expenses on these programs are assumed to decrease in relation to the speed of recovery. In FY22 total costs of the CROSS program are estimated to be \$6.1 million, and in FY23 to fall to \$4.3 million as recovery gets underway. By FY24 it is assumed these programs are finally terminated.

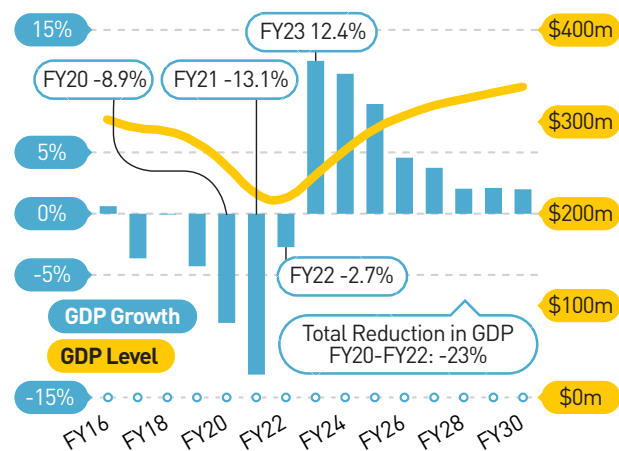
The economy is now projected to start a slow recovery in FY23 and achieve full recovery by FY25.

In FY23 the economy is projected to grow by 12.5%, albeit from a low base, see [Figure 16](#). However, this level of economic activity remains -20.2% and well below the level prevailing in FY18, a healthy year of economic activity. The tourism recovery is expected to proceed in FY24 and GDP to attain a value 0.6% higher than the FY18 level, seven years earlier. During the remainder of the decade through FY30, the economy is projected to grow by 3.0% per annum as capacity utilization and profitability levels return to normal. The trajectory for the private sector parallels that of the overall economy, only more pronounced, with full recovery achieved by FY26.

Palau will continue to operate fiscal deficits until FY24 when balance is restored. The

Figure 16: GDP level and growth: FY18-FY30

GDP is projected to contract further in FY22 before the recovery gets underway in FY23



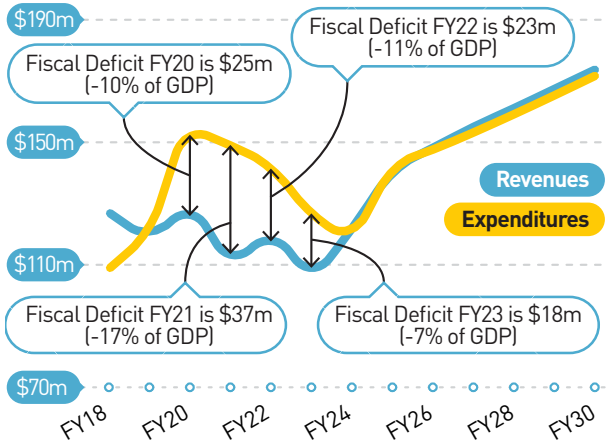
implications of the delay in the economic recovery for the fiscal deficit are shown in [Figure 17](#). The level of expenditures is projected to decline as the original outlays on health and the need for mitigation are reduced. The erratic path of revenues reflects initial US grants for health and subsequent receipt of resources from the CARES Act. The projected deficits in FY20 and FY21 are anticipated to continue into FY22 and FY23 and overall a total accumulated deficit of \$103 million or 44% of GDP is likely to result. If the request from Koror state is considered, the required financing is even higher.

If the recovery continues to be delayed, Palau will either need to consider incurring additional debt or undergo fiscal adjustment if the downturn is more entrenched.

In the earlier section on the fiscal output, it was indicated that Palau has received financing of \$90 million from the ADB to maintain government operations through the crisis [Figure 18](#) indicated the level of government deposits after adjusting the fiscal deficit for debt repayment. The graphic indicates that after receipt of Subprogram 2 of the RISES program in FY22 and without further borrowing, deposits will decline and after FY25 the cash-flow position is likely to turn negative.

