Republic of Palau

July, 2019

# ECONOMIC REVIEW

## PALAU FY 2018

FULL REPORT

Graduate School USA

EconMAP ECONOMIC MONITORING & ANALYSIS PROGRAM

July, 2019

# ECONOMIC REVIEW

## Palau Fiscal Year 2018

# Abbreviations

| | | |
|---|---|---|
| ADB | — | Asian Development Bank |
| ADF | — | Asian Development Fund (concessional lending resources of the ADB) |
| BGRT | — | business gross-receipts tax |
| BoP | — | balance of payments |
| c.i.f. | — | cost, insurance and freight |
| COFOG | — | Classification of the Functions of Government |
| Compact | — | RoP Compact of Free Association with the United States |
| CPI | — | consumer price index |
| CTF | — | Compact Trust Fund |
| EIB | — | European Investment Bank |
| FDI | — | foreign direct investment |
| FEIM | — | Facility for Economic and Infrastructure Management |
| FIB | — | Foreign Investment Board |
| FIC | — | Financial Institutions Commission |
| FISIM | — | financial-intermediation services, indirectly measured |
| FMIS | — | financial management information system |
| f.o.b. | — | free on board |
| FSM | — | Federated States of Micronesia |
| GDE | — | gross domestic expenditure |
| GDP | — | gross domestic product |
| GFS | — | Government Finance Statistics |
| GNDI | — | gross national disposable income |
| GNI | — | gross national income |
| HIES | — | Household Income and Expenditure Survey |
| ICT | — | information and communication technology |
| IIP | — | international investment position |
| IMF | — | International Monetary Fund |
| MICB | — | Mega International Commercial Bank |
| NDBP | — | National Development Bank of Palau |
| NGO | — | nongovernmental organization |
| OCR | — | ordinary capital resources (ordinary lending resources of the ADB) |
| OEK | — | Olbiil Era Kelulau (Palau's national congress) |
| PEFA | — | Public Expenditure and Financial Accountability |
| PFTAC | — | Pacific Financial Technical Assistance Center |
| PNCC | — | Palau National Communications Corporation |
| PPUC | — | Palau Public Utilities Corporation |
| RMI | — | Republic of the Marshall Islands |
| RoP | — | Republic of Palau |
| RPSSRF | — | Republic of Palau Social Security Retirement Fund |
| RUS | — | Rural Utilities Service |
| SOE | — | state-owned enterprises |
| TA | — | technical assistance |
| US | — | United States |
| VAT | — | value-added tax |
| WSIP | — | Water Sector Improvement Program (ADB) |

NOTE

The Republic of Palau government's fiscal year (FY) ends on September 30.

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## Disclaimer

*The views, thoughts, and opinions expressed in this review are those of the authors and represent an independent assessment of the economic performance in Palau. This document does not necessarily represent the views of the government of Palau, the Graduate School USA, nor any other organization, committee, group, or individual, real or implied.*

## Foreword

This review, the seventh 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 review 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 review is intended to assess the RoP's economic performance and policy environment and to present a comprehensive set of economic statistics.

This review contains ten chapters—described in the following summary section. On behalf of Graduate School USA and EconMAP, the review was prepared by Mark Sturton; Glenn McKinlay compiled the statistical appendix. Special thanks go to the following people: Casmir Remengesau, Director of Planning and Budget; Muriell Sinsak and Limei Tesei of the Department of Planning and Statistics; and many business owners from the RoP, who supported the preparation of the report and statistical appendix.

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

# Summary

**The Palau FY2018 Economic Review has been organized into ten chapters:**

1. The initial chapter sets the background for the review with a description of economic performance and review of sector developments, employment and migration, income distribution and poverty, wages and prices.
2. The second chapter analyzes tourism developments in greater depth, its impact on the Palauan economy, and the need for a sustainable tourism policy.
3. The chapter on the external sector looks at the balance of payments, competitiveness, real exchange rates, external debt and sustainability.
4. Chapter 4, a discussion of fiscal developments, provides an in depth look at the formwork under which fiscal policy is implemented, fiscal trends, revenues, expenditures, fiscal balance and sustainability.
5. The chapter on public financial management looks at the system of planning and budgeting, tax reform, payroll, public expenditure and financial accountability (PEFA), and the need for a fiscal responsibility framework.
6. The state-owned enterprise (SOE) sector is small in Palau, but reform has been initiated by the World Bank and Asian Development Bank (ADB) in the areas of information and communication technology (ICT), water supply and sanitation.
7. The financial sector chapter reviews the banking sector and despite the rapid growth in liquidity financial intermediation has remained weak and domestic lending is one of the lowest in the region. The sustainability of Social Security and the Civil Service Pension Scheme, which is close to collapse, are reviewed.
8. A chapter on private sector issues is presented, drawing on a review of the private sector conducted by the Pacific Private Sector Initiative and a review of the World Bank's Doing Business Survey assessment for Palau.
9. Chapter 9 reviews the performance of the COFA Trust Fund (CTF), which has been in existence since the outset of the Compact. A second section assesses the impact of market risk on the attainment of the objectives of the CTF with statistical simulations based on Monte Carlo techniques.
10. 1The final chapter of the review analyzes likely economic developments in the near term and prospects for the economy in the longer term. In this process several p**otential risks to the economy are identified. Addressing these issues, a policy reform scenario is outlined.**

# Summary

## A. Recent Economic Performance

### ECONOMIC PERFORMANCE

In FY2014 and FY2015 the tourism economy boomed, and GDP recorded a growth of 4.4 and 10.1 percent, respectively. In FY2016 the economy continued to grow by 0.8 percent despite a large drop-off in tourism as the forward momentum in the economy supported for growth from strong household demand in an election year. In FY2017 the economy contracted by a large 3.5 percent reflecting a drop in visitors from 146,629 to 122,050, a 17 percent reduction. In FY2018 the economy grew by 1.7 percent despite the continuing fall in visitors to 115,964. The outlook for the current year, FY2019, looks set to be a further large contraction as visitor numbers decline to less than 90,000.

In the tourism boom years, when the economy was clearly on the upswing, tourism was clearly the main driver of growth; However, capital investment was also a positive force. On the downside, not only did tourism demand negatively impact GDP but capital investment also failed to support growth of the economy. In FY2016 both household and public expenditures were positive forces in an election year that turned around what otherwise would have been a negative result. In the last two years all elements of demand were negative except for public expenditures which supported the economy in FY2018

### POPULATION AND INCOME LEVELS

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 percent, after allowing for external migration, reaching 12,890 in FY2015. 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 has risen by 1.1 percent per annum since FY2000. Gross national income attained a level of $17,072 in FY2017, placing Palau in the World Bank's high-income group by exceeding their $12,005 threshold.

### EMPLOYMENT AND WAGES

The labor market in Palau is close to full employment, and Palauan employment has risen by 0.4 percent annually since FY2000. Nominal wages in the public and private sectors in Palau have grown by 2.3 and 2.6 percent, respectively, since FY2000 with public sector wages being 79 percent above those in the private sector. Real wages have declined marginally in the public sector, -0.1 percent per annum but grown by an average of 0.1 percent per annum in the private sector. Citizen wages are 52 percent above non-citizen wages with a majority of Palauan workers in the public sector and a majority of non-Palauans in the private sector.

In January 2017, the president submitted a bill to the OEK to raise the minimum wage from the current level of $3.50 an hour by ¢50 effective October 1, 2017, and to raise it by a further ¢50 annually until reaching $8.50 ten years hence. Since the introduction of the bill there has been no further action; however, if passed by the OEK the law would apply to all wage earners, Palauan and foreign. Currently the minimum wage in Guam is $8.50, and the intent in the law is to attract Palauans working in the US to return to Palau. However, the new wage policy would likely have a significant negative impact on the cost of doing business in Palau.

## INFLATION

At the start of FY2015 the world economy entered a period of rapidly falling fuel prices, resulting in moderation in inflation in Palau to 2.2 percent for the year. In FY2016 these trends continued, but food prices were also declining resulting in negative inflation of 1.3 percent. However, these trends reversed in FY2017 with both food and fuel prices returning to positive territory, and the CPI recorded 0.9 percent for the year. FY2018 was a more normal year and the CPI rose by 2.0 percent with both fuel and food prices rising by over 4 percent. Overall the trends during the last 4 years, with prices rising on average less than 1 percent per annum, have helped moderate the cost of living.

# B. Sector Issues

## TOURISM DEVELOPMENTS

The rapid growth in tourism has presented special challenges to Palau. In FY2015, annual visitor arrivals grew by 34 percent and recorded a level of 168,767 visitors, an increase of 88,000 visitors above the FY2010 level. In FY2016, the number dropped back to 146,643, and again fell back to 122,050 in FY2017 and 115,964 in FY2018. Based on the first 7 months of data it is likely visitor numbers will drop back further to less than 90,000 in FY2019. The original increase in visitors was made possible by the large amount of excess capacity the nation had in tourist plant; occupancy rates increased from 38 percent in FY2010 to 61 percent in FY2015. The majority of the increase originated in middle-to lower-grade establishments with an associated large increase in package-tour visitors predominantly from China.

The large increase in visitors and improvement in occupancy rates encouraged additional construction in hotel plant. Coupled with the drop in arrivals through FY2018, the additional largely unoccupied plant led to a reduction in occupancy rates to 39 percent in FY2018. While the reverse in arrivals has been strongly associated with a contraction in the Chinese segment of the market, there have also been significant reductions in the more traditional, higher spending tourists.

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 on 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 as tourism boomed but was largely sustained through FY2018 despite the reduction in arrivals and falling occupancy rates. Even with the large drop forecast for FY2019 the fiscal position appears to have avoided running into deficit. The impact of the volatility of tourism on government revenues appears to have been less adverse than was anticipated: a favorable result.

## TOURISM POLICY

Palau has adopted a policy to attract high-value tourists but has limited resources 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. The need for a tourism strategy or master plan thus remains unfulfilled. Until a comprehensive approach can be developed, Palau will have limited options to mitigate the vagaries of market forces and to improve the likelihood of achieving its high-value tourism policy objectives.

## FISHERIES POLICY AND MARINE SANCTUARY

In October 2015 Palau passed the Palau National Marine Sanctuary bill which will preserve 80 percent of Palau's exclusive economic zone (EEZ) of 500,000 square kilometers as a protected area free from commercial fishing and exploitation. The reform will be executed gradually but the PMNS will be fully effective in January 1, 2020. Once implemented, the PMNS will be one of the largest protected ocean areas in the world.

Palau is currently a member of the Parties to Nauru Agreement, and thereby Palau benefits from the sale of vessel days to commercial fishing operators. While Palau's allocation of fishing days, or Party Allowable Effort, of about 600 days is small compared with other PNA members, fishing royalties have grown significantly in recent years and brought in $8.5 million in revenues in FY2018. While Palau hopes to maintain the benefits of the PNA through sale of days to other members, other partners have argued that it is inconsistent with a fish conservation policy when it encourages an increase in fishing in other waters. Palau hopes that if it does, indeed, suffer a loss of fishing days, that the appeal as a conservation area will motivate demand for high value tourism to make up the short fall. However, to attract environmentally conscious visitors, Palau will need to control the mass package tour market that has dominated in recent years. In the interim, and perhaps beyond, Palau also hopes it gains support from environmentally focused donors to offset any loss to its direct revenue base.

## C. The External Sector

### EXTERNAL DEBT

Palau's external debt, at 32 percent of GDP, is low by regional standards. Debt service of 7 percent of national government domestic revenues has remained well within the capacity of the national government to service and does not present any threat of debt stress. However, large on-going ADB loans, the Koror-Airai Sanitation Project Phase I ($28 million), the submarine-cable project for providing access to the internet backbone ($25 million), a possible KASP Phase II ($25 million), and two new loans including the forthcoming RoC housing loan ($15 million) and possible 2nd backup fiber optic cable loan ($25 million) suggest that Palau's debt profile should be monitored carefully for long-term sustainability.

All of the on-going and new loans are the liability of the national government but have been on-lent to the respective bodies. KASP I and possible KASP II will be serviced by the Palau Utilities Corporation, the existing submarine cable and possible backup cable will be serviced by the new Belau Submarine Cable Company, and the RoC loan will be on-lent and serviced by the National Development Bank of Palau. While the original cable project is already paying for itself there is strong justification for the 2nd fiber. However, there remains a risk that subsidies may be required in the case of the PPUC (especially if KASP II proceeds) depending on the pricing policy adopted, although PPUC is mandated to operate on a full cost-recovery basis. The new housing loan which includes funds for land subdivision in Babeldaob and loans to households may also require ongoing subsidies.

The debt-to-GDP ratio is projected to rise in FY2019 to 35 percent of GDP (excluding KASP II, which is now in deferred status) once KASP I and the original submarine cable loans are fully drawn down. If the new loans are also fully utilized, then the debt to GDP ratio is likely to rise above 40 percent of GDP by FY2020. While much of the debt service will be covered by tariffs and fees, the increased liability that may be placed on the national government needs to be monitored. While the historically low external debt profile has provided Palau with significant space for future borrowing, this may well be approaching a desirable limit.

## D. Fiscal Performance and Policy

### THE FISCAL OUTTURN

Palau has generally maintained a prudent fiscal policy. Between FY2005 and FY2013, it has recorded a fiscal balance in the range of -2.1 to +1.5 percent of GDP. With the onset of the economic recession in FY2008 and FY2009, the fiscal balance turned negative. However, since the recovery in FY2011, the government has recorded surpluses in each year. As the economy boomed in FY2014 a large surplus of 3.6 percent was recorded, with an even-larger surplus of 4.8 and 4.3 percent in FY2015 and FY2016, respectively. While the economy went into recession in FY2017, fiscal discipline was maintained, and a further surplus of 4.5 percent was attained. This fell to 2.5 percent in FY2018 with the continued economic weakness. By period end, government deposits had risen to $43 million, up from a level of $34 million five years earlier. Given the recent weakness in the economy this has been a favorable development.

### FISCAL RESPONSIBILITY AND FISCAL STRATEGY

Under a recent technical assistance project supported by the ADB, a fiscal strategy was outlined for Palau. It was proposed that government consider enacting a fiscal responsibility framework in law. The principles of fiscal responsibility would commit Palau to manage fiscal risks prudently by applying five principles:

- Manage debt prudently;
- Manage the tax regime to best fit the structure of the economy and to allow for predictability over time;
- Manage capital expenditures to achieve rising national net worth over time;
- Manage reserves and insurance coverage to offset cyclical volatility, natural disasters and the impact of climate change; and

Keep recurrent expenditures within available revenues over time.

### FISCAL CHALLENGES

Looking forward, despite the recent weaknesses, growth prospects and the fiscal outlook appear favorable. However, there remain significant potential fiscal shocks on the horizon:

- The collapsing reserve fund status of the Civil Service Pension Fund;
- The need to service the Koror-Airai Sanitation Project and other social loan repayments (requiring a potential substantial subsidy to the PPUC and NDBP); and
- The need to convert the current COFA Trust Fund from a sinking fund with a fixed nominal drawdown into a perpetual fund capable of supporting a reliable real distribution in perpetuity.

These elements are also identified in the fiscal strategy as requiring special focus.

### TAX REFORM

In 2013 tax reform efforts were initiated, with the main element being the introduction of the VAT. However, the proposal failed to gain sufficient votes in the OEK for passage into law. The VAT, now referred to as the Palau Goods and Service Tax, is ideally suited to Palau because a large part of the tax base falls on tourist expenditures. In FY2018 the tax base including household and tourist expenditures amounted to 99 percent of GDP, with tourist expenditures accounting for 40 percent. The introduction of The PGST has clear benefits in that a large part of the incidence of the tax falls on noncitizens. The tax-reform proposal also included introducing a net-profits tax. At present, business incomes, including those of tourist operators, are not taxed. After the failure of the 2013 tax reform initiative the proposal went on the back burner for several years. At the start of 2018 it once again came under active consideration, and updated versions of the tax reform bills were prepared with IMF support. However, the renewed interest by mid-2019 appears to have stalled, perhaps influenced by national elections looming in November 2020.

## E. Public Financial Management

### PUBLIC EXPENDITURE AND FINANCIAL ACCOUNTABILITY

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 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. The next stage in the PEFA process is for Palau to undergo a formal external assessment: this is planned for 2019. With the external assessment complete, Palau will be eligible to request that

PFTAC assist in the preparation of a road map to improve their PEFA score. The PEFA provides a desirable and objectively verifiable method to assess reform effort over time. Palau has been making slow progress but may very well make more rapid progress once a fully specified road map is adopted.

### FINANCIAL MANAGEMENT INFORMATION SYSTEMS

The FMIS in Palau is nearing the end of its effective life as the responsible software company is no longer operational. A replacement system is actively being pursued, and resources from the Compact Review Agreement have been allocated for this purpose. While it is self-evident that the replacement system must have adequate capacity to support accounting and audit requirements, the system update also provides a valuable opportunity to upgrade reporting of fiscal statistics and support for budgeting and performance management including output delivery.

### PUBLIC SECTOR PAYROLL

Recent trends in government payroll indicate a slight increase in equivalent person-years of 0.2 percent per annum between FY2005 and FY2018. Hourly rates of pay (including benefits) have risen from a level of $8.92 per hour to $12.74 an average annual growth rate of 2.8 percent; 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 0.4 percent since FY2005. The total cost of government's payroll has risen by an annual average rate of 2.9 percent, but payroll costs have remained largely unchanged as a share of total expenditures. In relation to GDP, government payroll has fallen from 20 percent in FY2000 to 15 percent in FY2018. In effect government policy has been to stabilize payroll costs as a share of public expenditures, but to reduce the overall size of government relative to the economy over time: a welcome and favorable outcome.

## F. State Owned Enterprise Reform

### THE SOE SECTOR

The SOE sector in Palau is not large in number of entities, in comparison to other Micronesian economies. There are four major SOEs of which one has been newly created: the Palau National Communications Corporation (PNCC), the Palau Public Utilities Corporation (PPUC), the National Development Bank of Palau, and the new 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 will be contracted to a public private partnership (PPP) through JICA and a private Japanese corporation.

There is no legal framework to support the commercial operations of the sector, and unsurprisingly the sector performs poorly[1]. Board members are political appointees and may lack experience in the functions of the SOE. SOEs are not required to operate on a commercial basis (except notionally for water) and prices are set at "affordable" rather than commercial rates. There is no monitoring mechanism of the sector and corporate planning is weak. As a result, maintenance is often insufficient and excessively deferred, resulting in disruption of services and, ultimately, in higher capital costs.

In 2014 the President issued an SOE policy with a primary objective that SOEs should operate as successful businesses and recover all their costs, including the costs of capital. A set of policy principles were outlined to support the primary objective: specification of community service obligations (CSOs), appointment of qualified directors excluding political appointees, preparation of annual performance targets, and performance monitoring and benchmarking, to name a few. The policy statement was well specified and would have greater effect if enacted into law.

## REFORMS IN THE WATER AND SANITATION SECTOR

Under the ADB Water Sector Improvement Program (WISP) provision of water and wastewater functions, formerly provided through a government department, were merged with the PPUC. A key element under the WISP was the provision of services at full cost recovery, and significant price increases have been achieved. A recent ADB review has studied the operations of PPUC including power and proposed a new tariff structure. A second ADB supported program in the sector, the Koror-Airai Sanitation Project (KASP $28 million), entails substantial upgrading of infrastructure with the possibility of a second phase to complete the task ($25 million). The KASP projects will result in significant increase in tariffs—in line with improved services—if full cost recovery is to be achieved. Current projections (based on the tariff study) suggest tariff increases of 34 and 28 percent, respectively for the two phases accumulating to a total of 63 percent. In the absence of a firm commitment to raise tariffs, which have already risen significantly, the sanitation projects pose a significant risk to fiscal stability.

## ICT REFORMS

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 complete. ICT services had been very poor in Palau with some of the highest prices in the Pacific region resulting in a "repressed" market, i.e. where demand is kept artificially low due to high pricing.

The implementation of the new fiber has resulted in considerable improvement in the quality of internet access and prices have fallen significantly. With currently over 3,800 fixed line and digital tv subscribers, and about 3,000 residential internet users, the market is nearing saturation. The major challenge for PNCC going forward will be to penetrate the remainder of the consumer market, introduce new products and tariffs in the business segment and for tourists while reducing cost.

The second phase of ICT reform 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 provider, the Palau National Communications Corporation. The law also creates a new regulatory bureau in the Ministry of Infrastructure, Industries and Commerce, which will regulate the sector and issue licenses to potential new entrants, although there is a moratorium on new entrants for a period of two years.

A major concern for the PUC has been the legacy loan incurred to finance the old copper and satellite-based telecom infrastructure. The remaining debt and high finance cost have disadvantaged the PPUC to engage in a deregulated competitive marketplace. The government is currently under negotiation with the ADB to refinance the RUS loan with expectations for sector reform. A further issue under debate has been the possibility to build a second fiber connection to enable Palau to guarantee continuous, disruption-free internet service. The financing costs appear comparable with that currently being paid for expensive satellite bandwidth, although that cost is likely to fall for any subsequent contract renewal. While there appears to be a strong business case for the 2nd fiber, it needs careful evaluation with realistic prices for ongoing satellite-based service-continuity protection.

# G. The Financial Sector

## BANKING

The deposit base in the Palau banking system ($283 million in FY2017) has grown very rapidly in the tourism boom period FY2011-FY2016 reflecting the booming economy, foreign direct investment, and land lease purchases. However, lending performance to the private sector has been weak and represents only 13 percent of the deposit base, probably the lowest in the region. The resulting surplus liquidity, now over $254 million, is invested offshore in low yielding assets. 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. 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

The accrued liability of the Social Security system at the time of the last actuarial report in 2015 was $268 million. The value of the assets of the fund was $91 million indicating an unfunded liability of $177 and a funded ratio of 34 percent. Despite the relatively low ratio compared with other social security funds in the region, the system is in a favorable position looking forward.

In recent years the Social Security system has undergone a series of reforms and adjustments to increase benefits and to maintain sustainability. In 2013 taxable earnings were raised from $5,000 to $8,000 effective October 2017. The retirement age of 60 was raised to 62 as of October 2015 and will be raised to 63 from October 2020. Other significant financial changes include an increase in the basic benefit from $98 per quarter to $148. As part of the FY2017 budget an additional benefit of $50 per month was awarded to beneficiaries and the government transferred $2 million to support the payment. At the start of 2018 the 6 percent contribution rate for both employees and employers was raised to 7 percent to pay for the increase and the cap on taxable wages was removed. While these changes significantly improved the sustainability of the fund, a further monthly benefit of $50 was awarded in 2018 coupled with a $2 million transfer to cover the additional cost, a cost that will be required annually in the FY2019 budget and thereafter. Our projections indicate that the Social Security system is now on a sustainable basis, but that a careful actuarial assessment is required using Palau demographic and "experience" data to replace the current use of US life tables.

### CIVIL SERVICE PENSION FUND

The Civil Service Pension Fund (CSPF) presents a significant risk to government. With an accrued net pension liability currently close on $260 million, fund assets are a mere 10 percent of liabilities. Without reforms the CSPF is projected to collapse before 2030 and require $7 million in annual support thereafter. Overtime the deficit is projected to rise as benefits are projected to exceed contributions.

Various remedies have been enacted and proposed. The mandatory retirement after 30 years of public service has been removed. The CSPF has proposed raising contributions from employers and employees from the current 6 percent to 10 percent each, but this seems an impossibly large increase. As part of the marine-sanctuary bill passed in 2015, the law provided for a further $50 increase in the Pristine Paradise Environmental Fee, of which $25 was to be devoted to the CSPF. The marine sanctuary act was subsequently revised and in order to maintain compliance with IATA rules, the $25 reserved for the CSPF was reallocated to the Palau International Airport. However, the law also stated that monies that otherwise would have been appropriated for the PIA would be transferred to the CSPF. An actuarial study and reform proposals have been called for, but the future of the CSPF remains highly uncertain.

As a general principal it would not be appropriate to use broad tax policy (although the PPEF is levied on non-citizens) to fund expenditures related to civil servants. More appropriate would be an increase in contributions or adjustment to benefits. However, the proposed rate increase is large and perhaps a combination of both might be more appropriate. Less desirable has been changes in law creating a 4 percent remittance tax on transfers to be earmarked for the fund. This tax is not applicable to commercial-bank transfers, acts as a tax on money-transfer agencies, and is effectively a distortionary tax on low-income foreign workers. In FY2018 the tax provided $0.4 million to the fund and although the CSPS needs every penny it can get; the tax is inequitable, inefficient and, over time likely to be avoided through alternative transfer methods.

## H. Private Sector Development

### THE WORLD BANK'S DOING BUSINESS SURVEY

The World Bank's ease-of-doing-business survey indicates that Palau ranks 133rd out of the 190 countries surveyed, in the bottom 1/3rd, and suggests there is considerable room for improvement. Palau fares better than the FSM and RMI, which are ranked 160th and 150th, respectively, but is substantially below most of the South Pacific nations. Overall, Palau's scores are generally weak, but ranks in the bottom 1/3rd in starting a business, getting electricity, protecting investors, trading across borders, and resolving bankruptcy.

### 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 the major means to effective implementation of policy and attainment of the high-value tourism objective would be supported through efficient land-use planning.

### THE REGULATORY ENVIRONMENT

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. The PSA review indicates that the current Companies Act is not suited to modern commerce, and the company registry is functioning poorly. The law contains only guidelines, with important details delegated to the regulations. Palau has draft legislation for a new reformed Companies Bill, which creates a modern electronic framework, but this has yet to be considered by the OEK.

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" that 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 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.

### FOREIGN DIRECT INVESTMENT

Palau operates an old-style foreign-investment board approach to FDI regulation, which imposes a range of bureaucratic restrictions and requirements. The law has been recently amended 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, whether the new law, which remains highly prescriptive, will result in improved quality and quantity of foreign investment remains to be seen.

# I. Compact Issues

## COMPACT RENEWAL

Near the end of FY2010 Palau signed the Compact Review Agreement (CRA) with the US. 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 FY2009 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 oa a mutual agreement between the U.S. and Palau, the remaining funds have been allocated, for the most part in the spirt 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 to support 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 and intent be rolled into the bi-lateral annual consultations—also specified in the CRA.

## 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 FY1999 to FY2009 and then $15 million annually for government operations through the Compact's 50th year in FY2044; 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 FY2009. This result was actually slightly better than the blended benchmark market rate of return of 7.32 percent over the same period; however, based on projections made at the end of FY2009 the CTF would have failed by FY2022, long before fulfilling the Compact objective of providing level funding through all 50 years (FY2044).

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 FY2010–FY2024. 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 FY2018, including a CRA deposit of $62.5 million near the end of the fiscal year, current projections indicate that the CTF will achieve its original objective and persist well beyond FY2044. Still it should be noted this implies a continual decline in the real value of transfers over the remaining period of the Compact. Taking market volatility into account, there remains a 5 percent chance the CTF will fail prior to FY2044 and the value of the CTF corpus is declining in roughly 40 percent of cases through FY2044.

### POST COMPACT REVIEW PERIOD UNCERTAINTIES

The term of the CRA will expire at the end of FY2024 and further funding 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 FY2024 from the creation of a perpetual Compact Trust Fund is estimated to be $5.8 million, the range of possible loss of Federal programs may, in the worst case, add a further $16 million or more to the size of potential fiscal adjustment. In the remaining years of the amended Compact through FY2024, clarity is required on the status of these programs so that Palau can effectively plan for the post-FY2024 Compact period.

## J. Economic Outlook

### IMPROVEMENT IN OUTLOOK EXPECTED IN THE NEAR-TERM

The period of weak economic performance experienced since the tourism boom is expected to continue in FY2019 as visitor arrivals are expected to decline by 25 percent to less than 90,000 and GDP is projected to drop significantly. However, economic growth is projected to resume during the next 5 years as the tourism industry recovers and occupancy rates return to normal. With occupancy rates returning to 50 percent, the average attained during FY2012-FY2016 period, visitor numbers would reach 165,000 in FY2024, but still below the peak level attained in FY2015.

A variety of construction projects are also planned for this period including the $30 million airport renewal PPP, the $15 million Japanese funded landfill relocation project, $20 million CRA infrastructure projects, and completion of the KASP I sewer and wastewater project. A variety of smaller projects are also anticipated including a new conference center, Angaur dock and visitor sites. Reflecting the assumptions that: (i) the private sector is able to obtain positive returns on the recent investments, (ii) the number of flights expands with new services as carriers have proposed, and (iii) the projected surge in infrastructure projects, growth is projected to average 4.5 percent through the end of the CRA period. No doubt there will be annual variation characteristic of a small economy like Palau, but prospects looks favorable.

### REFORMS NEEDED TO CONSOLIDATE THE FISCAL CHALLENGES

A reform scenario based on the fiscal responsibility framework and related fiscal strategy is developed[2] to redress the long-run fiscal risks under the of the current policy environment:

- **Tax reform**. Palau implements a comprehensive tax-reform strategy in FY2021.
- **Perpetual COFA Trust Fund**. Drawdowns from the CTF are reduced in FY2021 and thereafter maintained at the real rate of FY2021 allowing for a stable and secure level of funding on a perpetual basis.
- **Civil Service Pensions Fund reform**. Government allocates additional transfers from the PPEF to the CSPF together with an increase in employer and employee contributions.
- **SOE reform**: Government adopts the KASP I project requirement of full cost recovery and further implements KASP II with a Community Service Obligation (CSO) to address impact on vulnerable households.
- **Infrastructure Development**. Commitment is made to maintain national government infrastructure spending as a fixed proportion to GDP.
- **General Fund Reserve**: The GFR is restructured to maintain the reserve at a specified ratio to domestic revenue.

The impact of the reforms on the real economy, GDP and employment, is projected to be minor with little variation between the "baseline", that is before reform, and the reform scenario. However, the impact on inflation and incomes is less favorable as per capita real incomes fall by an estimated 5 percent to pay for the additional resource allocation to fund the reforms. However, the financial position of the nation is considerably improved: the CTF becomes perpetual, the CSPS is stabilized, the nation's infrastructure is improved, and fiscal policy has been protected against cyclical volatility. The nation would have implemented an economical efficient tax regime. Overall, the impact of adoption of the fiscal strategy on public sector financial wealth is estimated to improve significantly by over 25 percent. The tradeoff is the classical one between resource mobilization in the near term to support enhanced economic growth versus policies that will provide greater benefit to future generations.

## K. Other Issues

### STATISTICAL ISSUES

Statistical availability in Palau can now be accorded a high score. After a period of weak and deteriorating availability of macroeconomic data, Palau now has a comprehensive range of economic statistics through which to monitor 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 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 to improve integrity and consistency are largely complete. Quarterly GDP estimates—a priority of international institutions—are also under consideration. Staffing levels have improved considerably, and progress is being made with capacity building.

# 1. Review of Economic Developments

**After a period of rapid tourism-driven growth after the international financial recession GDP grew by 3.9 percent annually over the FY2010-FY2015 period. In FY2016 the boom came to an end, as visitor arrivals fell sharply, and the economy stagnated in FY2016 through FY2018, declining by 1.0 percent annually during this period. Given the large decline in tourism, the economy has performed well to maintain employment and living standards.**

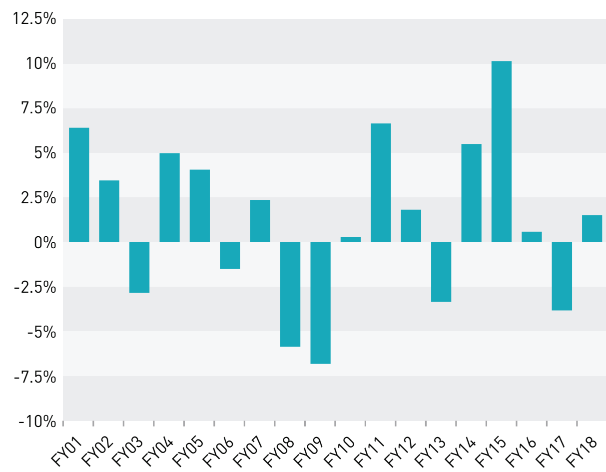
- The population of Palauans has remained little changed since the mid-80s, with external migration playing a significant role. The small size of the nation and growing economy has required Palau to rely heavily on foreign labor. The size of the foreign work force has varied in proportion to the demands for labor and the economy.
- Between FY2000 and FY2018, real GDP per capita expanded by an average annual rate of 1.6 percent and above the annual rate of GDP growth of 1.2 percent. In FY2018, gross national disposable income (GNI) per capita was $15,408, which places Palau well above the lower threshold of the World Bank's high-income group of$12,005. Studies on poverty indicate that 12 percent of the population exists below the basic needs poverty line. Measures of inequality suggest the Palau distribution is relatively unequal with estimates of the Gini coefficient ranging in the 0.4 to 0.5 range.
- While no unemployment data exists in Palau, the labor market is considered to be largely fully employed. Demand for labor in excess of Palauan participants in the labor market is filled through foreign workers. Employment growth in the public sector has been modest with that in the national government declining since FY2000. Employment growth in the private sector has matched that in the public sector
- Wages have grown modestly in Palau by 2.6 and 2.3 percent per annum in the private and public sectors, respectively since FY2000. However, once inflation has been taken into account, real wages have stagnated with real private sector wages growing by a mere 0.1 and public sector wages falling by 0.1 percent, indicating stable standards of living.
- After a period of negative inflation in FY2016 with falling world oil prices, inflation turned positive in FY2017, recording a 0.9 percent change. In FY2018 with return to higher fuel prices and increases in food prices, the Palauan CPI rose by 2.0 percent.

# 1. Review of Economic Developments

## A. Gross Domestic Product, Growth and Structural Change

### TRENDS IN ECONOMIC ACTIVITY

**Figure 1**
RoP real GDP annual growth, FY2015 prices, (%)




**Growth in early 2000s marked by strong tourism and construction activity:** The first part of the 2000s, FY2001 through FY2005, was a buoyant and positive period for the Palauan economy (Figure 1). The economy grew by an average annual rate of 3.2 percent,[1] reflecting both large construction projects and strong tourism growth. Of the total annual economy-wide growth of 17 percent over the period, construction (primarily the $149 million Compact Road project) contributed 4.7 percent and tourism activities (accommodation, meals, diving and tours) 3.3 percent. Tourist arrivals grew from 56,501 to 85,004, an annual growth rate of 8.5 percent.

**Onset of financial crisis accompanies large reductions in GDP:** In FY2008, the global financial crisis hit, and GDP dropped by 5.9 percent. The crisis continued into FY2009 and the economy contracted by a further 6.8 percent. Several negative forces occurred at the same time. Construction of the Compact Road, which had buoyed economic growth in the early 2000s, came to an end. That was the dominant negative force, responsible for 3.9 percent of the two-year loss in GDP of 11.5 percent. Tourism demand, reflecting the onset of the financial crisis, also turned negative and contributed 1.8 percent to the overall decline. Finally, the combined impact of these forces and high rates of inflation of 10 and 5 percent in FY2008 and FY2009, respectively, further eroded demand.

**After a very weak period, the economy entered a period of sustained tourism growth from FY2010 through FY2015.** Despite a weak year in FY2013, economic growth averaged 3.9 percent during this period. However, the forces of growth were different and more widespread. Of the total GDP growth during this period of 21 percent, the tourist sectors were responsible for 9.7 percent of this growth, construction activity represented only 0.7 percent. While new tourist plant was developed, this was offset by a decline in public infrastructure projects. Much of the growth in tourism was based on better capacity utilization of existing plant. Support services in retail trade and communications also played an important part in the expansion. Tourist arrivals rose from 81,101 in FY2010 to 168,767 in FY2015 at an annual average rate of growth of 16 percent.

**The tourism boom comes to an end and the economy stagnates:** Overall GDP fell by 1.0 percent during the FY2016-FY2018 period. Construction activity was stationary while tourism contributed negatively by 3.2 percent. Visitor arrivals contracted from a high of 168,767 in FY2015 to 115,964 in FY2018, a

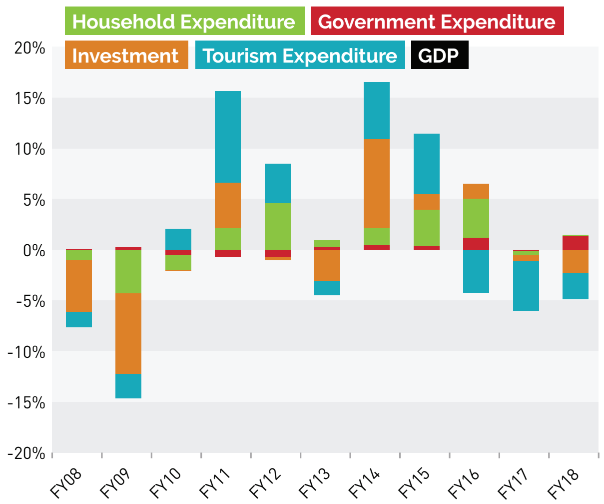
1 Note: GDP growth is measured as the average of GDP growth from the production and expenditure methods. The GDP series has also been rebased on FY2015.

massive reduction, of 12 percent on an annual basis. The impact of the downturn in visitor arrivals from the heights of the prior years was largely concentrated at the lower-end package-tour segment, although there has also been reduction in the traditional higher-spending segment of Palau's market. The impact on the economy has thus been lower than the overall drop in visitor arrivals might suggest. While tourism activity contracted severely, there have been important offsetting forces. The implementation of the new fiber internet connectivity was a positive force adding significantly to growth and adding 2.3 percent to the overall position. Public administrative services also grew--adding 1.5 percent to the result reflecting an election year in FY2016 and further growth in the last two years.

## SOURCES OF ECONOMIC GROWTH

**Tourism and investment major sources of both growth and contraction:** The sources of growth by expenditure component of GDP[1] are revealed in Figure 2. The major driving forces of the economy are clearly seen to be tourism and investment, with household expenditures,

**Figure 2**
GDP by major expenditure categories and contributioin to growth, FY2015 prices, (%)




as to be expected, reflecting the pattern of overall performance. Demand for government expenditures has been a moderate force, although it was more expansionary in recent periods.

**Annual performance varies from period to period:** In FY2008 and FY2009, the completion of the Compact Road had a stronger impact than the financial crisis and reductions in tourism. Between FY2011 and FY2012, tourism was the driving force, but in FY2013 declines in both public investment and tourism resulted in contraction in GDP. While tourism is generally considered the main driving force, in FY2014 it was investment in the utility sector and hotels that had the more significant impact. In FY2015, tourism was clearly the driver, replacing investment as the main contributor to economic growth. In FY2016, as tourism demand fell, investment, buoyant demand for labor and rising remuneration rates led to strong growth in household consumption, all maintaining the level of economic activity. In FY2017, the reductions in tourism were the major source, but in FY2018 both investment and tourism were negative.

**Annual economic growth has been highly volatile but with moderately positive performance over time:** The pattern that emerges for the Palauan economy is one subject to a high degree of volatility. Of the last 18 years for which there is data, 12 have been positive and 6 negatives. The amplitude and variation have been notably large: four years have shown growth greater than 5 percent one of which reached 10 percent, and 4 years with negative growth greater than 5 percent. These results are perhaps not surprising given the small size, concentration of production, and unregulated nature of the economy. Overall the average rate of growth over the period has been moderate growing by 1.2 percent on an annual average basis, and 0.8 percent when measured through log-linear trend regression.

1 Note: imports, which make up the difference in GDP growth, have not been included.

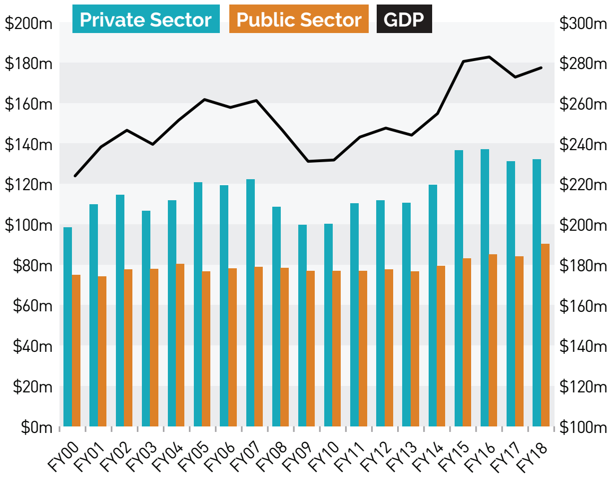
## GDP BY INSTITUTIONAL SECTOR

**Patterns of economic growth:** Figure 3 illustrates the overall level of constant-price GDP and the performance and contribution of the private and public sectors. A major observation from Figure 3 is that despite the recent growth in tourism, it was not until FY2015 that the level of GDP surpassed that attained in FY2005, and it is currently 1 percent below the FY2015 level. The recession in FY2008 through FY2010 was deep, and only after a sustained period of tourism growth was the lost ground made up.

**Private sector growth has moved in cycles:** The figure also clearly reveals the impact of the recent economic developments on the private sector, showing growth in the early 2000s peaking in FY2005, the impact of the recession, the recent improvements after FY2010 through FY2015 and stagnation since that time.

**Public sector remains stable:** The public sector, on the other hand, has remained very stable during the period, underpinning economic activity. During this time, the public sector has grown by an annual average of 1.0 percent. The public sector is represented by the national government, SOEs, the state governments and government agencies. While the national government has declined by an average annual rate of 0.3 percent, growth in the SOEs average 2.9 percent with the agencies and sate

**Figure 3**
RoP real GDP by private and public sector, FY2015 prices, (US$ million)




government averaging 1.6 percent. The relative strong performance of the SOEs reflects recent growth in the telecoms sector and new internet services. Taken as a whole, the non-national government components of the public sector are 27 percent larger than the size of the national government.

**Stable public sector has allowed private sector to be engine of growth:** It is clear from Figure 3 that variability in economic performance has come from the private sector and that responsible policies have held the public sector in check, allowing the engine of growth to be focused on private initiative. This has not come without cost, as dependency on a narrow range of economic activities brings significant risks in terms of downturn in periods of weak demand. However, given the size of the Palauan economy and resource constraints, such risks are largely unavoidable.