Figure 17: Government revenues and expenditures, FY19-FY30

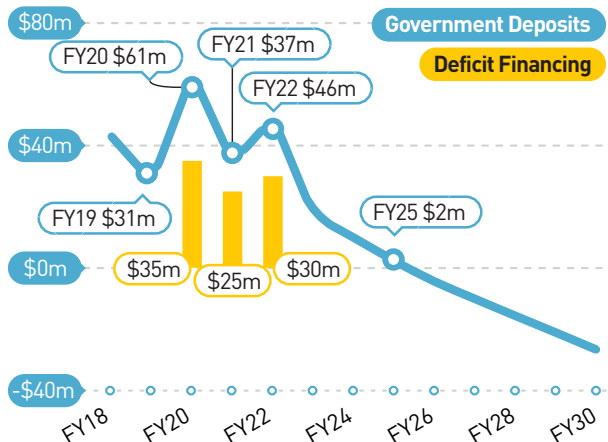
Government runs large deficits through FY20-FY23, until balance restored in FY24



Based on these projections government operations will not be able to continue with a negative cash flow. While recovery is well underway in much of the world, this is not the case in Palau. The implication is that Palau will need to continue with the cautionary approach to fiscal policy that has so far been adopted. Depending on developments in the near term, Palau may either need to consider taking on additional debt or undergoing fiscal adjustment if the downturn becomes entrenched.

Figure 18: Government deposits, FY19-FY30

Government deposits are projected to decline after FY22 and then turn negative after FY25 without adjustment or further borrowing



13. Policy Issues

The emerging structure deficit

The emergence of large and persistent deficits during COVID and into the recovery period disguises the emergence of a persistent deficit. It is therefore important to analyze the nature of the deficit so that once recovery has been achieved, Palau is not surprised that there remains a significant problem to deal with. Analysis of the fiscal deficit can be broken down into three major parts: (i) event-driven costs of the health response and mitigation efforts, (ii) the cyclical impact of the loss of the tourism industry on government revenues, and (iii) an emerging structural deficit. Of a total projected deficit of \$103 million over the four fiscal periods, FY20-FY23, the major element of the event-driven component has been the cost of implementing the CROSS Act; It is estimated that this will have cost \$27 million through the end of FY23. Additional costs of medical supplies and drugs were smaller than expected, while medical referral costs fell sharply reflecting travel restrictions. The size of the event-driven part of the fiscal deficit is thus largely limited to the implementation of the CROSS program.

A significant structural deficit has emerged during COVID-19, but if proposed reforms at PPUC, SS and CSPP are implemented, this should not pose fiscal risk.

The cyclical part of the deficit due to tax and revenue shortfalls is estimated to be -\$31.6 million during FY20-FY23. Notably, the unprecedented size of the fiscal deficit is mitigated by the structure of Palau's fiscal account. About half of revenues are non-tax revenues representing grants, drawdowns from the COFA trust fund, fishing fees, and other fees and charges. These were all largely unaffected by the pandemic. The principal components of the tax revenues are the payroll tax, gross revenues tax, hotel room tax, PPEF, and import taxes. Total tax revenue fell by -\$5.0 million in FY20—about half of the original projections—and further losses of -\$10.8 million and -\$11.2 million are projected for FY21 and FY22 compared with FY19, respectively. Over the four-year FY20-FY23 period, tax revenues are projected to fall by -\$31.6 million; this represents the size of the *cyclical deficit*.

Palau's structural deficit is estimated to have grown to \$44 million during the pandemic years, FY20-FY23. The major area of fiscal weakness has been in subsidies to SOEs and transfers to the Social Security and Civil Service Pension Plan. In the case of SOEs, subsidies for power production have until recently been small and well managed. However, the continuing pandemic-induced recession in Palau and recent surge in international oil prices (due to recovery from the pandemic elsewhere and the war in Ukraine), have led to large unsustainable subsidy payments to PPUC for power production. International conditions in the global energy market, as many democracies transition away from use of Russian oil, are unlikely to change in the near term, and Palau needs to adapt. In the case of water and wastewater, Palau has yet to implement the full cost recovery tariff that has been submitted to the regulator.

Reforms to Social Security that have been developed are awaiting consideration by the OEK. In the case of Social Security, and after a participatory workshop in November

2021, reforms have been drafted and are awaiting consideration by the OEK. However, until such time as action is taken, Palau will need to continue payment of unfunded supplemental benefits. In the case of CSPP, a similar program of reforms is underway, but adjustments will need to be more far reaching and deeper than SS if the CSPP is to become financially sustainable and able to live on its own without government infusion of cash. Adding together the cost of subsidies and transfers to government SOEs and agencies, the third element of the deficit due to structural weaknesses is estimated to be \$44 million.