## INDUSTRY DEVELOPMENTS

**The agriculture sector is small:** Agricultural production is small in Palau, accounting for 1.5 percent of GDP. It is represented by a few commercial farms, informal growers, subsistence production for household consumption, and government extension activities. Little is known about noncommercial production, and estimates are projected in relation to population change. With the recent estimated declines in population, production estimates are down, although backward linkages from the tourism sector would afford opportunities for increased output.

**Fisheries make small contribution to GDP:** The fishing sector is small in Palau compared with neighboring Micronesian economies. In economic statistics, the fish that are caught and owned by foreign fishing businesses (the sashimi-grade fish for export to the Japanese market) are not considered part of GDP. The onshore fish-based activities to package and re-export the fish from Palau are considered part of service exports and do contribute to GDP, although the activity is small. Taking the industry as a whole, including shore-based activities, aquaculture, fish for the home market and the tourism industry, together with a small contribution from subsistence production, it represents just 1.7 percent of GDP and has largely stagnated since FY2000, although there has been an uptick in the last two years. It is important to note that fishing-fee royalties, which have grown rapidly in the last few years, are not part of GDP but are captured in the balance of payments as primary incomes and are included in GNI.

**Utilities sector grows modestly with reform in water and sewer:** The manufacturing sector is very small. Although garments were produced for export at the start of 2000, those operations closed in 2001. The utilities sector is now completely operated by the Palau Public Utilities Corporation (PPUC) and has been since completing the amalgamation of the water and sewer operations previously operated under the government Bureau of Public Works. Electricity production has grown modestly since FY2009, with an average growth of 1.6 percent. Water was supplied through the Bureau of Public Works, but this agency has now been amalgamated into the PPUC as part of the ADB Water Sector Improvement Program (WSIP). Under the WSIP, the government has committed to operating water and sewer operations at full cost-recovery prices, and tariffs have risen significantly from low levels. However, achievement of commercial viability will lead to a further doubling of water and sewer rates.

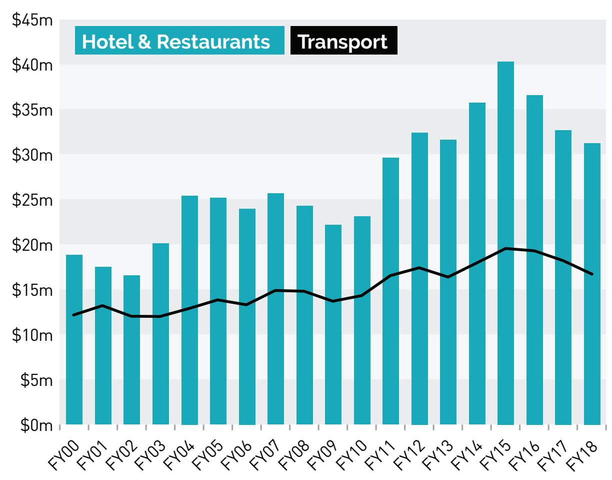
**Construction has been a leading sector:** Construction has been a leading industry in Palau. Initiatives have included a series of large public sector projects such as the Japan-Palau Friendship Bridge at the start of the 2000s, the Compact Road during the early and mid-2000s, the capitol complex during the same period and various airport improvement projects. Hotel construction has also been significant as new plant has been added through the period. However, some hotel construction is undertaken as "own account," or produced by the owners, and is not represented in the construction statistics. At the start of the 2000s, construction represented 8 percent of GDP. It rose to a peak of 14 percent in FY2002 and, reflecting a lack of new projects, fell to 3.5 percent by FY2013. Reflecting the recent rapid growth in tourism, several new hotel projects were completed in FY2014 and FY2015, but demand slowed with the downturn in the tourism industry, although several projects remain under construction.

Several public sector infrastructure projects, including the Koror Airai Sanitation project and the Japanese-funded water-supply improvement project, stabilized construction output, which now represents 4.4 percent of GDP.

**Wholesale and retail follows trends in the economy:** The wholesale and retailing sector depends on demand from the local and tourist economies. It comprises two major components: fuel importers and general merchandisers. Value added generated by fuel distributors has been erratic but dropped in FY2009–FY2010, reflecting restructuring in the sector as the original distributors left the market and new firms entered. Since market consolidation in FY2012, output has remained largely stationary. General merchandising has responded to the general well-being in the economy, growing in the 2000s with the large construction projects and growth in tourism. During the recession, output declined, but picked up with the revival in tourism and grew on average by 5 percent between FY2010 and FY2015 but subsequently stagnated.

**Significant structural change in the economy with the rapid growth in tourism:** The hotel accommodation, restaurant and transportation industries have been leading sectors in the economy, as shown in Figure 4. Value added in the two industries displayed a period of growth in the early 2000s, stagnation

**Figure 4**
Hotels, restaurants, and transport value added, FY2015 prices, (US$ millions)



and contraction in the mid- to late 2000s, a sustained period of rapid growth between FY2009 and FY2015, and the recent reductions in FY2016 through FY2018 as visitor numbers contracted. The transportation sector includes the operation of water-based tours and diving, land transportation and the operation of the local airport. The overall contribution of the two industries has risen from representing 13 percent of GDP in FY2000 to 21 percent in FY2015, but has subsequently contracted to 18 percent, but still indicates significant structural change.

**Commissioning of new fiber optic sees rapid growth in telecom output:** The communications sector includes the Palau National Communications Corporation (PNCC)—an SOE—and other providers of communications services. The telecommunications output of the PNCC expanded rapidly between FY2010 and FY2017, growing by an average of 8 percent per annum, reflecting the buoyancy of the telecom industry internationally, despite the poor service quality and exceptionally high cost arising from a lack of fiber optic internet connectivity during this period. However, in FY2018 and the creation of the third SOE, the Belau Submarine Cable Company, the new fiber connection was commissioned, and output expended by 41 percent, reflecting the rapid growth in use of newly available bandwidth.

**Improved banking regulation has led to better performance in the financial sector:** Performance in the financial-intermediation sector has been erratic. This sector is made up of commercial banking, the National Development Bank of Palau (NDBP), and other financial service providers, such as insurance and money-transfer companies. Performance in the commercial banking sector has been erratic. Factors have included weak regulation in the early 2000s, collapse of the Pacific Savings Bank in FY2007, restructuring, better regulation and a return to improved performance since FY2013. The NDBP grew rapidly through the 2000s but has declined since output peaked in FY2010. Other financial services are small in magnitude and have displayed only moderate growth.

**Demand for commercial real estate grew strongly with the growth in tourism:** Real estate activities are an important component of the economy, represented by ownership of both dwellings and commercial rentals. The former category is estimated to be in line with population growth, which grew up to 2005 but thereafter has declined. Commercial renting is a significant component of economic activity in Palau because of the large number of foreign nationals, slightly larger than 25 percent of the population. In the early 2000s, renting grew rapidly with the need to house a growing number of foreign workers in the construction and tourism industries. After the completion of the Compact Road, output adjusted downward, but since the adjustment in FY2006 the sector has grown strongly, averaging 5 percent per annum with booming tourism demand. During the boom years there was active growth in the construction of new commercial property, refurbishment of existing premises and conversion of home rentals to the short-term tourist market, which has subsequently waned.

**Minor business services reflect conditions in demand:** In the revised International Standard Industrial Classification version 4 currently used in Palau, business services are separated into professional, administrative and support services. These services make a minor contribution to GDP. Professional services declined during much of the initial period, picked up during the tourism boom and have subsequently fallen off. Administrative and support services which include several tourist related activities although minor have grown since FY2010 and the surge in tourism.

**Administrative services of the national government contract as State governments expand:** Public administration is made up of the national government, government agencies—such as the Palau Community Action Agency and the Palau International Coral Reef Center—state governments, and social security funds. The national-government public administration experienced a downward trend of 0.3 percent between FY2004 and FY2018, although there has been an uptick in the last three years. Koror's state government has grown consistently and rapidly since FY2000, by 5.1 percent, reflecting buoyant revenues derived from Koror State Park. The reduction in revenues with the downturn in tourism and disappearance of jelly fish from the State park has tightened the State's finances and led to a contraction in FY2018.

Other local government has grown more modestly, averaging 2.2 percent since FY2000. Local government represents 27 percent of the size of national-government administration, while the remaining agencies represent 15 percent.

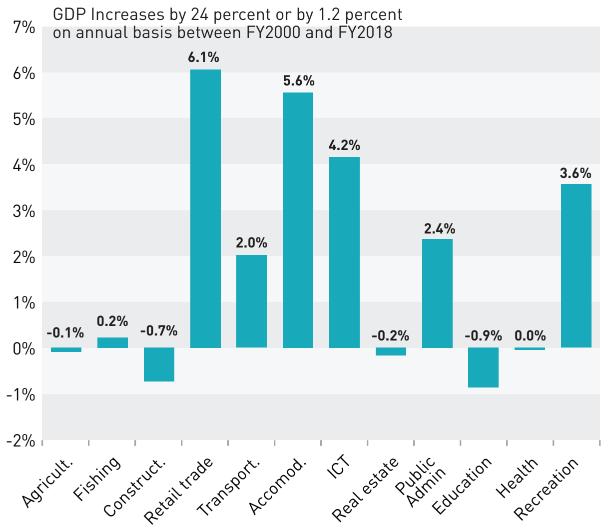
**Education services contract as health remains unchanged:** Education services are provided by the national government, Palau Community College and nongovernment schools. Services provided by the sector have declined by 1.0 percent through the period. Health services, which are predominantly provided by the national government, have displayed an erratic trend since the start of the 2000s, but perhaps by coincidence the trend has mirrored that of the economy. Health service levels currently stand slightly below those attained in FY2000. In addition to education and health services, there are several private services provided to households, including entertainment, recreation, arts and employment within households.

**Indirect taxes and subsidies:** GDP also include the receipt of indirect taxes and payment of subsidies to the SOE sector. There are three major categories of indirect taxes: import taxes, the business gross-receipts tax (BGRT) and additional taxes on products (hotel-occupancy tax). While import taxes have largely stagnated—with the exception of discretionary tax increases in taxes on tobacco products—the path of the BGRT has mirrored that of the private sector contribution to GDP during the economic cycle[1]: declining during the global financial recession, growing with the recent expansion in the tourism industry, and declining in FY2017 with the weak economic performance. Other taxes on products, mainly the hotel-occupancy tax (an ad valorem tax), have mirrored the fortunes of the tourism industry. Subsidies to the SOE sector, in particular to the utilities (PPUC), have generally been small. Water and sewer operations were transferred to the PPUC in 2013 and currently require a significant government transfer to cover costs. However, these are treated as nonmarket operations and thus are considered as transfers in the national accounts and not subsidies. In the future, this may change as the PPUC attains full-cost recovery and tariffs reach economically significant levels.

**FISIM reflects banking sector performance:** Finally, an adjustment is made to GDP for "financial-intermediation services, indirectly measured," the difference between interest receipts and payments of the banking sector relating to productive activities. The trend resembles that of the banking sector but with opposite sign.

**While tourism services dominate economic growth, the decline in education and health is a cause for concern:** Figure 5 summarizes the relevant contribution of each major industry to GDP, some of which will be anticipated and others unexpected. Overall GDP grew by 24 percent during the period or 1.2 percent on an annualized basis. While construction actually had a negative impact on overall growth, the distributive trades were the largest component reflecting overall economic performance and the growth in household incomes during this period. The tourism sectors, accommodation, transport and recreation (mostly Koror State park), were responsible for nearly half of GDP growth. Perhaps surprisingly telecom or ICT services also make a significant contribution reflecting

**Figure 5**
Contributions to GDP by Industry since FY2000




1 This result should not be surprising as the BGRT is a major indicator of private sector activity.

the increasing demand for internet services, and also the introduction of new lower cost products. While public administration growth was positive, the declining or stagnant levels of education and health services could at some point become a cause for concern.

## STRUCTURE OF THE ROP ECONOMY

**Institutional change in GDP structure is little changed:** The structure of the RoP economy is presented in two parts: by institutional sector and by industry. Changes in the structure of the economy by institutional sector between FY2000 and FY2018 are indicated in Figure 6. The main observation is that institutional change has been modest. For the most part, the picture presents a healthy structure, with private enterprise representing the largest share of economic activity, which increased its share by 2.0 percent during the period. Government activity, including the national and state governments plus agencies, currently represents 22 percent, and its share has fallen by nearly 4.1 percentage points during the period. This is an appropriate level for a small developing economy and is considerably less than the large public sectors in the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI). The role of the public sector in commercial activity is limited to utilities and telecommunications. The public sector represents 10.1 percent of GDP and increased its share by 2.0 percentage points. The financial sector has undergone significant restructuring following the closure of several banks and the collapse of the Pacific Savings Bank. Overall, the financial sector is small and now represents only 1.9 percent of the economy. Its share has fallen by 1.8 percentage points, reflecting the changes in the industry, structural weaknesses in the lending environment, and a lack of a proactive business culture of the remaining banks. The share of the household sector has grown slightly and makes a significant contribution to GDP in both marketed and nonmarket production. Market production consists of mixed incomes derived from agriculture and fishing. Nonmarketed production (for household subsistence or own consumption) mainly entails home ownership but also includes agriculture and fishing. Lastly, the share of indirect taxes has increased by 3.0 percentage points and represents 11.7 percent of GDP. The increase reflects changes in discretionary tax rates, namely significant increases in taxes on tobacco.

**Significant transformation in industrial structure has occurred since FY2000:** Figure 7 indicates the structural changes in the economy from an industry perspective. Unlike the institutional structure, there has been significant change in the industry composition. The share

**Figure 6**
Structure of RoP economy by institutional sector

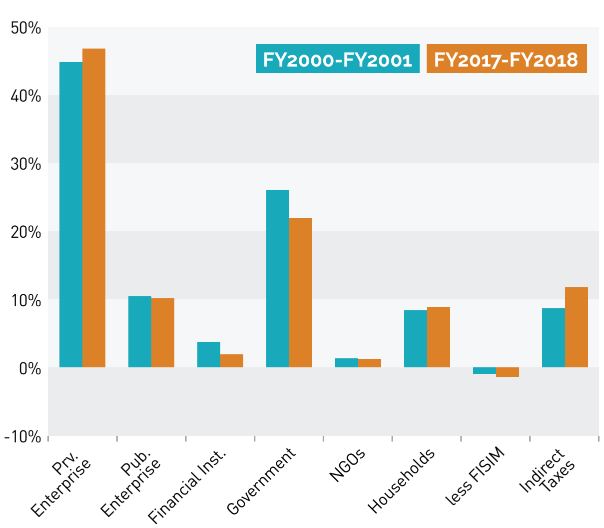
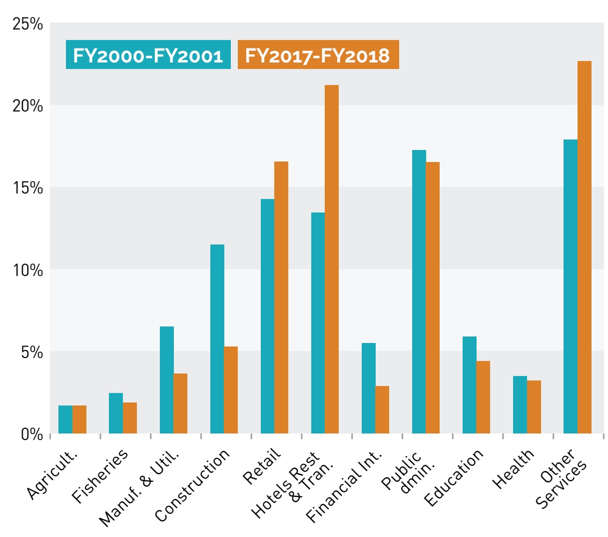



**Figure 7**
Structure of the RoP economy by industry



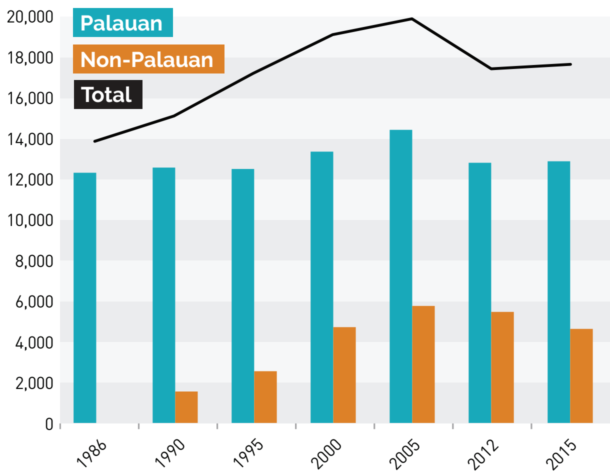
of manufacturing dropped markedly in the early 2000s with the closure of the garment factories. The importance of the construction industry also fell as infrastructure, the capitol and hotel projects were completed by the mid-2000s. Conversely, the share of tourist activities in hotels, restaurants and transportation has grown rapidly, from 14 to 21 percent of GDP. Clearly, the change indicates the transformation of the economy into one highly dominated by and dependent on tourism. While Palau has benefited from tourism growth, the substantial size of the industry indicates the potential risks of being dependent on one industry. The share of merchandising, wholesaling and retailing together with that of other nonfinancial services has grown collectively by 7 percentage points and risen with the growth in tourism. The share of public administration has declined as noted in the previous discussion. Education and health have dropped as well.

## B. Population, Incomes, Distribution and Poverty

### POPULATION

**The Palauan population remains little changed since the mid-80s:** Figure 8 displays recent trends in population as recorded by population censuses from 1986 onward. For Palauans, population remained largely unaltered between 1986 and 1995. However, it grew by 1.3 percent annually between 1995 and 2000 and by 1.5 percent annually between 2000 and 2005. Between the mini-census in 2012 and the full census in 2015, the Palauan population remained little changed. Since 2005, the Palauan population declined by an annual average of 1.1 percent. It is difficult to explain the trends. During the first period (1986–95), it would appear that there was significant out-migration, but between 1995 and 2005, people preferred to stay home. Certainly, the economy was expanding during this period. Between 2005 and 2012, it appears that out-migration again accelerated as large numbers of people left the country. This is consistent with severe recession in the economy from FY2008 through FY2010. However, while population trends respond to economic incentives, this period was also one where opportunities were less

**Figure 8**
Population by Palauan and non-Palauan, by selected years



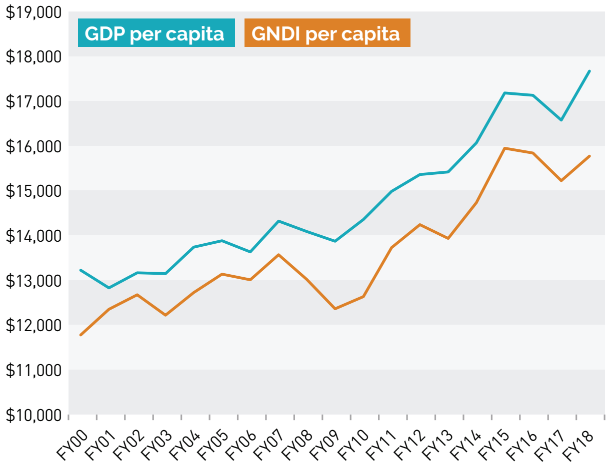

favorable overseas. Between 2012 and 2015, the population stabilized as opportunities in Palau became favorable with growth in the economy.

**Resident non-Palau population reflects demand for labor and state of the economy:** For non-Palauans, of whom an estimated 63 percent are from the Philippines, the trends are more in accord with economic developments and reflect the demand for alien labor. Demand rose from the mid-1980s as the economy grew, with a significant increase in the size of both the public sector and tourism during these early days. In the first part of the 2000s, there was strong demand for foreign labor to support the building of the Compact Road and tourism infrastructure. As these projects came to a close, demand slackened, and the number of non-Palauans fell by 838 between 2006 and 2012. During the last three years, these trends reversed as the demand for foreign labor increased with the growing economy. Overall, taking both Palauans and non-Palauans together, the population rose more smoothly between 1986 and 2005 but subsequently fell by 2,246 between 2005 and 2015, an annual average decline of 1.2 percent.

### PER CAPITA INCOMES

**Palau in World Bank high income category:** Figure 9 indicates the changes in constant-price

**Figure 9**
GDP and GNDI per capita, constant prices FY2015, (US$)




GDP and real gross national disposable income (GNDI) per capita in 2015 prices. An important observation is that the relatively high level of GDP per capita places Palau in the high-income group of the World Bank classifications. In 2018, in current prices, Palau had a gross national income (GNI) per capita of $15,408, well above the World Bank's high-income threshold of $12,005.

**Per capita incomes rise due to economic growth but also due to out-migration:** Constant-price GDP per capita rose during FY2000–FY2007, although somewhat erratically, and peaked at $15,762 per capita in FY2007 (FY2015 prices). GDP per capita fell precipitously in FY2008 and FY2009, falling over $1,207 after FY2007 as a result of the 11 percent loss in economic activity. In the following years, GDP per capita righted itself as economic activity recovered, and GDP per capita attained a level of $15,937 in FY2015, although it subsequently fell in FY2016 and FY2017 with the reduction in economic activity. However, recent rises in GDP per capita have partly resulted from the reduction in population rather than increased economic activity. While GDP growth averaged 1.2 percent between FY2000 and FY2018, GDP per capita rose by 1.6 percent. This is an unusual outcome: average living standards improved because a large number of people emigrated.

**Measures of economic activity:** GDP, GDI, GNI, and GNDI: Figure 9 also includes the trend in GNDI per capita from FY2000. Real GNDI measures GDP adjusted for terms-of-trade changes plus primary and secondary incomes from the balance of payments. In Palau, the two measures are generally in close proximity and move in parallel to each other. The terms-of-trade adjustment revalues exports for changes in the ratio of export to import prices. If export prices rise relative to import prices, there is a real income gain and GDI (gross domestic income) exceeds GDP. In most periods, the effects tend to offset each other. Primary income includes interest and dividend earnings on foreign investments less dividend outflows. Dividend outflows are large in Palau because of the large foreign-investment component in the economy. The latter dominates net primary-income flows, and GNI is traditionally lower than GDI. Secondary incomes are composed of grant incomes from the rest of the world, which are substantial, less remittance transfers of foreign workers. In this case, secondary incomes are always positive, which causes GNDI to exceed GNI.

**The structure of primary and secondary incomes has acted as an automatic stabilizer on real disposable incomes through the economic cycle:** Throughout the period, GNDI is greater than GDP per capita, indicating grant incomes plus terms-of-trade gains outweighed profit and other remittances. During weak periods in the cycle, dividend outflows fall while grant levels remain constant, and the gap between GNDI and GDP widens. These forces reverse during periods of growth as profit repatriation exceeds stagnant grant levels. To this extent, the sum of primary and secondary income flows tends to offset declining GDP during weak periods. During the financial recession the gap between FY2007-FY2010 widened significantly reflecting rising secondary incomes as primary incomes fell. On the upside from FY2010 through FY2015 the gap moved in the opposite direction as the economy strengthened, but in the last 3 years the pattern reversed as the economy weakened.

## POVERTY

**Low level of poverty in Palau:** Based on the results of the 2014 Household Income and Expenditure Survey (HIES), a basic-needs poverty line (BNPL) of $3,508 per adult equivalent and per annum has been estimated by the UNDP.[1] Using this as a benchmark, the survey indicates that 11.5 percent of households have an income below this threshold. These results indicate a low level of poverty in Palau and appear consistent with the unemployment rate of 5 percent estimated in a recent mini-census.

### INCOME DISTRIBUTION

**Palau has a relatively high level of income inequality:** Analysis also indicates that the Gini coefficient based on average household incomes from the HIES was 0.40. (The Gini coefficient is a measure of inequality with perfect equality having a coefficient of zero and total inequality one.) While measurement of incomes from employment was well recorded in the HIES, the survey failed to capture the majority of business incomes. The actual Gini coefficient is thus likely to be higher than estimated. Recent analysis of the distribution of gross wages collected under the Social Security Administration (SSA) indicates Palau has a Gini coefficient of 0.49, relatively high by international standards. For Palauans, disregarding non-citizens, the Gini coefficient falls to 0.40, indicating the sizeable difference between Palauan and non-Palauan incomes. However, both measures of inequality are only partial as they are not based on a full analysis of all sources of income. The Social Security Administration study is based on individuals and does not capture subsistence or business incomes. The overall results from the HIES and SSA sources are that Palau has a relatively high level of income inequality.

**Factorial distribution and share of wages fall in the upswing but reverses on the downside:** Other interesting indicators of distribution can be derived from the factorial distribution of income in the national accounts (share of wages and profits in GDP). At the start of the 2000s, the share of wages in GDP averaged 59 percent from 2000 to 2002 but then trended downward recoding 47 percent at the end of the 2015. The reduction in the share of wages and commensurate increase in the share of operating surplus reflects the changing structure of the economy. As the tourism economy has grown relative to the public sector and other labor-intensive activities, profit-earning activities have increased their share. The rapid growth in tourism was made possible by an increase in capacity utilization, with only modest additional demand for labor. The increase in labor productivity thus also contributed to the increased share of profits. In the more recent period FY2015-FY2018 the trend has reversed as the economic situation deteriorated; employment levels were maintained as profit levels fell.

## C. Employment, Earnings and Wages

### EMPLOYMENT

**Employment stats based on Social Security:** Recent trends in employment are based on quarterly data collected by the Republic of Palau Social Security Retirement Fund (RPSSRF). The figures are estimated from the returns submitted to the RPSSRF by employers, and employment is measured by a count of individuals. Transfer of individuals from one job to another during the quarter or turnover in migrant labor will tend to overstate the numbers. However, the information is the best available at this time and considered to be representative of actual trends.

**Citizen employment has grown slowly with non-citizen employment responding to demand:** Figure 10 indicates recent trends in employment of both Palauans and non-citizens. Citizenship employment has displayed a stable trend over time and has grown from 5,218 to 5,669 during the last 18 years. There was a slight peak in the mid-2000s, reflecting the additional demand for labor to complete the construction projects. Citizenship employment fell with the poor economic performance in FY2009 but has subsequently strengthened with the recent tourism-led growth. The pattern for non-citizenship employment reveals a significantly different story. There was rapid growth in the early 2000s to work on the growing tourism industry and construction projects, and the use

1 UNDP, Pacific Centre, Results of Poverty Analysis Conducted on the Palau HIES, Koror, Palau, 2015.

**Figure 10**
Employment by citizenship

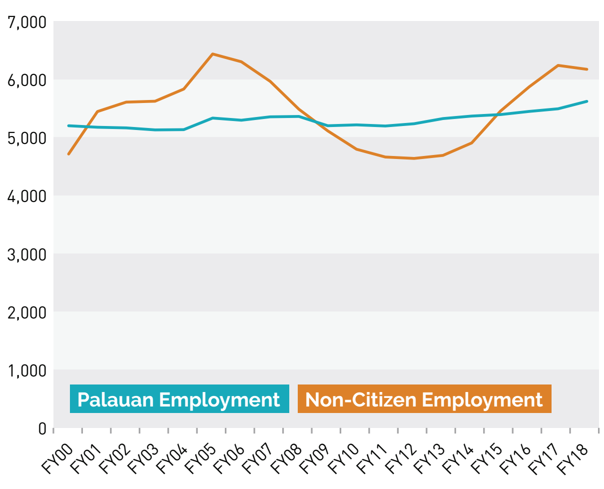
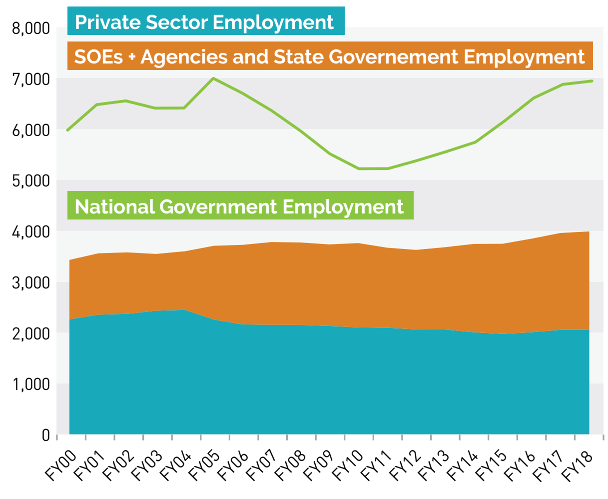



**Figure 11**
Employment in the private and public sectors




of foreign labor surpassed that of Palauans. However, with the completion of the projects, the demand for foreign labor fell and the workers returned home. Since FY2012, the demand for foreign labor has picked up strongly, with the booming economy, but slackened in FY2018 as the economy weakened.

**Demand for private sector labor follows the trend in the economy:** Figure 11 indicates the level of employment in the private sector, national government and a third group comprising the SOEs, government agencies and state governments. Trends in the private sector indicate growth in the early 2000s, with the additional demand for labor for the infrastructure projects. However, the private sector declined from FY2005 through FY2010, with the completion of the projects and the onset of the recession. Demand for private sector labor increased between FY2011 and FY2018 because of the resurgence in the tourism industry, although less strongly than the growth in visitor numbers. This implies greater capacity utilization of facilities and growth in productivity. In FY2017, as the tourism economy weakened, demand for labor increased because of the large infrastructure projects in water and sanitation. In FY2018 private sector employment was largely stationary.

**National government and public sector employment has grown at less than GDP rate:** Employment in the national government maintained an average level of 2,369 during the FY2000–FY2004 period, but then showed a dip in FY2005, a gradual decline through FY2015, followed by some additional hiring in the last three years. National government employment now stands at 2,055, an annual average decline of 0.5 percent. Compensating for the reduction in national government, employment in the SOEs, state governments and government agencies has grown from 1,168 in FY2000 to 1,930 in FY2018, an annual rate of 2.8 percent. Taken as a whole, employment in the public sector has grown modestly, by an annual average of 0.8 percent, less than the rate of GDP growth of 1.2 percent during the period, indicating a reduction in the role of the public sector in the economy. Fiscal policy and employment in the public sector has followed a cautious track, protecting Palau from the pitfalls experienced by other Micronesian economies, which led to painful adjustments and reductions in public sector employment during cyclical downturns. At the same time, the cautious public sector employment policy has allowed resources to flow to the private sector and reduce distortions in the labor market.

## WAGE RATES

**Average Palauan wages greater than non-citizens but reflects skill differences:** Figure 12 provides an indication of the trends in Palauan and non-citizen wages. The strong divergence between the two series could be taken to imply that non-citizen labor is paid less than citizen labor. However, more-detailed analysis suggests that the story is more complex. In the corporate part of the private sector, citizen wages are currently 5 percent higher than those for non-citizens, although in the noncorporate part of the private sector, citizen wages are 15 percent higher. In banking and the national government, the pattern is the other way around, with non-citizen wages being 14 percent higher than citizen earnings. Clearly, wages reflect the required skill set, scarcity and qualifications in the different sectors.

**Strong growth in non-Palauan wages after the financial recession:** For Palauans, nominal wages have risen through the period by an average rate of 2.6 percent annually. The annual rate of increase moderated in FY2010 with the onset of the recession and again in FY2013 with the downturn in tourism activity. The data indicate in the last four years more rapid growth in Palauan wages—averaging 4.3 percent—with strong wage growth in most sectors, reflecting tightening of the labor market. For the non-citizen segment, nominal wages were relatively stable through FY2009, but since that time they have shown an upward trend, reflecting the increasing growth in the economy, rising by 4.8 percent per annum and more rapidly than citizen wages, which grew by 2.9 percent.

**Average wages in the public sector are higher than the private sector but reflect skill differences** Figure 13 indicates the level of average real and nominal wage rates in the private and public sectors. Clearly, the public sector pays the highest rate of remuneration, with rates of pay exceeding those in the private sector by more than 79 percent in FY2018. While it might be inferred that public sector wage policy is distorting the market through paying higher wages, such a conclusion, as in the comparison between Palauans and non-citizens, may not be warranted. The skill sets in the two sectors are different. Government-administration, education and health workers require a higher level of skills than employees in the tourism sector. Wage rates in the public sector have risen by an annual average rate of 2.3 percent during the period, in comparison with a rise of 2.6 percent in the private sector.

**While nominal wages grow the real wage stagnates:** While nominal wages grew economy-wide by 2.4 percent in the 18 years under discussion, the same is not true of real wages (the level of nominal wages adjusted for inflation, or the CPI). For the economy, real

**Figure 12**
Palauan and noncitizen average wage rates

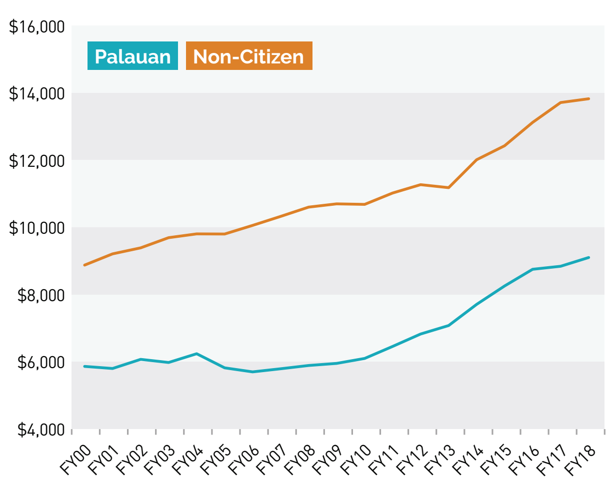
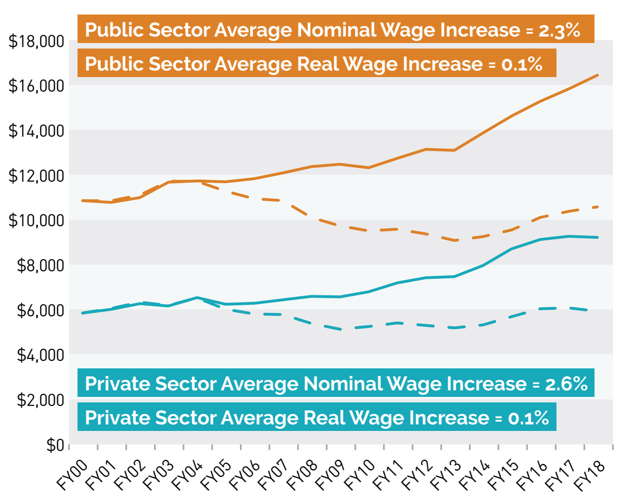



**Figure 13**
Average nominal and real wage rates in the private and public sectors



wages fell by an average of 0.1 percent, with public sector real wages falling by 0.1 percent and private sector real wages growing by 0.1 percent.

**Minimum wage currently $3.50 an hour:** In April 2013, the Palauan congress, known as the Olbiil Era Kelulau (OEK), passed a revised minimum-wage bill, increasing the minimum wage from $2.50 an hour to $2.75 beginning October 1, 2013. The bill stipulated that the minimum wage would increase by 25¢ in the subsequent years until it reached $3.50, where it now stands. The bill also permitted employers to take into account reasonable deductions for cost of housing and food provided to an employee. The bill applies to both citizen and "nonresidential" employees. Exemptions from the minimum wage apply to farm labor, domestic helpers, NGO employees and a few other selected groups. Given the near-full employment of Palauan labor and recent increase in demand for foreign labor, the minimum-wage bill has not had any noticeable impact on unemployment.

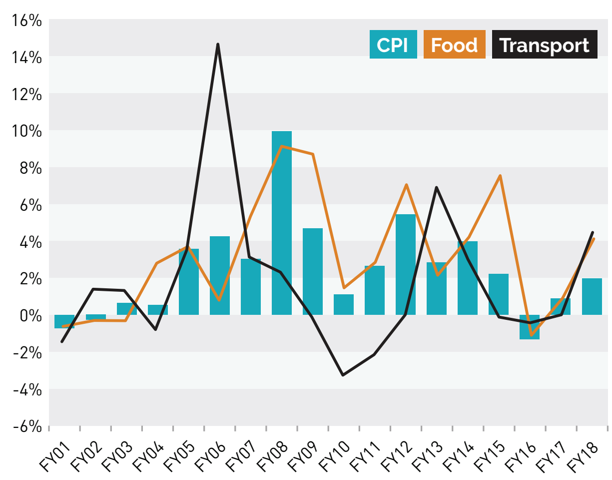
**President submits bill in 2017 to raise minimum wage to $8.50 by 2027:** In January 2017, the president submitted a bill to the OEK to raise the minimum wage from the current level of $3.50 an hour by 50¢ effective October 1, 2017, and to raise it by a further 50¢ annually until reaching $8.50 10 years hence. The law if passed by the OEK would apply to all wage earners, Palauan and foreign. Currently the minimum wage in Guam is $8.50, and the intent in the law is to attract Palauans working in the US to return to Palau. However, the new wage policy is likely to have a significant impact on the cost of doing business in Palau. The average wage of non-Palauans was $4.55 in FY2018 based on a 40-hour week over 50 weeks in the year. For Palauans working in the private sector, wages range between $5.83 and $3.98 in the corporate and noncorporate sectors, while average wages for national-government employees are $9.63. Clearly the impact on the cost of doing business in Palau would rise significantly over time if the bill is passed into law. It would have a lesser but still significant impact on the cost of providing government services. While a full analysis of the bill needs to be conducted, the indicators presented here suggest it would have a significant adverse impact on the cost of doing business, international competitiveness, government expenditure and domestic inflation.

## D. Prices

**After negative inflation in FY2016 prices rose by an average of 2.0 percent in FY2018:** Figure 14 provides information on the annual rate of inflation and major driving forces in the Palauan CPI, including food and transportation prices. In the early 2000s, inflation was very modest, averaging 0.0 percent during the FY2000–FY2004 period. While there was some pick-up, averaging 3.6 percent, during FY2005–FY2007, it was not until FY2008 that inflation reached 9.9 percent, a peak. Since that time, inflation has moderated, although in FY2012 prices again rose by 5.4 percent. By FY2015, inflation had fallen to 2.2 percent, and during FY2016 it turned negative as prices fell by 1.3 percent. In the last two years inflation has returned to positive territory growth by 0.9 and 2.0 percent in FY2017, and FY2018, respectively.

**Rapid increase in food prices and to a lesser extent fuel prices have exerted significant inflationary forces in Palau:** There have been two main driving forces behind the recent developments in inflation. The first is the impact of increases in food prices, which, because

**Figure 14**
Change in the CPI by selected commodity groups



of their large weight in the Palauan CPI (25 percent), have a significant effect on measured inflation. Second, world energy prices have a direct impact on remote island economies such as Palau, which have few alternative possible responses to reduce the impact. In FY2006, fuel prices jumped, increasing not only the cost of fuel but indirectly utility charges. The increase in prices was mitigated to some extent by moderate inflation of food prices during that period, and the overall CPI only rose by 4.2 percent. However, in early FY2008, as the world economy was at the height of its prerecession boom, not only did fuel prices skyrocket but food prices were rising rapidly because of a disequilibrium in world food markets. The combination of the two pushed the CPI up to 16.8 percent in the third quarter of 2008.

**Food and fuel price rises major contributors to inflation in FY2018:** The subsequent onset of the recession brought prices back down, with food and fuel prices moderating. Toward the end of 2011 and start of 2012, the same pattern of rising food and fuel prices appeared to be occurring again. However, although the CPI had risen by 8.7 percent in the last quarter of 2011, the period was short-lived, and by the end of 2012, inflation had moderated. At the start of 2015, the world economy entered a period of rapidly falling fuel prices, which continued into 2016. Food prices also began to fall from the last quarter of 2015, mimicking the pattern in fuel prices but with a lag. The reduction in both fuel and food prices resulted in negative inflation at the end of 2015 through the first half of 2016. In 2017 inflationary forces were generally muted, but significant food price rises mid-2018 and increases in international fuel price towards the end of the year pushed up the overall CPI in FY2018 to 2.0 percent.

# 2. Tourism Developments and Policy

**The rapid growth in tourism has created unique challenges for Palau. In FY2015, annual visitor arrivals grew by 34 percent and recorded a peak level of 168,767, an addition of 88,000 visitors since FY2010. In the following three years arrivals dropped in each year falling to 115,964 in FY2018, 2 percent below the level attained six years earlier.**

- The increase in visitors was made possible by the large amount of excess capacity the nation had in tourist plant; occupancy rates increased from 38 percent in FY2010 to 61 percent in FY2015. However, with additional rooms being added, occupancy rates fell to 39 percent in FY2018 with some establishments operating below cost.
- Most of this increase originated in middle-to-lower grade establishments, with an associated large increase in package-tour visitors predominantly from China. The contraction since has seen reductions in both the Chinese and traditional markets.
- With anticipated further reductions in visitors in FY2019 and plant operating at low levels of occupancy, it might be concluded the industry is in crisis; however, with an excellent product and anticipated increases in scheduled flights, confidence remains strong and investments continue.
- The rapid increase in visitors had a significant impact on government revenues. The fiscal surplus rose significantly as tourism boomed and was largely sustained through FY2018 despite the reduction in arrivals and falling occupancy rates.
- Palau has adopted a policy to attract high-value tourists but has limited resources 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.
- The need for a tourism strategy or master plan remains unfulfilled. Until a comprehensive approach can be developed, Palau will have limited options to mitigate the vagaries of market forces and improve the likelihood of achieving its high-value tourism policy objectives.

# 2. Tourism Developments and Policy

## A. Tourism Developments

### RECENT PERFORMANCE

**Tourism booms with rapid growth in arrivals, peaking in FY2015, but has subsequently fallen back significantly:** In FY2010, the Palauan tourism industry began to emerge from a recession brought on by the world financial crisis. Visitor arrivals to all of Palau's traditional destinations began to improve, and the total level of visitors reached 118,928 in FY2012. After a weak year in FY2013, visitor arrivals began to surge, and they grew to 125,674 (13 percent) and 168,767 (34 percent) in FY2014 and FY2015, respectively. The rapid growth resulting from a large influx of visitors from China led to an active debate in Palau over whether tourism growth was proceeding too rapidly, thereby having adverse impacts on existing operators, local infrastructure and the environment. In FY2016, the number of visitors dropped significantly to 146,634, again in FY2017 to 122,050, and again in FY2018 to 115,964, a drop of 31 percent below the level achieved in FY2015 and 2 percent below the level of FY2012.