The impact of a minimum wage increase

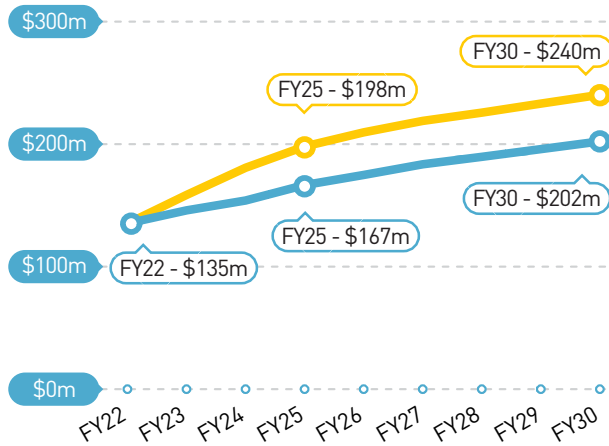
The impact of an increase in the minimum wage from \$3.50 to \$5.00 is simulated. An important policy change under consideration in Palau is the increase in the minimum wage from \$3.50 an hour by \$0.75 in FY23 and a further increase of \$0.75 in FY24 bringing the new minimum wage to \$5.00 per hour. The economic model is used to simulate the impact of the wage increase assuming that all wage earners, regardless of wage level, benefit from the increase in both private and public sectors. Four major economic forces have been modeled:

1. The impact on inflation in both tourism and consumer prices,
2. The impact of inflation on the price of Palau's tourism product and on demand,
3. The impact on household incomes, and
4. The impact on the fiscal balance, including on taxes, and the wage bill.

Assumptions: wage bill is estimated to rise by 19%: Based on the assumed increase in minimum wages being applied to all wage earners, it is estimated that the total wage bill for the economy will rise by 19%, see [Figure 19](#). This wage increase in turn will increase the prices of items consumed in

Figure 19: Total Wage bill before and after minimum wage increase: FY22-FY30

Total wage bill increases by 19% by FY25 and through FY30



Palau and the cost of tourism. In the case of consumers, the model projects that consumer prices will rise by 5.8%, and in the case of tourism the price impact is estimated to be larger at 11%. The difference between these projections reflects the use of labor in production and the import intensity of household and tourist expenditures. Clearly, the greater the use of labor, the greater will be the impact on inflation. The model further assumes that producers pass on the cost of inflation⁷, which amplifies the impact of wage inflation on prices. The model also draws on an investigation of the impact of price increases on tourism demand in the South Pacific nations of Fiji, Cook Islands, Sāmoa, Tonga and Vanuatu⁸. The study estimates that for every 1% increase in prices, visitor arrivals will fall 0.61%. This price elasticity of demand is used in the current impact estimates, although the tourist markets for Palau will be different from those in the South Pacific.

⁷ The model uses a cost-plus assumption that employers increase prices in proportion to costs.

⁸ Kumar, N., Kuma, R. R., Patel, A., Hussain Shahzad, S. J., & Stauvermann, P. J. (2019). Modelling inbound international tourism demand in small Pacific Island countries. *Applied Economics*, 1–17. <https://doi.org/10.1080/00036846.2019.1646887>

GDP is projected to fall by 1.2% and visitor arrivals by 6.6% due to the increase in minimum wages. Real household disposable incomes are projected to rise by 8.6% by FY25. Figure 20 indicates the impact on visitor arrivals and suggests that by FY25 visitor arrivals will be 6.6% lower and 7,343 less than in the base case without the minimum wage. The impact of the reduction in visitors plus other macroeconomic effects, (including additional demand due to higher wages but offset by the impact of inflation) suggest the economy is likely to be 1.2% lower after the minimum wage increase.