**Reasons for recent contraction are varied:** It is not clear that there is any one reason for the recent contraction in the industry. Rather, several explanations are relevant and discussed in further detail in this chapter. In April 2015, the president of Palau imposed a policy to limit the number of charter flights into Palau. At about the same time, China initiated stricter enforcement of its policy that travel agents in China can only sponsor travel to countries with approved-destination status, which Palau does not have. At the start of 2016, Palau underwent a severe El Niño, which led to the loss of jellyfish in the Rock Islands, a major tourist attraction. Further, Delta airlines withdrew from the market in mid-2018, and certain charter operations suffered financial and operational problems that led to a reduction in flights. All of these forces contributed to the contraction in the industry.

**Increasing hotel plant and reduced visitor arrivals imply unprofitable occupancy rates, but the mood remains optimistic:** Before the start of the recent boom in FY2012the supply of hotel rooms in Palau stood at 1,480. With the increasing demand new hotel plant was constructed and by FY2018 the room stock stood at 2,022. Further construction of hotel rooms is in the pipeline and nearing completion; an additional 250 rooms will be available to bring the total to 2,300. In FY2015 occupancy rates stood at a healthy 61 percent, but with the additional supply had fallen to 39 percent in FY2018. Current trends during FY2019 suggest that the arrival rate is continuing downwards. We have projected 89,600 visitors by year end. It is understood that two new air service providers from Japan are about to commence operations and thus the projection is probably a lower bound. However, this level of visitors implies an occupancy rate of just 29 percent. By any normal measures this would imply an industry in crisis. However, with new scheduled flights in the pipeline and Jellyfish lake reopening the mood remains optimistic that Palau has a unique product to offer.

### COMPOSITION OF VISITORS, CONCENTRATION AND DISPLACEMENT

Rapid growth in tourism accompanied by concentration in Chinese segment, but contraction of traditional markets: Figure 15 indicates recent trends in visitor arrivals by nationality. Since FY2013, the Chinese market exploded in a very short period, reaching over 91,174 in FY2015, but fell back to 50,211 by FY2018. As the Chinese market expanded, other segments contracted: the Japanese market contracted from a peak of 38,200 in FY2014 to 24,437 in FY2018, a large 36 percent drop; Taiwan dropped from 31,175 to 11,354, a very large 64 percent fall; and South Korea by 19 percent, from 15,834 to 12,872. There is thus evidence to suggest that the rise in the Chinese

**Figure 15**
Visitior arrivals by Nationality

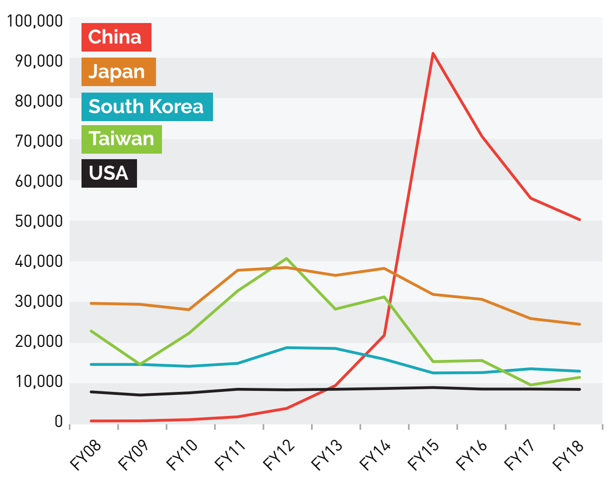
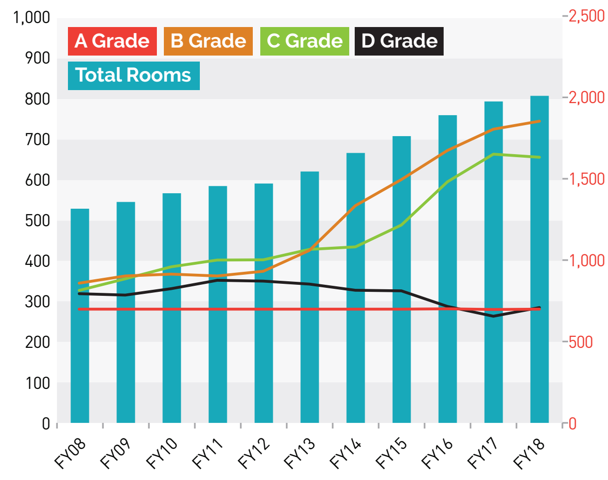



**Figure 16**
Hotel rooms by Hotel Grade




market displaced arrivals from Palau's traditional sources. During the expansion phase, large-scale bookings and increased integration of Chinese operators in Palau ate up the available capacity and displaced business from other sources. However, even as the Chinese expansion peaked and then contracted, visitors from the more traditional components of the market continued to contract further. These developments led to a significant concentration in visitors from one source. In FY2014, Japan held the largest share with 30 percent of the market, China held 17 percent, and other markets 52 percent. By FY2018 and after the contraction, China dominated, with its share rising to 43 percent while that of Japan fell to 21 percent and others fell to 36 percent.

## IMPACT ON THE HOTEL SECTOR

**Grading system adopted for analysis:** Palauan tourism plant includes a variety of different grades and categories ranging from higher-quality to more-basic facilities, including small operators in remoter parts of the country and dive-boat "live-aboards." In total, at the end of FY2018, there were 2,022 rooms available in Palau, a 37 percent increase since FY2012 at the start of the recent boom (Figure 16). While no formal grading of tourism plant has been established in Palau, for the analysis presented in this review, hotels have been graded in consultation with industry representatives. Four grades have been given: A through D. Most of the growth has occurred in the B and C grades, while at Palau's top end there has been little change other than the addition of a few high-end, over-water bungalows.

**High grade hotels operate at healthy occupancy rates while mid-range operators are close to or below breakeven.** Figure 17 presents a picture of the changes in occupancy since FY2008.[1] Clearly, all grades of hotels saw a significant improvement in occupancy rates through the end of FY2015, but rates dropped significantly after the boom came to an end. Overall occupancy rates improved from 39 percent at the low point of the cycle, in FY2008, to an average of 61 percent in FY2015, but fell back very significantly to 39 percent in FY2018. At the top end, the A-grade resorts improved their occupancy rates from 70 to 100 percent, at full capacity, before dipping to 78 percent as demand fell. At the middle level of the industry, both the B- and C-grade groups were operating in FY2015 at satisfactory levels of profitability

1 Based on hotel-room stock available and visitors' hotel of destination recorded in the immigration statistics, estimates of occupancy rates can be made by assuming an average number of persons per room of 1.8 (based on tourist-expenditure survey information).

**Figure 17**
Hotel occupancy by grade

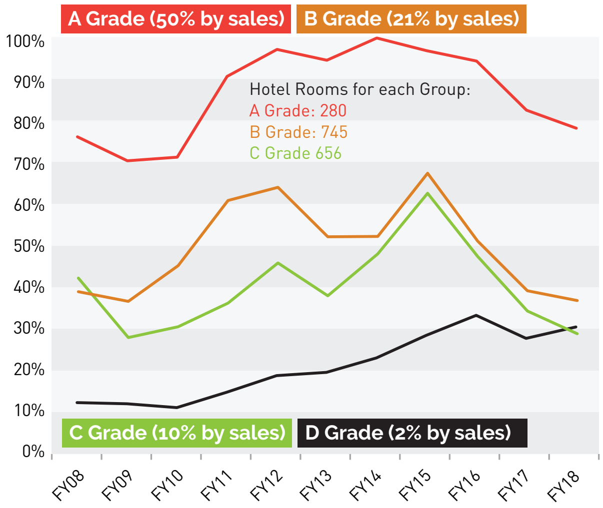
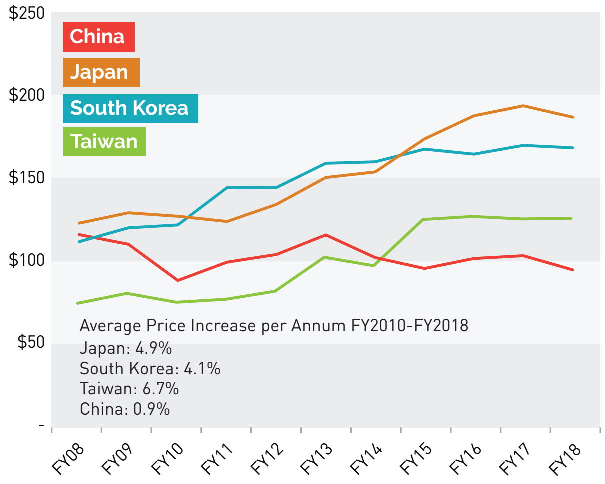



**Figure 18**
Average hotel-room rates by Nationality




with an average occupancy rate of 65 percent, but rates dropped significantly to 33 percent in FY2018.

**High grade hotels capture majority of room sales:** Figure 17 also indicates that the A-grade hotels generated sales representing 50 percent of the total market, while the number of rooms represents only 14 percent of total hotel plant. The remaining groups generate the remaining 50 percent of sales but represent 86 percent of room stock. This emphasizes the desirability of adopting a high-value tourism policy.

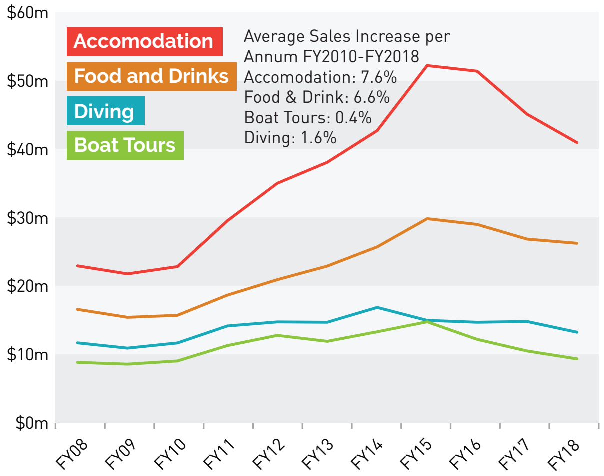
**Japanese and Koreans stay at the higher grade establishments while Chinese and Taiwan visitors occupy the lower end:** Further light can be shed on these developments from estimates of average room spend per visitor, by nationality (Figure 18).[1] The outturn indicates that the Japanese and South Korean segments of the market typically stay at the upper end of Palau's facilities, while visitors originating from China and Taiwan are accommodated in the lower-grade establishments. The average room price paid in 2018 by Japanese visitors was $185/night, over 97 percent higher than the $94/night paid by visitors originating from China.

The recent influx of tourists from China is thus associated with greater plant-capacity utilization at the lower end of the spectrum. Two other interesting features can be derived from the figure. Firstly, visitors from China were, before the start of the visitor boom, some of the highest spenders. However, the boom in Chinese arrivals has been at the low end. Secondly, in the Taiwan segment, visitors were originally relatively large in number at the low end, but as the numbers have fallen, they have moved up the scale for those still traveling to Palau.

**The reduction in tourism demand is reflected in a price correction at the high end but little adjustment in the mid-range:** Figure 18 also indicates that hotel-room rates have on average risen by 3.3 percent since the end of the recessionary period in FY2010. However, the trends by grade through the period have been significantly different. At the high end, room rates grew at 8.0 percent during the expansionary period and dropped to 1.8 percent during the contraction as occupancy rates fell. In the B and C grades, average rates rose by 4.4 percent during the expansion but continued to rise by an average of 2.1 percent during the

1 Matching the gross sales of each establishment from the BGRT statistics with the number of visitors staying in them from immigration data provides an estimate of average room price per visitor. These average rates can then be applied to the immigration data by nationality to derive average room prices paid by each of the major nationality groups. The estimates of average room price paid by nationality assumes the same price is paid regardless of nationality. This may not be the case.

**Figure 19**
Tourist expenditure by market segment



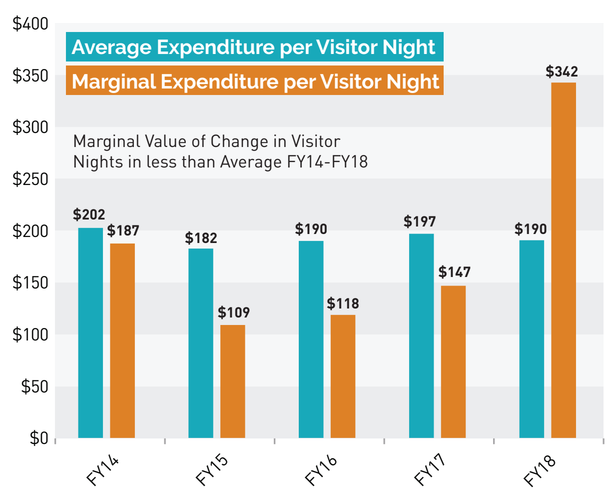

recession. Clearly, the rapid rates of increase in room rates were no longer tenable as the boom came to an end, and a correction was required. At the high end, occupancy rates fell and remained at what would normally be considered profitable rates. However, in the midrange the current low occupancy rates averaging 33 percent, and at the margin of profitability, suggest the small price correction was not sufficient. The discussion in chapter 3 indicated the rise in Palau's real exchange rate and loss of competitiveness and reinforces the conclusion that travelers in the "economy"-grade range are becoming reluctant to pay the high cost of visiting Palau.

## ECONOMIC IMPACT OF BOOMING VISITOR ARRIVALS ON THE TOURISM ECONOMY

**Boom in tourism has varying impact on product segments:** Prior discussion on economic developments indicated the strong impact of tourism on the recent growth in the economy. Figure 2 indicated the strong impact of tourism expenditures and investment in hotel plant on the economy, while Figure 4 indicated the upward trend in the hotel and transport industries. However, the growth within the tourism economy has not been even. During FY2010–FY2018, visitor nights rose at the annual rate of 5.0 percent including the fallback in FY2016 through FY2018. Figure 19 indicates that while accommodation grew by 7.6 and restaurants by 6.6 percent, the other major components of the tourism sector saw little expansion in revenues. The impact of the additional visitor nights had less of a simulative impact on the boat-tour and diving segments. From the foregoing analysis, it is clear that the additional tourists filled up the lower-grade hotels, but it might have been expected that the additional visitors would have had a proportionate impact on the ancillary services. This was not the case.

**While the gains and loss of tourists has been at the low end in FY2018 Palau the impact of the lost tourists was at the high end:** Further analysis of the average and marginal impact of the large influx of package-tour visitors is indicated in Figure 20. The first series in the graph indicates the average spend per visitor night; this series was largely stationary through the period. The second series shows the marginal benefit from an additional tourist night. In FY2014 and FY2015, as the industry was expanding, the benefit from the additional tourists was less than the average, reflecting the expansion in the low-end visitors. In FY2016 and FY2017, the industry contracted, but the results were the same: the average spend was greater than the marginal, indicating the loss of the visitors was also at the lower end. However,

**Figure 20**
Average and marginal benefits of tourism spending per visior night

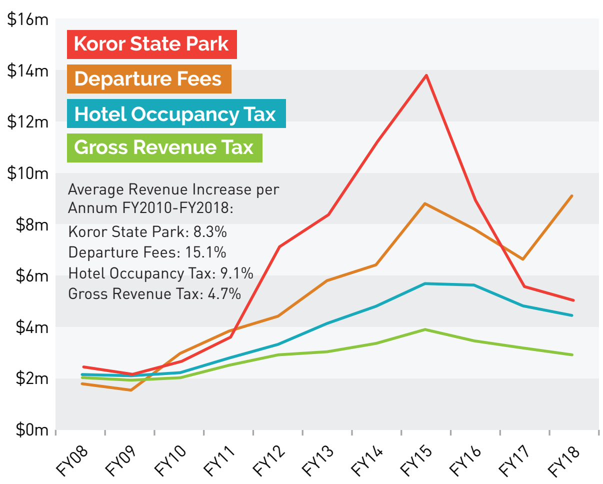


in FY2018 the marginal rate was 80 percent higher than the average, indicating that the lost tourist were high spenders. The overall impact of the tourist boom and contraction FY2015 through FY2017 was thus mitigated by the increase and subsequent loss of low-spending visitors. However, the FY2018 result is alarming indicating the Palau lost many of its high yeilding visitors.

## GOVERNMENT REVENUES

**Koror State revenues grew rapidly during the boom but fell back precipitously with the contractions and loss of jellyfish:** As for government revenue, Figure 21 indicates recent trends in the major components: Koror State Park, hotel-occupancy tax, departure fees and the gross-receipts tax (effectively a sales tax). Rates of revenue growth in Koror State Park had been very buoyant until the large contraction in FY2016 through FY2018, which reflected both the increase and loss in visitors, discretionary increases in rates, and loss of jellyfish. In June 2012, the cost of permits to visit the Koror State public assets—Rock Island and Jellyfish Lake—rose from $25 to $50 and $35 to $100, respectively.[1] However, in FY2016 and FY2018, the jellyfish in the lake went into hibernation,

**Figure 21**
Average and marginal benefits of tourism spending per visior night




resulting from the adverse impact of La Niña in the early part of FY2016. In these three years, revenues were derived from Rock Island tours and not from Jellyfish Lake. In the case of the departure taxes, these rose from $30 to $50 at the start of 2013, and then doubled to $100 at the start of 2018 and written into passenger airline tickets. For the hotel-occupancy tax, which is levied on room sales, rates were raised from 10 to 12 percent in 2013. The gross-receipts tax (GRT) is levied at 4 percent of gross revenues.

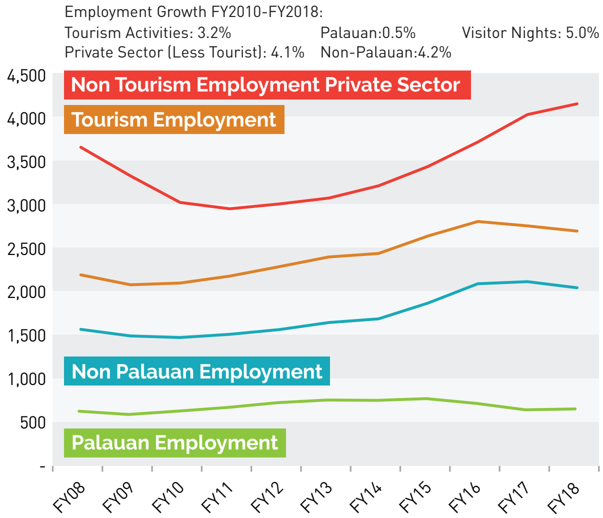
**Large fluctuations in public sector revenues:** Overall, public sector revenues from tourism-related activities rose from $10 million in FY2010 to $32 million in FY2015 and then fell back to $22 million in FY2018. Unlike the other segments of the tourism market, which are related to the value of sales, public sector revenue is strongly linked to the number of visitor arrivals and thus fell in proportion to their reduction plus the impact of the closure of Jellyfish Lake. The impact on Koror State was exceptionally large as state revenues rose from $2.6 million in FY2010 to $13.8 million in FY2015 but crashed to $5.0 million in FY2018. National-government revenue also rose and fell but not to the extent of Koror State with the closure of Jellyfish Lake. As a share of GDP, public revenues from tourism doubled from 5.4 percent of GDP in FY2010 to 11.5 percent in FY2015 but contracted to 7.6 percent in FY2018. Jelly fish are starting to re-emerge at the lake and revenue efforts should improve as a result.

## EMPLOYMENT

**Employment levels in the industry have held despite the large reduction in numbers.** The impact on employment of the recent expansion in tourism is indicated in Figure 22. The growth in tourism-related employment has averaged 3.2 percent per annum annually since FY2010, below the rate of increase in visitor nights, at an average of 4.6 percent. This reflects greater capacity utilization and corresponding increases in productivity. Interestingly, employment in the tourism industry continued to expand during FY2016 despite the falling number of visitors, reflecting the addition of new plant and the

1 The Jellyfish Lake permit includes access to the Rock Islands.

**Figure 22**
Tourist expenditure by market segment




forward momentum left over from the previous rapid expansion. By FY2017, the contraction in the industry had become sustained and employment fell in both FY2017 and FY2018 although by relatively small rates compared with the reduction in visitors.

**Growth in tourism accompanied by increased demand for labor of non-Palauans with employment of Palauans remaining stationary:** Figure 22 also indicates demand for Palauan and non-Palauan labor in the tourism industry. All of the growth was in the non-Palauan segment, which grew by an annual average of 4.2 percent, representing 571 jobs, while that in the Palauan segment remained unchanged. Direct employment of Palauans in the industry was 24 percent in FY2018, or some 650 jobs. Of some concern is the fact that in FY2015, some 768 Palauans were employed in the industry, implying a loss of 118 jobs by FY2018. During the boom years average wages rose rapidly reflecting the increase in demand. However, with the contraction the rate of increase slackened and stagnated in FY2018, with average wages falling for Palauans.

## TOURISM GROWTH AND MARKET VOLATILITY

**Palau's tourism is highly volatile with large swings in occupancy and below breakeven point at low points in the cycle:** The foregoing analysis has indicated a significant increase in visitor arrivals and the recent rapid growth in visitors from China. Since FY2012, tourism plant has expanded by over 542 rooms, or 37 percent. These recent additions coupled with the existence of unused capacity at the mid- and lower grades permitted the rapid expansion. As a result, most of Palau's tourism plant was operating at healthy occupancy rates above 60 percent by the end of FY2015. However, since FY2015 through FY2018, arrivals dropped precipitously and occupancy rates in the mid-range have fallen to 32 percent, probably below the breakeven point. Reviewing the long-term history of Palau's tourism sector and going back to the late 1990s suggests a very volatile industry subject to large swings in market forces.

**Key impacts of the recent boom on the economy:** While the impact of tourism development has been volatile at the industry-wide level, it has not occurred without disruption and market stress in its different segments. In particular,

- The dive market was disrupted in FY2015 because divers were unable to find accommodation when wholesale booking demand from package tours rose.
- Both national- and state-government revenues boomed with the rapid rise in tourism but fell off rapidly with the recent contraction, especially in Koror State, where Jellyfish Lake was closed due to the El Niño in 2016 and the resulting hibernation of the jellyfish.
- Demand for labor has also grown, and new jobs have been created through increases in foreign labor. Given the full-employment and supply constraints in the Palauan segment of the labor market, few Palauan jobs have been created.
- With the high level of foreign ownership in the tourism economy and sizeable representation of foreign labor, the main economic benefit has been through the very significant increases in public revenues.

While development has been rapid, it has been volatile and the distribution of the benefits uneven.

## B. Tourism-Sector Policy

**Concern at the rapid tourism growth on the economy:** The rapid increase in visitor arrivals from China toward the end of 2014 and during 2015 engendered concern from many quarters in Palau that tourism was developing too quickly, that demand was outstripping supply and that the market was not operating efficiently as it was displacing visitors from traditional markets. Despite the increase in overall visitors, sales in some segments of the market were falling. There was also concern that pressure was being placed on Palau's fragile environment at the Rock Islands and Jellyfish Lake, and on infrastructure—namely, the aging and inadequate water-and-sewer system in Koror.

**Despite the downturn potential for unconstrained growth in tourism growth remains:** In FY2016 through FY2018, the numbers of visitors dropped off rapidly dipping below the level attained in FY2012 before the boom. Looking forward, construction of new facilities in Koror and Babeldaob, about 250 rooms in total, is under development. There has been a proliferation of land-lease sales, and there are a variety of further projects in the pipeline, and over 2,000 additional rooms have received Environmental Quality Protection Board (EQPB) approval. The current reductions in visitor numbers will no doubt dampen the past exuberance of the private sector for hotel development. However, a further rapid expansion and boom is quite possible once the current drop-off in demand has passed. For these reasons, despite the current downturn, the debate on the role of tourism policy in Palau remains active.

**Need for a broad-based tourism strategy or master plan:** These developments suggest the need for a comprehensive, broad-based tourism strategy or master plan that protects the environment in the long term. In 2015, as Palau was experiencing the influx and growth in the package-tour segment of the market, the government requested support from the ADB to prepare an assessment of options for tourism development, and presented a short but well-prepared assessment.[1] In 2016, a tourism-policy framework was prepared under a TA funded by the US Office of Insular Affairs. Although some good ideas and institutional arrangements were outlined in the framework, it was not designed to fulfill the needs of a tourism master plan or analyze tourism in the context of the economic and financial circumstances of Palau.[2] These studies are reported on in this section together with an analysis of a few key economic elements that need to be considered in the design of a comprehensive tourism strategy.

### ECONOMIC BENEFITS

The major economic benefits from tourism are frequently itemized in the categories listed below. Analysis of the impact of tourism on these categories provides a useful framework in the design of tourism strategy:

i. value added
   a. wage income (Palauan and foreign labor)
   b. business profits (domestic enterprises and FDI)
ii. government revenues (taxes on tourism)
iii. employment

**High level of foreign ownership in the hotel sector; greater Palau representation in tourism support services:** Palau's tourism industry is composed of a high level of foreign participation in both the labor and capital markets. Foreign labor represents 76 percent of total employment, and foreign ownership of tourism-related businesses is 49 percent. However, FDI is strongly concentrated in the hotel sector, where ownership is 70 percent foreign. Domestic business is thus not well represented in the hotel sector but dominates in the provision of tourism support services, where local ownership is 74 percent. However,

1 Walter Jamieson, An Assessment of Selected Policy Options for Tourism Development in Palau, ADB TA 8565-REG, April 2015, Manila
2 Bureau of Tourism, Palau Responsible Tourism Policy Framework, Palau, 2016. Currently under discussion at the OEK.

it should be borne in mind that the prevalence of “front” businesses in Palau, where the owner is registered as Palauan, but the business is effectively capitalized and operated by foreign nationals, is widespread. Real rates of foreign ownership may, in actuality, be higher than the statistics indicate.

**Labor market and employment.** In the labor market, the Palauan segment is effectively fully employed for those seeking work, and there is little scope for additional job creation. This is reflected in the recent tourism-related employment statistics, in which total employment expanded significantly but the number of Palauans employed remained little changed. While opportunities for Palauan job creation are limited by supply constraints, there is scope for upgrading skills so that those participating in the industry can find higher-remunerating work. Nevertheless, it must be recognized that future expansion in tourism is likely to be based almost exclusively on foreign labor.

**Ownership and FDI.** In the ownership of hotel plant, the scope for domestic investment will be limited to partnerships between foreign investors and local business interests. FDI will likely dominate, and a policy to attract high-value tourism will be based on foreign investment. The current foreign ownership in the hotel sector of 70 percent attests to the limited scope for domestic participation.

**Ancillary services.** While local participation is limited in the hotel sector, there is much greater scope for local ownership in tourism support services. As can be seen in the earlier discussion, this segment of the industry prospered less well during the recent tourism expansion. While the overall marginal gain from the surge in the package-tour market was lower than the average (with the exception of FY2018), the fall was greater in the nonhotel segments. This observation reflects two factors. Firstly, the greater vertical integration of the package-tour market resulted in lower recorded sales of ancillary services such as water tours through both price and volume adjustments. The pricing of these services fell either through transfer pricing, greater competition or increases in tour boatload factors. Secondly, the demand for diving activities and volumes fell, reflecting that the new visitors were not divers. The new visitors actually had a negative impact and occupied the hotel space previously occupied by this segment of the market. These arguments suggest the benefits of moving away from a package-tour, vertically integrated, low-value tourism to a model with greater demand for ancillary services where local business interests are higher.

**Government revenues.** As indicated in Figure 21, government revenues have also surged in recent years despite the contractions in the last three years, reflecting both the growth in visitors and discretionary tax and fee increases. The Palau Pristine Paradise Environmental Fee (PPEF) and the hotel-occupancy tax have been increased as well as charges for tours to the Rock Islands and Jellyfish Lake. From a level of 5.4 percent of GDP in FY2010, public revenues have grown to 11.5 percent in FY2015, although they fell back to 7.5 percent in FY2018 as demand weakened and Jellyfish Lake was closed. As part of the Palau National Marine Sanctuary Act, passed into law during October 2015, the PPEF (essentially a departure tax earmarked for specific purposes) was increased from the prior $50 to $100, and was included in the purchase price of international airline tickets at the start of 2018 (see chapter 4 on fiscal developments for more detail).

**Tax reform**

i. The hotel-occupancy tax. At present, a 12 percent hotel-occupancy tax is levied on the value of room sales. However, the tax could be restructured and collected as a flat rate per visitor night. The incidence of the tax would fall more on low-end package tours and less on high-value hotels. This would encourage the high-value tourism concept that Palau has adopted.

ii. Park and site fees. In the area of fees for natural sites and in particular for the Rock Islands and Jellyfish Lake, there has been no assessment of the holding capacity of the facilities or environmental impact. A proper assessment and a fee structure that encourages environmental conservation should be considered.

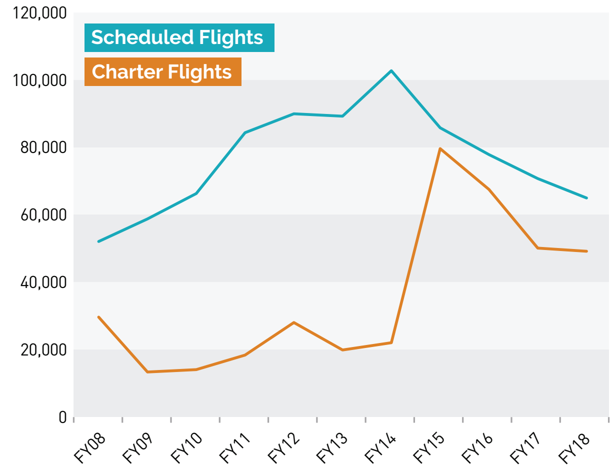
iii. Implementation of tax reform and the

VAT. In 2013, tax reform legislation was introduced into the OEK, with the main element being the introduction of the VAT. However, the proposal failed to gain sufficient votes for passage into law. The VAT is ideally suited to Palau because a large part of the tax base falls on tourist expenditures. In FY2017, the tax base including household and tourist expenditures amounted to 99 percent of GDP, with tourist expenditures accounting for 45 percent. The introduction of a VAT has clear benefits in that a large part of the incidence of the tax falls on non-citizens. The tax-reform proposal also included introducing a net-profits tax. At present, business incomes including tourist operators are not taxed. Reintroduction of the tax-reform initiative is strongly desirable, and the proposal is considered in more detail in chapter 5 on public sector management.

## CHARTER POLICY

**Charter policy introduced to reduce the surge in package tour visitors:** In mid-April 2015, the president issued a policy to halve the number of charter flights into Palau to limit the surge in visitors and pressure being placed on the environment and infrastructure. Figure 23 indicates the number of visitors coming to Palau by both scheduled and charter flights. During FY2008–FY2014, arrivals on charters were largely stationary, with the increase in arrivals originating from regular scheduled flights. However, in FY2015 the number of charter visitors surged, reflecting the boom in the Chinese package-tour segment, and the number of scheduled flights decreased. Between FY2015 and FY2018, the number of visitors carried by scheduled flights fell by 21,000 and those by charters by 30,000, indicating that the impact of a declining numbers of visitors was experienced by both types but focused on the charter segment. The impact and effectiveness of the policy is thus not entirely clear, because while there was a significant reduction in charters (as well as scheduled flights), the drop in charters did not occur until 18 months after the policy had been introduced.

**Figure 23**
Visitor Arrivals by Flight Type




Allocation of charters should be auctioned rather than direct allocation: While the charter policy was understandable at the time given environmental and infrastructure stress, it raised a variety of issues. Firstly, a proposal was made, although not adopted, that charter flights should be rationed through auction rather than by direct allocation by government officials. This would enable the economic rent generated through the forced reduction in supply to be captured by government, rather than by private interests. Secondly, it could be questioned whether the policy was really needed. In FY2015, occupancy rates averaged 61 percent and the industry was close to reaching full capacity levels. Without the policy, there was a natural cap on the number of arrivals, which Palau was in any case rapidly approaching.

**Charter policy impacts profitability of mid to lower grade hotels:** Thirdly, the effective imposition of the policy would have reduced occupancy rates in the lower segments of the hotel segment. For investors, many of whom were Palauan and had finally attained a profitable rate of occupancy, the charter policy would have reduced earnings and had a negative impact on the business environment. Part of the intention of the policy was to encourage a greater number of scheduled flights and higher-value tourists, clearly a desirable policy. However, FITs (free independent travelers) that tend to use regular scheduled flights are unlikely to be attracted to package-grade hotels. The charter policy thus had the implication of starving the lower segment of Palau's tourism plant of clients.

**Need to replace charter policy with efficient policies to encourage growth in scheduled flights:** To conclude, the charter policy may have had an unintended negative impact on the lower end of Palau's tourism operators. While tourism policy has rightly focused on attracting higher-value tourists, there remains a role for government to support existing plant and operators. Going forward, the high-value strategy should encourage construction of high-quality facilities and place a constraint on further construction at the lower end. The existing charter restrictions should be phased out and replaced by a more efficient set of policies that encourage regular scheduled flights in those areas consistent with Palau's strategy.

## THE ADB TOURISM ASSESSMENT

In response to the emerging problems at the start of 2015, the government requested support from the ADB to (i) consider the adoption of the "Pristine Paradise. Palau" branding and marketing concept, (ii) review the present aviation policy and formulate criteria for licensing, and (iii) consider suspending tourism projects given the environmental, social, cultural and economic pressures on the country. The ADB fielded a TA in February 2015 to assist with support for the tourism issues confronting the nation.[1] The TA provided the following sound set of recommendations in response to the terms of reference.

**Adoption and development of the "Pristine Paradise. Palau" branding and marketing strategy.** The report indicates that the adoption of a high-value tourism marketing strategy needs to be developed and distinguished from a high-end strategy. High-value tourism does not necessarily imply high-end tourism; it recognizes that a high-value experience is respectful of local culture and values, and that high-value tourists are looking for a high-quality experience not necessarily of a five-star nature. The ADB report indicated that adoption of a marketing strategy is not a replacement for a strategic or action plan, which would take at minimum five years to develop and implement.

**Limitations of charters.** While the impulse to reduce the number of charters to limit the rapid increase in visitors was understandable, the TA recommends that this should be seen only as a temporary policy until a tourism strategic/action plan can be developed. Many investors have made decisions to develop the tourist plant on the basis of market indications and the existing regulatory environment for the private sector. The decision to limit charter flights has consequences for existing operators and those in the pipeline, and there has been a strong response from the affected parties. The justification for the action has been made on the grounds of the impact of pressures on specific parts of the system, and the issuance of licenses should be designed to alleviate that pressure.

**Moratorium on new tourism development.** Since the current water and sewer systems were unable to accommodate the existing levels—let alone future tourism developments in Koror—The ADB report suggested there were strong grounds to place a temporary hold on new projects. This would allow for the development of regulatory and planning processes to catch up with tourism activity. However, the imposition of a moratorium on tourist development should not restrict development outside the Koror area or inhibit projects that place no burden on the existing waste infrastructure or threaten the environment.

**Report outlines long list of activities:** Apart from providing a response to the immediate tourism issues on hand at the time of presentation, the ADB report outlined key components of a tourism-management action plan. There is a large list of activities, many of which are common to development and private sector matters in general. The most important of these include

- the need for a land-use policy to provide a framework for resort development to fit the tourism strategy,

1 Ibid.

- the need for manpower policies to reduce the reliance on foreign labor and raise the quality of Palauan skills,
- development of an infrastructure strategy, and
- assessment of visitor carrying capacity by destination and attractions.

## THE RESPONSIBLE TOURISM POLICY FRAMEWORK

**OIA awards grant for development of the Palau Tourism Master Plan:** In 2015, the Palauan government requested TA support from the US Department of the Interior's Office of Insular Affairs to prepare a tourism master plan.[1] A $415,091 grant was awarded for the development of the Palau Tourism Master Plan. As a result, the Responsible Tourism Policy Framework was drafted, coupled with a series of supporting studies and consultancies. The framework was subsequently endorsed by the president and submitted to the OEK for adoption. The tourism framework is based on the vision "A Pristine Paradise. Palau for Everyone," with a mission statement "We intend to grow and sustain a visitor industry that is Respectful of our people and environment, ensures the Optimum flow and retention of revenue in our economy, and consistently delivers on the Promise of a Pristine Paradise. Palau experience to all." The tourism framework is composed of six targets and corresponding goals. An outline and the key features are discussed briefly.

i. **Responsible tourism awareness and alignment is a national priority.** This is defined as the development of an adequate and appropriate national capacity to manage and sustain the tourism sector. Most critically, it includes support for land-use planning and tourism zoning, the central feature lacking in Palau's tourism regulatory framework. It is also the principal means of implementing the selected strategy. The framework proposes the National Tourism Coordination Board (NCTB) as a central feature of tourism planning.

ii. **Palau's economy is responsibly managed.** This is defined as developing visitor-to-resident ratios that reflect sustainable carrying capacity. This goal is defined at the microlevel, meaning at the visitor and site levels. An attempt to specify a macro-level definition at an economy-wide visitor carrying-capacity level is not attempted.

iii. **Responsible product development attracts targeted high-value markets.** This is the core of Palau's tourism strategy: development of a high-value, low-impact tourism model. High-value tourists are defined as FIT visitors in targeted niche markets such as birding, soft adventure, cultural heritage, private cruising, ecotourism and so on.

iv. Palau's visitor experience reflects the "Pristine Paradise. Palau" brand. This is defined around a set of standards that reflect the strategy.

v. **Palau's tourism industry improves visitor yield.** This concept is defined as increasing the yield from the tourism dollar—that is, increasing linkages to other sectors of the economy and increasing local participation. This is consistent with the niche-market product embedded in Pristine Palau. It is not defined in terms of increased revenue per visitor, which would be consistent with a high-spending tourism strategy.

vi. **Palau's tourism development is community driven.** Communities are actively engaged in responsible tourism planning and decision-making.

**Responsible framework more a list of aspirations than action or master plan:** The framework goes on to state that it is accompanied by an action plan. However, the action plan is more of a framework outlining general activities that need to be undertaken than a well-defined set of activities that would be implied in a tourism strategic or master plan. The framework is thus a set of aspirations or guiding first principles that might be deployed in preparing a comprehensive strategy or plan.

**Responsible framework not informed by**

1 Ibid.

**economic analysis of tourism:** From the earlier discussion in this chapter, it can be seen that the framework was not informed by the economic structure of the Palauan economy or tourism industry. The economic analysis indicates employment potential of Palauans is weak and that policy needs to focus on upgrading skills. With foreign ownership in the hotel segment dominating, strategies to develop Palauan participation (and not front businesses) in ancillary services should be the focus. Government revenue is by far the largest economic benefit from tourism. Tax reform needs to play a central role in tourism strategy. This suggests a suitable blend of the niche-market, culturally aware ecotourism model adopted by the framework and a higher-end revenue-generating form of tourism. As argued in this review, support for the existing low-end plant also needs to be part of the strategy, as do methods to upgrade low-quality plant to a more acceptable level to the extent possible, although this will be limited in practice.

## CONCLUSION

**Need remains for a comprehensive tourism policy, strategy or master plan:** It should be clear from the foregoing discussion and analysis that a comprehensive tourism policy, strategy or master plan does not exist in Palau. While the nation has adopted a “Pristine Paradise. Palau” brand and a policy to attract high-value tourism, there is little further depth and few strategies on how to attain these goals. At the current time, the contraction in the industry, whether due to the impact of the charter policy, uncompetitive pricing, or the fact that Palau does not have official China-approved destination status has taken the heat off the need for a well-designed policy framework. However, the unregulated nature of the industry means that it will be subject to unconstrained market forces. With a significant increase in plant and further developments in the pipeline, the potential for a future surge in unconstrained tourism activity from investors seeking a return on their investment is to be anticipated. At the current time, Palau is unprepared and does not have a framework to prudently guide these forces.

# 3. External Sector

**In Palau the current account has normally been in deficit reflecting the large deficit on goods and services with tourism related receipts failing to match large imports of goods and services. On the secondary income account grants are large but there are significant outflows of remittances to migrant workers families. On the financing account FDI is a major item with the large buildup of domestic liquidity adding to commercial bank holding of foreign assets.**

- The terms of trade facing Palau, while historically remaining stable, improved during the tourism boom years and with reductions in fuel prices. In the last two years both of these force have reversed and the terms of trade have deteriorated but remain favorable.
- During the tourism boom years of rising prices the real effective exchange rate appreciated indicating a loss in competitiveness. While the high price of vacationing in Palau certainly played a part in the subsequent falling number of visitors, there were a large number of other structural reasons that were responsible for the decline. With a price adjustment in tourism-related prices the real effective exchange rate fell from its peak and has now stabilized.
- Palau has maintained a favorable external debt position, with debt falling from 40 percent of GDP in FY2000 to 23 percent in FY2015. With large loans from the Asian Development Bank for water, sanitation and ICT projects, coupled with borrowing from Taiwan for social projects, external debt rose to 32 percent of GDP in FY2018.
- With some further borrowing in the pipeline under existing ADB loans, but no new scheduled increase in net indebtedness, external debt is projected to steadily decline until all loans are liquidated. The government is currently considering refinancing the expensive RUS debt from the ADB but this will not incur any new net indebtedness.
- The statement of Palau's International Investment Position (IIP) has been re-estimated with new estimates of foreign direct investment. The COFA Trust Fund has also now been included in the IIP. Over the period, the stock position has improved as rising portfolio investment in the COFA Trust Fund, Social Security, and foreign assets of banks has accumulated faster than foreign direct investment. The position improved from a negative $80 million in FY2010 to negative $31 million in FY2018.

# 3. External Sector

## A. Balance of Payments

### CURRENT ACCOUNT

**Exports of goods are a minor part of the BoP in Palau:** The current balance-of-payments (BoP) account is presented in abbreviated form in Table 1. On the trade account, exports comprise two main items: fuel re-exports and others. Estimates of re-exports to ships and airlines have been made on the basis of aviation-gas imports and margins of resident fuel companies. Other exports comprise small quantities of commodities, including material for recycling. Fish transshipped in Palau is not considered an export because the commodity is owned by nonresident long-line fishing vessels. However, the onshore handling and packaging is sold to the vessel owners, considered an export and captured on the services account.