Out of the 19% increase in nominal wages, disposable incomes rise 9.2%. While average nominal wages are projected to rise by 19% in FY25, this is offset by a series of increases in taxes, social contributions, reductions in overseas remittances of foreign workers, and inflation. Figure 21 indicates the share of the increase in minimum wages arising from these categories: 3.8% of the benefit is paid on taxes and social costs, -0.3% on remittances, and a large 6.2% is eroded by inflation. Due to the projected contraction in the economy under the minimum wage scenario, the demand for foreign workers falls and more than offsets the increase in outward

Figure 20: Visitor arrival projections with and without minimum wage increase: FY22-FY30

Minimum wage increase to \$5 is projected to lead to a reduction in 7% in visitors in FY30

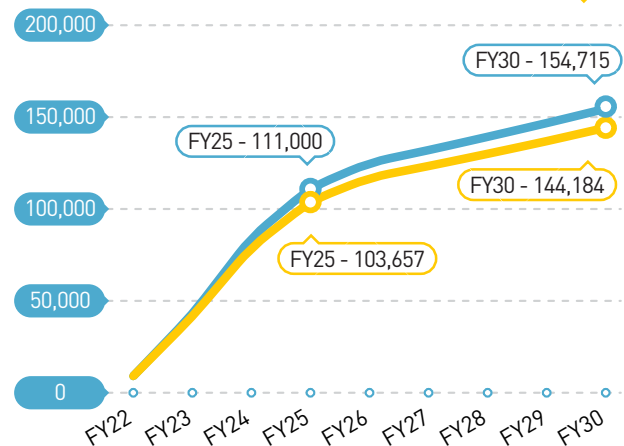
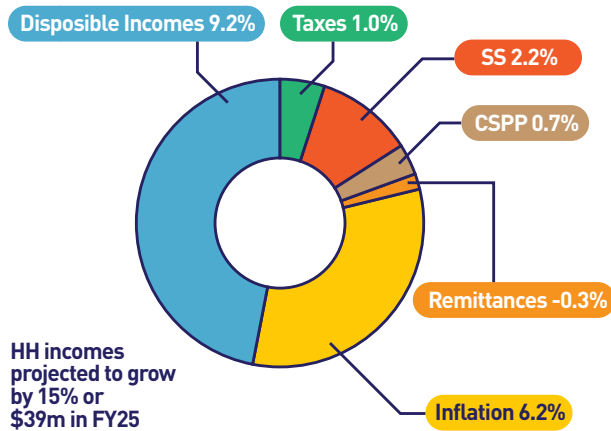


Figure 21: Allocation of benefit of minimum wage increase, FY30

After allowance for taxes, SS, CSPP, remittances and inflation, households are left with 9.2% of the original 15% gain in nominal wages



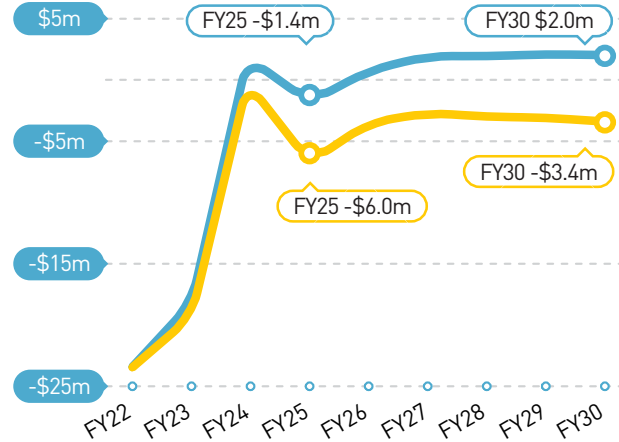
remittances due to higher wages. After deduction of these costs wage earners are left with an increase of 9.2% in disposable income out of the original increase in the minimum wage of 19%.

Impact on fiscal position is large but partially offset by growth in taxes. The impact of the minimum wage increase on the fiscal deficit is shown in [Figure 22](#). The impact of the payment of higher payroll costs is clearly negative as expenses rise although they are offset by an increase in tax collections. Of the increase in the government's wage bill of \$9.9 million in FY25, tax collections (wage taxes and PGST) will have covered \$4.9 million of the increase. It may be noted that application of the minimum wage increase solely to national government employees will leave the increase in payroll cost untouched

An increase in the minimum wage from \$3.50 to \$5.00 will add 19% to economy-wide wage costs and lead to a real wage improvement of 9%.

Figure 22: Fiscal deficit with and without minimum wage increase: FY22-FY30

Accumulated additional financing required to fund minimum wage increase by FY30 is \$32 million



but will only be offset by increased wage tax collections of civil servants, estimated to be \$0.7 million. Application of the minimum wage increase only to civil servants would thus be far more costly. By FY25 the fiscal position is projected to have deteriorated by \$4.7 million or 2.4% of GDP and the total accumulated deficit to have risen by \$7.8 million.

The Social Security system and Civil Service Pension Plan are significant beneficiaries of an increase in the minimum wage. Of special note is the impact of the minimum wage on the Social Security system and Civil Service Pension Plan. In FY25 contributions to the SS are projected to rise by \$4.5 million or 19.0%, and over the period FY23-FY25 to have accumulated by \$10.0 million. For a system under financial stress these increases are welcome, but it should be noted that in the process of time, the increase in contributions will be paid out in benefits to members of the program. Similar increases, albeit of lesser magnitude, are projected for the CSPP, but make little difference to the projected collapse of the system.



14. Statistical Issues

Statistical

Palau's administrative statistical systems have provided a sound base for fiscal and economic monitoring. Statistical availability in Palau can be accorded a high score compared with regional standards. After a period of weak and deteriorating availability of macroeconomic data, Palau now has a comprehensive range of economic statistics for monitoring economic performance: GDP by production and expenditure in current and constant prices, employment, wages, consumer prices, banking, balance of payments, and GFS statistics. An initial set of economic statistics is available by the end of March of the following fiscal year and final estimates are available after completion of the annual audits at the end of June. Current weaknesses exist in the lack of a comprehensive business survey to estimate private sector value added, and provision of producer prices to estimate the constant price series. Efforts to integrate the statistical system through data base management has improved data integrity and consistency considerably.

The tax reform initiative has the potential to significantly improve Palau's economic statistics. Implementation of the Palau Goods and Services Tax and Business Profits Tax will generate a stream of information that will considerably enhance the accuracy of Palau's economic statistics. The current value-added estimates are based on gross

tax receipts plus a coefficient derived from a set of annual corporate returns. This will be replaced by direct estimates of value added and intermediate consumption. On the expenditure side the PGST will also provide estimation of the major elements of household consumption, business investment, and imported services. The annual business profits tax will provide additional information on business inputs, inventories and investment. The main remaining weakness will be the lack of a producer price series on which the constant price series is derived. Finally, Palau will be able to produce a regular series of quarterly estimates.