**Imports grew strongly with the rise in tourism demand but have flattened since FY2015:** Imports have generally been well recorded, although the value of commodities on which tax is levied on a volume basis is less precise. Imports of food items have risen through much of the period, reflecting international food-price increases and domestic demand, including tourism growth. However, since FY2015 imports of food have remained stationary, reflecting reduced prices in FY2016 and lower demand with the drop in the tourist economy. Likewise, fuel imports are strongly related to international prices, given the inelastic nature of demand. In FY2015, with the very low level of fuel prices, imports dropped very significantly from $54 million in the previous year to $34 million in FY2015 despite the additional tourism demand. In the following two years, imports remained little changed but grew strongly in FY2018 reflecting the increase in prices despite the weak economy. Other import items reflect inputs into the construction and tourism industries and consumer items. In FY2015, the value of other imports stabilized after the rapid increase in the previous year and has largely remained at that level.

**Tourist receipts fall with loss in visitor arrivals:** The service account on the receipt side comprises fish processing, tourism revenue and a series of other, small items. As noted, fish transshipped through Palau is not considered a BoP transaction, but the value added in packaging and transfer fees is included. Estimated exports of tourism services are based on the sales of hotels, restaurants, dive and tour operators, and other tourist-related activities. After the rapid, 34 percent growth in visitor arrivals in FY2015, the numbers fell back by 13 percent in FY2016 and by a further 17 and 5 percent in FY2017 and FY2018, respectively. Tourism receipts rose by 16 percent in FY2015 and fell by 7, 11 and 7 percent in FY2016 through FY2017, respectively. The implied lower marginal value of the additional (or reduced) visitors in FY2015 through FY2017 reflects that the major impact of the changes occurred in the lower-value package-tour segment of the market. In FY2018 the forces were reversed and the loss in visitors was associated with a loss in higher spending tourists. Other service exports reflect a variety of small items.

Imports of services include the insurance and freight component of imports (c.i.f.), passenger fares, overseas travel expenses and technical assistance. The level of imported business services is not known with any degree of accuracy.

**Receipts from the VDS have grown significantly in recent years:** Primary incomes include compensation of nonresident workers, interest and dividends, and royalties from fishing. Fishing royalties are not large in Palau relative to other Pacific nations, but the Vessel Day Scheme, part of the Parties to the Nauru Agreement, has resulted in significant increases since FY2012, from $1.5 million to $8.5 million in FY2018. The future status of these revenues is unclear with implementation of the marine sanctuary in 2020, which effectively bans commercial fishing in Palau's waters. However, under the operation of the Parties to the Nauru Agreement, vessel days can be traded with other nations, and it is anticipated that Palau will be able to sell its allocation to other nations and thus maintain an important source of earnings. Interest and dividend receipts are represented by earnings of the Social Security and Civil Servant Pension Funds, government, and offshore investments of the commercial banks.

**Dividend payments fall with the reduction in tourism:** On the payments side, the dominant item is the payment of dividend earnings of foreign companies, mostly in the tourism sector, which rose to a significant $30 million in FY2015 before dropping to $27 million by FY2018 with the fall in visitor arrivals and reduced occupancy rates (this item is not known with great precision and is subject to a wide margin of error).

**Both grants and foreign worker remittances are significant elements of the BoP:** The major items in the secondary income account (see continuation of Table 1) are grants and household remittances. Grant receipts consist of Compact grants, other US grants (mainly federal programs), and other-country current grants.[1] In FY2018 with passage of the Compact Review Agreement by the US Congress, Compact grants rose significantly, but in future years will

**Table 1** Balance of payments, FY2010-FY2018, (US$s millions)

| (US$ millions) | FY10 | FY11 | FY12 | FY13 | FY14 | FY15 | FY16 | FY17 | FY18 |
|---|---|---|---|---|---|---|---|---|---|
| **Current account balance** | **-16.2** | **-24.5** | **-32.4** | **-31.7** | **-43.5** | **-24.4** | **-40.8** | **-54.8** | **-47.2** |
| Goods and services balance | -48.5 | -57.2 | -62.4 | -62.9 | -73.4 | -46.2 | -57.9 | -78.3 | -83.2 |
| Goods balance | -84.0 | -106.8 | -117.5 | -125.1 | -151.7 | -136.8 | -134.3 | -139.5 | -138.2 |
| Exports of goods | 14.2 | 14.9 | 17.7 | 16.6 | 15.9 | 13.1 | 13.3 | 14.1 | 13.8 |
| Re-exports | 11.3 | 12.0 | 13.7 | 13.0 | 13.0 | 10.5 | 10.6 | 10.2 | 10.0 |
| Other | 2.9 | 2.9 | 4.0 | 3.6 | 2.9 | 2.5 | 2.7 | 3.9 | 3.8 |
| Imports of goods f.o.b. | 98.2 | 121.7 | 135.2 | 141.7 | 167.6 | 149.9 | 147.6 | 153.5 | 151.9 |
| Food | 26.3 | 27.6 | 32.5 | 32.7 | 36.4 | 37.8 | 37.3 | 36.5 | 37.0 |
| Fuel | 32.2 | 45.6 | 50.1 | 50.4 | 54.4 | 33.7 | 28.8 | 30.2 | 37.2 |
| Other | 39.7 | 48.5 | 52.6 | 58.6 | 76.9 | 78.4 | 81.5 | 86.8 | 77.8 |
| Services balance | 35.4 | 49.6 | 55.1 | 62.2 | 78.3 | 90.7 | 76.4 | 61.2 | 54.9 |
| Exports of services | 78.1 | 94.6 | 110.5 | 116.0 | 133.0 | 151.7 | 142.4 | 129.2 | 119.7 |
| Fish processing | 1.2 | 1.1 | 1.5 | 1.5 | 1.2 | 0.9 | 1.1 | 1.7 | 1.7 |
| Travel | 69.6 | 86.3 | 101.3 | 107.0 | 122.7 | 140.4 | 131.1 | 117.0 | 108.6 |
| Other | 7.3 | 7.2 | 7.8 | 7.6 | 9.1 | 10.4 | 10.2 | 10.5 | 9.4 |
| Imports of services | 42.6 | 45.0 | 55.4 | 53.8 | 54.7 | 61.1 | 66.0 | 68.0 | 64.8 |
| Transport | 19.5 | 17.3 | 20.9 | 19.6 | 20.2 | 24.3 | 24.6 | 24.9 | 22.8 |
| Travel | 6.7 | 10.1 | 13.0 | 13.7 | 13.7 | 14.6 | 15.5 | 15.8 | 15.4 |
| Other | 16.3 | 17.7 | 21.5 | 20.5 | 20.8 | 22.2 | 25.9 | 27.2 | 26.6 |
| Primary income balance | -2.7 | -2.1 | -5.1 | -4.4 | -8.0 | -11.3 | -14.5 | -5.6 | -7.6 |
| Primary income, inflows | 14.1 | 15.9 | 14.5 | 18.3 | 15.4 | 18.8 | 18.1 | 23.0 | 22.5 |
| Fishing licence fees | 1.1 | 1.7 | 1.5 | 3.4 | 5.0 | 7.9 | 6.8 | 9.8 | 8.5 |
| Dividends and interest | 10.8 | 12.0 | 10.6 | 12.3 | 8.2 | 8.8 | 9.1 | 10.5 | 11.6 |
| Social Security & Pension Plan | 4.4 | 4.9 | 4.8 | 3.5 | 3.1 | 2.4 | 1.9 | 3.3 | 2.9 |
| Other | 6.4 | 7.1 | 5.8 | 8.8 | 5.1 | 6.4 | 7.2 | 7.3 | 8.7 |
| Others | 2.2 | 2.2 | 2.5 | 2.6 | 2.1 | 2.1 | 2.3 | 2.6 | 2.4 |
| Primary income, outflows | 16.8 | 18.0 | 19.6 | 22.8 | 23.4 | 30.1 | 32.6 | 28.5 | 30.1 |
| Dividends related to direct investment | 14.0 | 15.4 | 18.9 | 21.2 | 22.1 | 29.9 | 32.0 | 27.1 | 27.5 |
| Interest on loans | 2.7 | 2.6 | 0.7 | 1.6 | 1.3 | 0.2 | 0.6 | 1.4 | 2.6 |

1 The COFA (Compact of Free Association) Trust Fund was formerly treated as a multilateral-institutional unit and non-resident. IT is now treated as resident.

**Table 1** Balance of payments, FY2010-FY2018, (US$s millions) - Continued

| (US$ millions) | FY10 | FY11 | FY12 | FY13 | FY14 | FY15 | FY16 | FY17 | FY18 |
|---|---|---|---|---|---|---|---|---|---|
| Secondary income balance | 35.0 | 34.9 | 35.1 | 35.7 | 37.9 | 33.1 | 31.6 | 29.0 | 43.6 |
| Secondary income, inflows | 47.6 | 48.0 | 49.0 | 50.2 | 53.9 | 52.2 | 53.3 | 52.1 | 67.1 |
| Government grants | 38.5 | 38.3 | 38.3 | 37.6 | 40.5 | 36.4 | 37.3 | 38.1 | 50.4 |
| US compact grants | 13.1 | 13.1 | 13.1 | 13.1 | 13.1 | 13.1 | 13.1 | 13.1 | 24.6 |
| US non-compact grants | 10.7 | 10.3 | 10.5 | 9.7 | 9.9 | 10.2 | 10.0 | 9.7 | 9.7 |
| Other grants | 14.6 | 14.8 | 14.7 | 14.7 | 17.4 | 13.1 | 14.2 | 15.2 | 16.1 |
| Departure tax and Green fees | 3.0 | 3.8 | 4.4 | 5.8 | 6.4 | 8.8 | 7.8 | 6.6 | 9.1 |
| Other | 6.1 | 5.9 | 6.3 | 6.8 | 7.0 | 7.0 | 8.1 | 7.4 | 7.6 |
| Secondary income, outflows | 12.5 | 13.1 | 13.9 | 14.5 | 16.0 | 19.1 | 21.7 | 23.1 | 23.5 |
| Household remittances | 10.8 | 11.1 | 11.7 | 12.3 | 14.0 | 16.6 | 19.0 | 20.4 | 20.8 |
| Other | 1.7 | 2.0 | 2.2 | 2.2 | 2.0 | 2.5 | 2.7 | 2.7 | 2.7 |
| **Capital account balance** | **26.1** | **16.8** | **22.9** | **19.5** | **32.6** | **17.6** | **24.4** | **10.3** | **74.7** |
| Capital inflows | 26.1 | 16.8 | 22.9 | 19.5 | 32.6 | 17.6 | 24.4 | 10.3 | 74.7 |
| US contributions to Compact Trust Fund | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 65.3 |
| US | 6.6 | 3.5 | 4.4 | 3.5 | 4.0 | 6.7 | 7.1 | 1.2 | 0.4 |
| Compact Rd | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Japan | 5.8 | 1.1 | 5.3 | 3.8 | 4.0 | 3.5 | 4.2 | 3.9 | 3.9 |
| Other | 13.7 | 12.2 | 13.2 | 12.1 | 24.6 | 7.4 | 13.2 | 5.2 | 5.2 |
| Capital outflows | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Net lending/Borrowing (Curr + Cap)** | **9.9** | **-7.7** | **-9.5** | **-12.2** | **-10.9** | **-6.8** | **-16.4** | **-44.6** | **27.5** |
| **Financial account balance** | **-14.1** | **-17.9** | **-10.7** | **-18.0** | **-17.5** | **7.0** | **-24.7** | **-37.6** | **-5.8** |
| Direct investment( net lending (+) = assets - liabilities) | -19.9 | -31.4 | -28.5 | -28.1 | -33.5 | -60.6 | -58.1 | -37.2 | -68.4 |
| Portfolio investment (net lending (+) = assets - liabilities) | -3.1 | 0.3 | -0.3 | 4.4 | -11.9 | 5.2 | 0.3 | 1.4 | 67.6 |
| Compact Trust Fund | 0.0 | 0.9 | -2.2 | 1.7 | -2.6 | -1.3 | -0.9 | -1.9 | 64.2 |
| Other | -3.1 | -0.6 | 1.9 | 2.7 | -9.4 | 6.5 | 1.2 | 3.3 | 3.4 |
| Other investment (net lending (+) = assets - liabilities) | 8.9 | 13.2 | 18.1 | 5.7 | 28.0 | 62.3 | 33.0 | -1.9 | -4.9 |
| Assets (increase: -) | 2.9 | 9.4 | 23.4 | 2.1 | 33.7 | 56.4 | 48.8 | 4.2 | 0.9 |
| Liabilities (increase: +) | -5.9 | -3.8 | 5.3 | -3.6 | 5.8 | -5.9 | 15.7 | 6.1 | 5.8 |
| Financial institutions | -2.4 | -0.4 | -1.6 | ~ | ~ | -0.0 | ~ | ~ | 0.4 |
| Loans, Public | -3.5 | -3.4 | 6.9 | -3.6 | 5.8 | -5.9 | 15.7 | 6.1 | 5.4 |
| **Errors and omissions** | **-24.0** | **-10.2** | **-1.2** | **-5.8** | **-6.6** | **13.7** | **-8.3** | **6.9** | **-33.3** |

be replaced by drawdowns from the COFA Trust Fund. Receipt of remittances from Palauans living abroad is not known with any accuracy but is understood to be small. On the payment side, significant remittances are sent offshore from the large resident non-citizen-worker community living in Palau. This is estimated in relation to the number of non-citizens living in Palau, which fell after the completion of the large infrastructure projects but has shown growth with the booming tourism industry.

## CAPITAL AND FINANCING ACCOUNTS

**Capital account reflects donor grants contributions:** The only estimated items on the capital account are capital grants. These are received from the US, Japan and other countries, particularly the Republic of China (Taiwan). A major specific capital grant was received from the US to build the road in Babeldaob known as the Compact Road.

**Finance account dominated by FDI and commercial bank foreign assets:** In regard to the financing account, the estimation of direct investment, like dividend outflows, is not known with any precision. It is estimated to have grown significantly with the expansion in the tourism industry, reflecting investment in tourism plant and large capitalized land-lease payments, but is thought to have contracted with reduction in tourism demand. The national-government, social security and civil service pension funds all have significant portfolio investments offshore. Net acquisitions of other investments mainly reflect the changes in commercial bank foreign assets. Data for this series only became available with the new banking statistics series in 2010, but recent changes have been very large. Incurrence of other investment liabilities reflects small changes in financial institutions (banks and insurance companies) and public debt, from both government and the SOE sector.

**Net incurrence in external debt has been positive in recent years as the government has undertaken important infrastructure projects:** External In recent periods, drawdowns under new loans has exceeded repayment as Palau has incurred new external debt. In FY2012 the government received the first tranche of the ADB water-and-sewer-improvement loan of $9.9 million, and in FY2014 received the second tranche of $6.2 million. In FY2016, the government borrowed $10 million from the Republic of China (Taiwan) for housing and agricultural development on the island of Babeldaob. There were also drawdowns from the ADB under the Koror-Airai Sanitation Project (KASP) and ICT fiber optic loans of $6.0 million and $5.8 million, respectively. In FY2017 and FY2018 the government received similar amounts under the two loan programs.

**Palau runs a current account deficit:** The structure of the balance of payments has resulted in a negative balance on the goods-and-services account, despite a large positive entry for tourism. In FY2015, the deficit on the goods-and-services account narrowed as tourism receipts grew rapidly while fuel imports fell significantly with the reduction in world fuel prices. In the subsequent years, the balance on goods and services deteriorated as imports stabilized and tourist receipts fell. The current-account balance has also been negative, with the large positive balance on the secondary-income account being insufficient to offset the negative balance on the goods-and-services and primary-income accounts.

**Current account deficits financed through capital account transfers and finance account inflows:** Reflecting the one-directional flows balance on the capital account has always been positive. Balance on the finance account has tended to be positive reflecting large FDI flows to support investment in tourism plant but offset by increases in the foreign-asset holdings of the commercial banks and net external borrowing. In FY2018 under the new Compact Review Agreement the US made a large and unusual capital grant of $65.3 million to the COFA Trust Fund. This was offset by a build up of foreign assets of the Fund.

**Errors and omissions generally small in recent years:** In the majority of years since FY2010, the BoP errors and omissions as a percentage of goods and services has remained within 4 percent, an acceptable range. However, in FY2018, the errors rose to unacceptably high positive level of 9 percent. This reflects the large level of FDI which at a time of tourism decline and reduced activity appears overstated.

## B. The Terms of Trade, Gross National Income, and Gross National Disposable Income

Estimates of gross domestic income (GDI) are derived from GDP with the addition of trading gains or losses arising from changes in the terms of trade. Gross national income (GNI) and gross national disposable income (GNDI) are estimated in turn from GDI with the addition of the primary-income account of the balance of payments, and the secondary-income account, respectively.

**The terms of trade improved during the tourism boom years and with falling fuel prices, but the trend reversed in the last two years:** The terms of trade is a measure of the ratio of export to import prices and indicates whether trading relations with the rest of the world are moving favorably or not. Figure 24 displays the terms of trade as an index with base =100 in FY2015. The Figure indicates that during FY2000 through FY2010 the terms of trade

**Figure 24**
Terms of trade (FY2015 = 100)

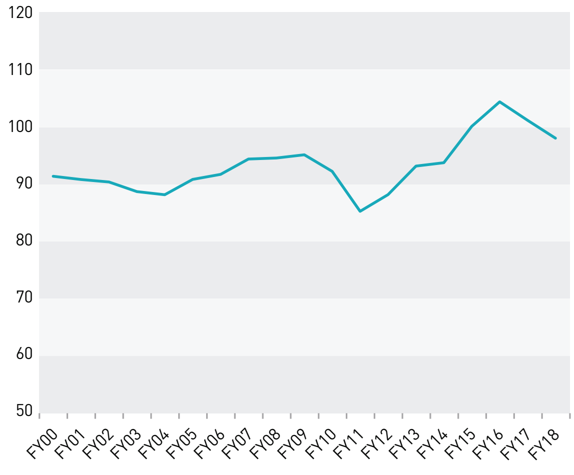
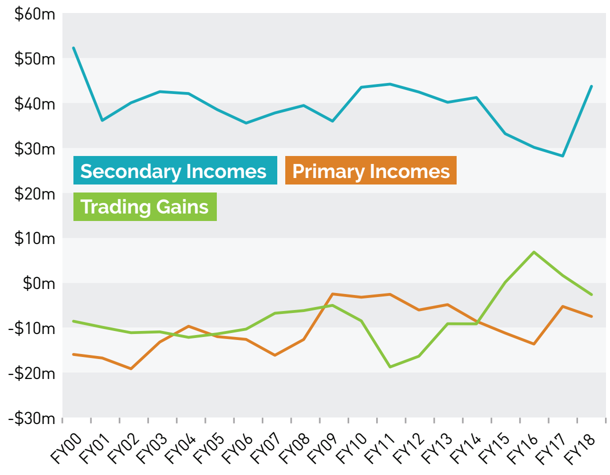



**Figure 25**
Trading gains, primary and secondary incomes, constant prices FY2015




were largely stationary but moved adversely in FY2011 due to a rise in oil prices and weak export prices. During the next few years through FY2016, the terms of trade improved by about 20 basis points, reflecting rising tourism prices, and in FY2015 and FY2016 a large reduction in fuel prices. In FY2017 and FY2018, these trends reversed as tourism prices moderated and fuel prices started to rise leading to reduction in the terms of trade.

**Estimates of GDI are based on GDP plus the value of exports adjusted for changes in the terms of trade.** Thus, when a nation's terms trade rise incomes rise. Figure 25 indicates the gains from trade in FY2015 dollars and the trend closely mirrors the terms of trade.

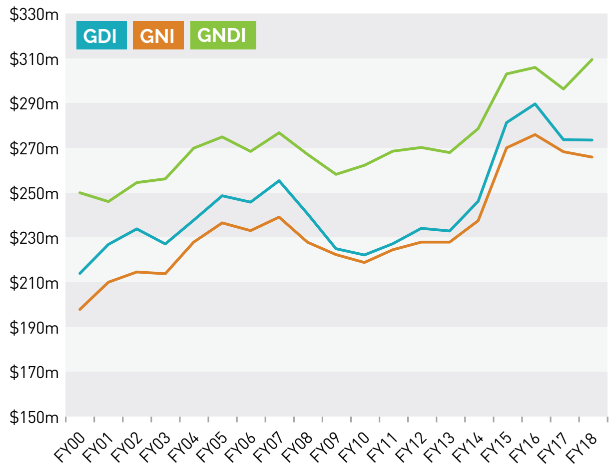
GNI and GNDI important measures of economic activity: While analysis of GNI and GNDI might be placed in the section on GDP, we thought it would be more appropriate to put it in the section following the analysis of the BoP since the data to construct the additional series come from the BoP. Primary and secondary incomes (net) have represented an average of −3 and 12 percent of GDP during the last three years, respectively. In analyzing the results, it is useful to single out developments in constant-price changes in primary and secondary incomes. Both the primary and secondary incomes of the BoP have been deflated by the index of the gross domestic expenditure (GDE) deflator.