Palau summary economic indicators, FY2015-FY2021

	FY15	FY16	FY17	FY18	FY19	FY20	FY21
Per Capita Income measures							
GDP current prices, \$ million	287.79	302.78	287.43	286.95	282.21	255.28	215.01
Population	17,661	17,882	17,887	17,514	17,474	17,427	16,893
GDP per capita \$	16,296	16,932	16,069	16,384	16,150	14,649	12,728
GNI per capita \$	15,517	16,012	15,680	15,914	15,967	15,244	13,852
GNDI per capita \$	17,426	17,812	17,337	18,546	17,428	17,273	15,681
National accounts							
GDP, at constant FY2019 prices, \$ million (ave. GDP(P) and GDP(E))	284.7	283.6	271.2	275.2	278.8	249.5	209.8
GDP, % growth	10.3%	-0.4%	-4.4%	1.5%	1.3%	-10.5%	-15.9%
Prices (annual percent change)							
Consumer price index	2.2%	-1.3%	0.9%	2.0%	0.6%	0.7%	0.5%
Employment and Wages							
Number of employees	10,885	11,342	11,725	11,757	11,430	10,965	9,742
% change	5.3%	4.2%	3.4%	0.3%	-2.8%	-4.1%	-11.2%
Private sector	6,195	6,624	6,856	6,896	6,601	6,102	5,027
% change	7.2%	6.9%	3.5%	0.6%	-4.3%	-7.6%	-17.6%
Public sector	3,672	3,767	3,875	3,897	3,890	3,952	3,867
% change	-1.0%	2.6%	2.9%	0.6%	-0.2%	1.6%	-2.1%
Other	1,017	952	994	963	939	911	848
Palau citizens	5,453	5,494	5,527	5,656	5,539	5,406	5,123
Foreign workers	5,432	5,849	6,198	6,101	5,891	5,559	4,619
Average annual wage	10,377	10,926	11,210	11,479	11,690	11,750	11,850
% change	4.1%	5.3%	2.6%	2.4%	1.8%	0.5%	0.8%
Private sector	8,685	9,143	9,304	9,294	9,323	8,895	8,400
% change	9.3%	5.3%	1.8%	-0.1%	0.3%	-4.6%	-5.6%
Public sector	14,912	15,588	16,153	16,808	17,147	17,449	17,505
% change	3.5%	4.5%	3.6%	4.1%	2.0%	1.8%	0.3%
Palau citizens	12,599	13,327	13,948	14,109	14,309	14,572	14,492
Foreign workers	8,147	8,670	8,768	9,041	9,227	9,006	8,920
Average annual real wage (less inflation)	10,597	11,306	11,498	11,549	11,690	11,668	11,714
% change	1.9%	6.7%	1.7%	0.4%	1.2%	-0.2%	0.4%
Government Finance Statistics, (\$ million)							
Revenue	114.9	124.7	115.0	126.7	119.4	127.8	111.7
Tax revenue	56.6	59.1	56.9	60.5	51.8	46.8	41.0
Grants	43.7	49.3	37.3	49.4	50.3	65.0	57.9
Other revenue	14.6	16.3	20.7	16.9	17.3	15.9	12.7
Expense	-87.0	-97.2	-92.8	-102.3	-103.6	-135.8	-130.6
Compensation of employees	-37.6	-41.0	-42.9	-44.6	-45.5	-47.4	-46.4
Use of goods and services	-24.4	-25.9	-25.1	-26.6	-27.1	-28.1	-26.4
Other expense	-24.9	-30.4	-24.8	-31.1	-30.9	-60.4	-57.8
Net Worth and its Changes	-27.9	-27.5	-22.2	-24.4	-15.8	8.1	19.0
Nonfinancial assets	-13.5	-16.8	-8.4	-6.6	-16.9	-16.6	-18.2
Financial assets	-9.4	-27.8	-18.4	-29.3	-3.3	-27.9	12.2
Financial liabilities	-5.0	17.2	4.6	11.4	4.4	52.6	25.0
Overall fiscal balance (In percent of GDP)	14.4	10.7	13.8	17.8	-1.0	-24.6	-37.2
Revenue	39.9%	41.2%	40.0%	44.2%	42.3%	50.0%	51.9%
Taxes	19.7%	19.5%	19.8%	21.1%	18.3%	18.3%	19.1%
Domestic revenues	15.2%	16.3%	13.0%	17.2%	17.8%	25.5%	26.9%
Grants	5.1%	5.4%	7.2%	5.9%	6.1%	6.2%	5.9%
Expense	-30.2%	-32.1%	-32.3%	-35.6%	-36.7%	-53.2%	-60.8%
Compensation of employees	-13.1%	-13.5%	-14.9%	-15.5%	-16.1%	-18.6%	-21.6%
Use of goods and services	-8.5%	-8.5%	-8.7%	-9.3%	-9.6%	-11.0%	-12.3%
Non Financial Assets	-4.7%	-5.6%	-2.9%	-2.3%	-6.0%	-6.5%	-8.5%
Overall fiscal balance	5.0%	3.5%	4.8%	6.2%	-0.4%	-9.7%	-17.3%

Palau summary economic indicators, FY2015-FY2021 cont'd

	FY15	FY16	FY17	FY18	FY19	FY20	FY21
Depository Corporations Survey (\$ million)							
Net foreign assets	200.3	249.1	253.3	254.2	238.5	290.5	287.5
Domestic claims	8.7	-3.8	-6.9	-6.4	2.7	-27.9	-10.9
Net claims on national government	-22.3	-35.6	-43.2	-42.9	-31.0	-60.7	-37.2
Claims on other sectors	31.0	31.8	36.3	36.5	33.7	32.8	26.3
Private non-financial corporations	1.2	1.2	6.5	8.4	5.4	5.2	2.1
Individuals	29.8	30.6	29.8	28.1	28.2	27.6	24.2
Broad money liabilities	201.4	236.4	237.1	237.9	230.3	254.1	371.0
Demand deposits	88.9	106.1	96.8	91.0	99.4	115.4	191.3
Other deposits	112.5	130.3	140.4	146.9	130.9	138.7	179.7
Capital and other accounts	6.0	8.8	9.6	11.2	10.7	6.3	8.1
Loans to deposit ratio, %	15.4%	13.4%	15.3%	15.4%	14.6%	12.9%	7.1%
Memo: item: National Development Bank of Palau lending	18.3	18.2	19.3	n.a.	n.a.	n.a.	n.a.
Balance of Payments \$ million							
Trade balance	-20.7	-15.5	-16.1	-23.4	-26.4	-21.2	-21.4
Service balance	109.2	103.1	83.0	75.4	61.8	23.9	-16.8
Primary Income balance	-0.9	-1.1	-1.7	-1.7	-1.3	-0.4	0.0
Secondary Income balance	-61.8	-65.6	-70.8	-63.8	-62.8	-57.3	-52.0
Current Account, balance	-38.2	-50.2	-68.3	-52.9	-88.0	-106.2	-122.0
Capital Account, balance	17.6	24.4	20.6	82.6	34.9	29.5	15.0
Financial account balance	0.6	24.6	45.2	-11.5	77.8	47.8	65.9
International Investment Position (IIP), \$ million							
Total stocks, net	-109.1	-101.1	-107.8	-60.5	-132.4	-171.7	-171.3
Direct investment, net	514.3	584.3	624.7	711.1	684.7	741.3	800.5
Portfolio investment, net	623.3	685.5	732.5	771.6	817.1	913.0	971.9
Other investment, net	385.4	418.3	444.0	464.2	494.1	524.1	545.4
memo: COFA Trust Fund	183.9	196.8	219.5	297.5	286.4	280.0	323.4
External Debt, \$ million							
Gross External Debt, total	64.4	75.0	81.1	87.6	87.2	138.7	167.2
National Government	28.2	43.6	53.4	62.4	64.6	117.9	149.1
Public Enterprises	36.2	31.5	27.7	25.2	22.7	20.8	18.1
Gross External debt as % of GDP	22.4%	24.8%	28.2%	30.5%	30.9%	54.3%	77.7%
Debt Service	7.6	9.1	7.4	8.1	9.4	9.8	10.9
Debt service as % of national government revenues	6.6%	7.3%	6.4%	6.4%	7.9%	7.7%	9.7%
Tourism							
Total Tourism receipts, \$ million	136.3	128.4	112.0	107.3	89.1	48.2	6.4
Tourist nights	764,123	684,908	589,514	564,474	460,612	231,014	17,807
Receipts per visitor, \$	809	878	921	928	997	1,159	1,886
Receipts per visitor night, \$	178	187	190	190	193	209	360
Direct value added per visitor night, \$ million	96.5	103.7	102.1	96.8	102.2	25.3	21.7
Average length of stay, nights	4.5	4.7	4.8	4.9	5.2	5.5	5.2
Tourism arrivals	168,424	146,268	121,670	115,564	89,379	41,628	3,400
Japan	31,733	30,546	25,777	24,384	19,585	10,623	80
South Korea	12,406	12,480	13,419	12,833	11,541	6,211	12
Taiwan	15,196	15,436	9,422	11,296	14,024	6,258	1,912
China	91,095	70,637	55,358	50,063	28,368	9,721	33
USA	8,822	8,459	8,490	8,378	7,804	4,009	1,191
Europe	4,611	4,248	4,962	4,447	3,753	2,535	19
Other	4,560	4,462	4,242	4,163	4,304	2,271	153
Hotel occupancy rate	64.5%	54.4%	43.3%	40.2%	33.7%	15.8%	1.0%
Number of Hotel rooms, yearly average	1,674	1,785	1,911	1,961	1,876	1,920	1,944
Tourism Direct Value Added, \$ million	73.8	71.0	60.2	54.6	47.1	5.9	0.4
% change							
Tourism receipts	17.9%	-5.8%	-12.7%	-4.3%	-16.9%	-45.9%	-86.7%
Tourism arrivals	34.3%	-13.2%	-16.8%	-5.0%	-22.7%	-53.4%	-91.8%
Tourism nights	27.0%	-10.4%	-13.9%	-4.2%	-18.4%	-49.8%	-92.3%
Tourism receipts per visitor	-12.2%	8.5%	4.9%	0.8%	7.4%	16.2%	62.7%
Tourism receipts per visitor night	-7.2%	5.1%	1.4%	0.0%	1.8%	7.9%	72.4%



2022 ECONOMIC BRIEF

Republic of Palau

June 2022

The Palau Economic Brief is produced annually to provide an independent assessment of the Republic of Palau's economic performance and policy environment, as well as independently verified economic statistics. The Palau Economic Brief summarizes the full Palau Economic Review, which is developed to assist the government of Palau and the U.S. Department of the Interior's Office of Insular Affairs to fulfill their respective reporting requirements under Palau's Compact of Free Association with the United States.

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