**Primary income balance driven by tourism dividend payments and fishing fee receipts:** The result in constant prices for the primary income balance reflects a variety of different forces with no discernable trend through much of the period. Dividend remittances play the most significant role, with the state of the tourism industry exerting the dominant force. Fishing-fee receipts, although relatively small in Palau, have also risen sharply in the last five years. In FY2014-FY2016, with the booming tourism industry, dividend outflows increased significantly, and net primary incomes fell; these trends reversed in FY2017 and FY2018 as tourism related dividends declined and fishing fee revenues expanded.

**Secondary income balance reflects stationary grant levels and in recent years rising foreign worker remittances:** In the case of secondary incomes, the series is dominated by Compact and other country grants on the receipt side and foreign-worker remittances on the payment side. While current-grants receipts have largely stagnated, remittance outflows declined as the number of foreign workers fell after the completion of the Compact Road project. Remittances have subsequently trended upward with the growth in demand for labor as the tourism industry has grown. Putting these forces together and deflating by the GDE price index, the secondary-income constant-price series has trended downwards since FY2010. In FY2018 the large receipt of grants under the CRA led to an unusual increase in receipts, but will revert to trend in FY2019.

**As grant transfers decline in real terms the gap between GNDI and GDI has narrowed:** We are now in a position to analyze the movements in the GDI, GNI and GNDI series by adding the changes in real primary and secondary incomes to the GDI constant-price series (see Figure 26). Given the relatively small influence of primary incomes, the GNI series is largely a small downward translation on GDI. In the case of GNDI, the series is in the opposite direction, an upward translation on GNI. However, the gap has narrowed in the last five years, reflecting falls in real aid flows and rising remittances with the recent boom in the economy.

**Figure 26**
GDP,GNI, and GNDI, constant prices 2015

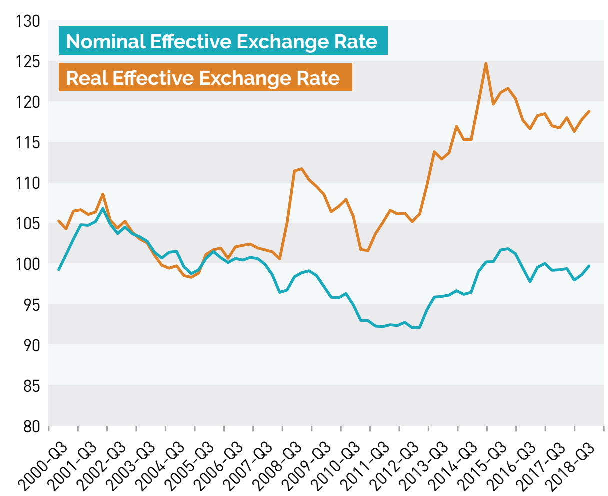



## C. Nominal and Real Effective Exchange Rates

**Nominal effective exchange rate reflects movement of the US dollar weighted by Palau's trading relations:** The nominal effective exchange rate (NEER) is a trade-weighted index of the exchange rates for the currencies with which Palau engages in trade in goods and services. The currency composition of Palau's trading relations has been estimated through analysis of the origin of imports and estimation of exports of both goods and services. Given Palau's historical relationship with the US, the US dollar dominates with for 55 percent of international trade. Considering that Palau uses the US dollar as its currency of exchange, the NEER is a trade-weighted index of the US dollar against Palau's trading partners. Figure 27 indicates that the NEER depreciated between FY2002 and FY2012, reflecting the depreciation of the US dollar. However, from the start of 2013 the NEER and US dollar started to strengthen against the currencies of Palau's trading partners until mid-2016, when the dollar weakened, and the series dipped. In the last two years the series has remained largely unchanged

**Real effective exchange rate appreciates in FY2017 due to high inflation and rises during the tourism boom:** The real effective exchange rate (REER) is a measure similar to the NEER, but currency movements are adjusted for changes in the CPIs of the respective countries. It is thus a proxy for the gains or losses of international competitiveness. At the start of the period through FY2007, the REER largely mirrored the NEER, but after that point, with the significant increase in inflation in Palau resulting from rising fuel and food prices, the REER spiked in FY2008, resulting in a loss of competitiveness. The REER depreciated from FY2009 through the end of FY2010, mirroring the downward movement of NEER, but it did not adjust downward to

**Figure 27**
Nominal and real effective exchange rates, FY2000-FY2018, (FY2003 = 100)



the prior level. After FY2010, the REER again appreciated, reflecting both the appreciation of the NEER and also higher inflation in Palau. The movement in the REER during this period implies a significant loss of competitiveness. From FY2015 onward, the REER depreciated, reflecting not only weakening of the US dollar but also lower inflation in Palau, in turn reflecting weakening conditions in the Palauan economy.

## D. External Debt[1]

### DEBT PROFILE

**Palau has maintained a modest external-debt profile with a total of 10 public sector loans:** 6 incurred by the national government, 2 by the National Development Bank of Palau (NDBP), 1 for the Palau Public Utilities Corporation (PPUC) and 1 remaining by the Palau National Communications Corporation (see Table 2). The national government incurred three loans from the Mega International Commercial Bank (MICB) of China for $20 million, $8 million and $10 million, respectively, to construct the national capitol, airport upgrades and a housing/agricultural development loan for Babeldaob development. The term of the three loans is for 20 years at 3.5 percent interest for the first two and LIBOR plus 1 percent for the housing loan.

**Government borrows from ADB for reform of the water and sewer sector:** The national government borrowed its first of three loans from the Asian Development Bank in 2011 for the Water Sector Improvement Program (WSIP). The program includes borrowing under two facilities. The first includes a loan of $12.6 million from the ADB's Ordinary Capital Resources (OCR) with a 3-year grace period over a total of 15 years. The interest rate is LIBOR plus 0.15 percent. A second facility includes a loan of $3.4 million from the ADB's Asian Development Fund (ADF), the bank's concessional arm. The second loan carries a 24-year term with an interest rate of 1.5 percent after an 8-year grace period. There is a 1 percent service charge during the grace period. The WSIP is designed to ensure the future demand for water and sewer is satisfied on a sustainable basis. The WSIP was also intended to transform the delivery of water from the Bureau of Public Works to an independent body on a commercial basis (now under the Palau Public Utility Corporation). The loan will assist the government in providing resources to facilitate the transfer and eliminate the current implicit subsidy.

**Government borrows for improvement to the water and sewer system and construction of a fiber optic link to the internet:** In FY2016, the government made its first drawdown under the ADB Koror-Airai Sanitation Project (KASP) with a planned borrowing of $28.8 million to be on-lent to the PPUC. As with the WISP, the borrowing is structured in two parts: a borrowing of $26.9 million of OCR funds and $1.9 million of ADF resources. The KASP is designed to refurbish, renovate and extend Palau's existing sewer system to support the growing economy. The project was initiated in FY2016, and construction was anticipated to be completed over several years. At the end of 2015, the OEK passed a bill to create the Belau Submarine Cable Company (BSCC) to own and manage a fiber optic connection to the internet backbone. The construction of the cable has been financed through a third ADB loan to the government and on-lent to the BSCC for $25 million of combined OCR and ADB resources. Cable construction was completed at the end of 2017, and there are significant savings on the original project and loan estimates, which will be programmed into other related areas.

**National Development Bank of Palau and PPUC have minor external debt obligations:** The NDBP has incurred two loans: one from the MICB and the second from the European Investment Bank (EIB). Both loans are to support the NDBP in its role as lender for development purposes. The MICB loan has a term of 20 years, while that of the EIB is for a shorter term of 13 years. The MICB loan carries a 3.5 percent interest rate, while the EIB loan is structured in two parts: one part at 3.7 percent and the other at 5.2 percent. The PPUC incurred a debt of $7 million in 2006 to purchase portable generators from a foreign bank at an interest rate of 3.5 percent over 17 years.

1 The external-debt profile is based on public audits. At the time of writing, the FY2018 audits were under preparation. The data presented are derived from the FY2017 position and repayment schedules.

**Table 2** External debt by loan

| Borrower | Purpose | Lender | Year | Interest rate | Original debt, $'000 (unless stated) | Estimated outstanding principal September 2018, $'000 |
|---|---|---|---|---|---|---|
| National Government | Construction New Capital | Mega International Commercial Bank | 2003 | 3.5% | 20,000 | 2,286 |
| National Government | Palau Airport Upgrade | Mega International Commercial Bank | 2005 | 3.5% | 8,000 | 2,971 |
| National Government | Water Sector Improvement | Asian Development Bank | 2011 | Libor & 1-1.5% | 16,000 | 13,057 |
| National Government | Housing and agriculture | Mega International Commercial Bank | 2016 | Libor & 1% | 10,000 | 10,000 |
| National Government | Koror Airai Sanitation Project | Asian Development Bank | 2016 | Libor & 1-1.5% | 28,800 | 14,765 |
| National Government | ICT internet connectivity | Asian Development Bank | 2016 | Libor & 1-1.5% | 25,000 | 19,951 |
| NDBP | Capital funds | Mega International Commercial Bank | 2004 | 3.5% | 5,000 | 1,714 |
| NDBP | Loan and capital funds | European Investment Bank | 2006 | 3.7% & 5.2% | € 5,000 | 1,233 |
| PPUC | Purchase of generators | Foreign Bank | 2008 | 3.5% | 7,000 | 3,400 |
| PNCC | Telecom development | Rural Utilities Services | 1992 | 4.6% | 39,143 | 18,851 |
| **Total** | | | | | | **88,229** |

Note: NDBP EIB loan converted at €1 = $1.3
excludes $3 million obligation to establish Compact Road trust fund to support road maintenance

**PNCC debt to the RUS remains substantial:** The PNCC incurred a significant level of debt at a relatively high interest rate of 4.6 percent to the US Rural Utilities Service (RUS) originating in 1992. The RUS loans supported the development of communications infrastructure in Palau, but in legacy copper-based technology that would now be considered obsolete. The PNCC incurred small loans to finance the replacement of its billing system, and to finance the installation of a third-generation network. These two loans have now been repaid.

**External debt has fallen as a percent of GDP but has risen in the last few years with new borrowing:** Figure 28 shows the level of external debt as a percentage of GDP and debt servicing as a percentage of national-government domestic revenues. The level of debt as a percentage of GDP has fallen through the period from 40 percent in FY2000 to 32 percent in FY2018. The level of debt has risen from $58.5 million to $91.3 million, indicating the rise in nominal GDP has outstripped the rise in external debt. This is a favorable outcome and has supported financial stability.

External debt fell as a percentage of GDP from FY2000 through FY2006 as loans were repaid. In FY2007, there was new borrowing both by the national government for the airport improvement and for NDBP lending resources. The next incurrence of debt was in FY2009, with further borrowing for the NDBP from the EIB and a small loan for the PNCC. As a result, debt to GDP rose between FY2006 and FY2009 from 31 to 38 percent. In following six years the national government drew down the ADB loan for the WSIP, but the debt ratio fell to 23 percent, the lowest point in the review period. In the next three years though FY2018 government incurred significant new debt and debt to GDP rose significantly. In FY2016 the government borrowed for Babeldaob housing and agricultural development and made its initial drawdowns under the KASP and BSCC loan

**Figure 28**
Palau external debt and deb servicing, FY2000-FY2018

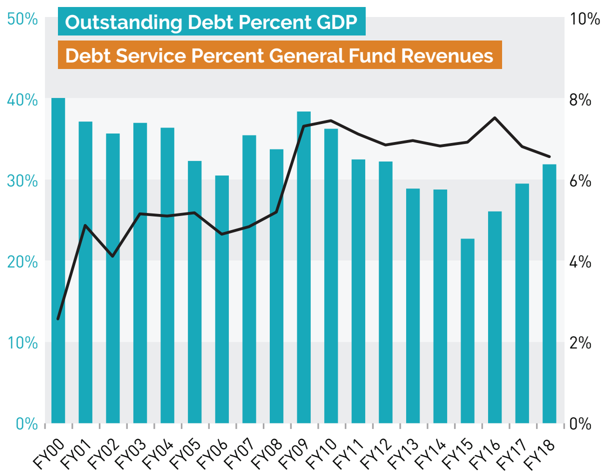
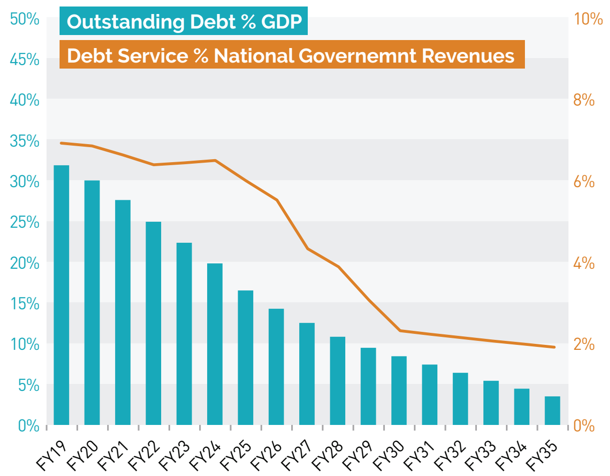



**Figure 29**
External debt and debt service projections, FY2019-FY2035




projects. Drawdowns under the ADB programs continued in the next two years and by FY2018 debt to GDP had risen to 32 percent.

**Debt service grows significantly but remains sustainable:** Debt service has risen significantly as a percentage of national-government revenues, from 2.6 percent in FY2000 to 7.5 percent in FY2010, and declining slowly to 6.6 percent in FY2018. While much of the debt service is maintained by the SOE sector, the national government is ultimately responsible in case of default. In terms of value, the total cost of debt service, including both interest and capital payments, has risen from $1.7 million in FY2000 to $8.3 million in FY2018.

## DEBT SUSTAINABILITY

**Debt projections and assumptions:** The analysis presented in the previous section indicated that Palau had a favorable external-debt profile. However, the two new large ADB loans, the Koror-Airai Sanitation Project (KASP) phase I ($28 million) and the submarine-cable project for providing access to the internet backbone ($25 million), suggest that Palau's debt profile should be examined carefully for long-term sustainability. Figure 29 indicates Palau's projected debt profile through FY2035 on the basis of existing debt-repayment schedules and incorporating the two new loans, which have a 25-year term with 5-year grace and 20 years of capital repayments. It has been assumed the KASP loan is drawn down over a 10-year period, as projected by the project-management unit, and that for the cable project $20 million is drawn down in FY2017 and the remainder drawn in FY2018 and FY2019. It is further assumed that no net incurrence of debt takes place, although the government has been reconsidering refinancing the RUS loan with the ADB to support ICT reform.

**Both debt and debt service are projected to remain sustainable and decline providing scope for future borrowing should the need arise:** While further funds will be drawn under the KASP and cable loans, the debt to GDP ratio is projected to remain stable in FY2019 and to decline smoothly thereafter. This reflects both the repayment of loans and the projected growth in nominal GDP (using the projections discussed in chapter 10 of this review). Clearly, external debt remains sustainable and there remains scope for additional borrowing should this be required. In terms of debt service, this rises to 6.9 percent of national-government projected revenues in FY2019 and remains little changed through FY2021 from whence it is projected to decline throughout the period. It is assumed that both new ADB loans will be serviced by the respective SOEs: the PPUC and the new Belau Submarine Cable Company. However, there remains a risk that the PPUC may require subsidies depending on the pricing policy adopted by government, although both entities are intended to operate on a full cost-recovery basis.

## E. International Investment Position

**FDI has grown rapidly in Palau reflecting attractiveness as a destination for investment:** The Palauan international investment position (IIP) is presented in Table 3. The data show stock positions at the end of each year corresponding to the financial account of the BoP. The estimates of direct investment, or FDI, which have recently been

**Table 3** International investment position, FY2010-FY2018 (US$ millions)

| (US$ millions) | FY10 | FY11 | FY12 | FY13 | FY14 | FY15 | FY16 | FY17 | FY18 |
|---|---|---|---|---|---|---|---|---|---|
| TOTAL STOCKS, NET | -80.1 | -111.1 | -83.0 | -77.7 | -71.5 | -76.3 | -67.8 | -68.0 | -30.5 |
| Total assets | 337.6 | 335.7 | 399.1 | 428.9 | 471.4 | 514.3 | 584.3 | 624.7 | 707.6 |
| Total liabilities | 417.7 | 446.7 | 482.1 | 506.6 | 542.9 | 590.6 | 652.1 | 692.7 | 738.1 |
| | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Direct investment, net | -339.0 | -370.5 | -398.0 | -425.0 | -454.5 | -507.1 | -552.6 | -585.9 | -624.4 |
| Assets: Direct investment abroad | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Liabilities: Direct investment in Palau | 339.0 | 370.5 | 398.0 | 425.0 | 454.5 | 507.1 | 552.6 | 585.9 | 624.4 |
| Corporations | 339.0 | 370.5 | 398.0 | 425.0 | 454.5 | 507.1 | 552.6 | 585.9 | 624.4 |
| Banks | 21.5 | 23.8 | 25.7 | 27.7 | 30.0 | 33.6 | 37.4 | 40.4 | 44.3 |
| Hotels | 253.2 | 274.4 | 291.5 | 308.5 | 327.3 | 362.1 | 391.7 | 426.8 | 465.2 |
| Fuel companies | 38.5 | 43.8 | 49.7 | 55.9 | 61.7 | 72.0 | 81.3 | 94.0 | 107.3 |
| Other corporations | 25.8 | 28.5 | 31.1 | 32.9 | 35.6 | 39.4 | 42.2 | 24.7 | 7.6 |
| Land | n.a. | n.a. | 1.0 | 2.0 | 6.0 | 14.0 | 26.6 | 30.4 | 60.4 |
| Portfolio investment, net | 252.3 | 239.9 | 279.0 | 305.7 | 313.4 | 298.9 | 319.2 | 354.4 | 435.3 |
| Assets | 262.3 | 250.9 | 291.0 | 318.7 | 327.4 | 313.9 | 335.2 | 371.4 | 453.3 |
| Government | 262.3 | 250.9 | 288.0 | 314.9 | 323.2 | 309.7 | 330.5 | 365.3 | 446.5 |
| Compact Trust Fund | 151.1 | 146.5 | 171.8 | 189.6 | 199.2 | 183.9 | 196.8 | 219.5 | 293.3 |
| General Fund | 1.8 | 1.2 | 4.1 | 4.6 | 3.9 | 3.9 | 3.8 | 4.3 | 4.5 |
| Social security portfolio | 65.9 | 66.1 | 77.0 | 84.1 | 84.4 | 90.8 | 99.0 | 110.4 | 117.9 |
| Civil Service Pension Fund | 37.7 | 31.7 | 32.1 | 33.6 | 32.6 | 28.2 | 27.4 | 27.3 | 26.6 |
| Other funds | 5.8 | 5.4 | 3.0 | 3.0 | 3.1 | 3.0 | 3.4 | 3.9 | 4.1 |
| Other Public Entities | 0.0 | 0.0 | 3.0 | 3.7 | 4.2 | 4.2 | 4.8 | 6.1 | 6.9 |
| Palau Public Utilities Corporation | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Palau Community College | 0.0 | 0.0 | 2.5 | 3.1 | 3.6 | 3.6 | 4.2 | 4.9 | 5.2 |
| Palau National Communications Corporation | 0.0 | 0.0 | 0.5 | 0.6 | 0.6 | 0.6 | 0.6 | 1.1 | 1.7 |
| Liabilities | 10.0 | 11.0 | 12.0 | 13.0 | 14.0 | 15.0 | 16.0 | 17.0 | 18.0 |
| Other investment, net | 6.7 | 19.5 | 36.0 | 41.6 | 69.6 | 131.9 | 165.6 | 163.6 | 158.5 |
| Assets (deposits banks) | 75.4 | 84.7 | 108.1 | 110.2 | 143.9 | 200.3 | 249.1 | 253.3 | 254.2 |
| Deposits, banks | 75.0 | 84.5 | 107.9 | 110.0 | 143.9 | 200.3 | 249.0 | 253.2 | 254.2 |
| Loans, banks | 0.4 | 0.2 | 0.3 | 0.2 | 0.0 | 0.0 | 0.1 | 0.1 | 0.0 |
| Liabilities, loans | 68.7 | 65.3 | 72.2 | 68.6 | 74.3 | 68.5 | 83.5 | 89.8 | 95.7 |
| Other (banks) | 2.0 | 1.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.4 |
| Government | 21.1 | 19.5 | 27.7 | 26.1 | 30.4 | 28.2 | 47.8 | 57.6 | 66.0 |
| Other public entities | 45.4 | 43.2 | 41.4 | 38.9 | 40.2 | 36.2 | 31.5 | 27.7 | 25.2 |
| Households | 2.2 | 2.6 | 3.1 | 3.5 | 3.7 | 4.0 | 4.3 | 4.5 | 4.5 |

revised, are currently estimated to have risen from $174 million in FY2000 to $624 million in FY2018, an annual rate of growth of 7 percent, and indicating the attractiveness of Palau as an investment destination. This item is now broken out into banks, hotels, fuel corporations, others and land.

**Portfolio investment consists of the COFA Trust Fund (CTF), the Social Security Fund and Civil Service Pension Fund investments**, along with minor investments of the national government. The CTF was established as part of the original Compact with the US and was considerably augmented when the CRA came into effect in FY2018 with the $65.25 million contribution. Under the agreement Palau has been entitled to draw $5 million annually and has done so since FY2002. The outstanding balance of the CTF reflects the combination of the original deposits of $66 million, the $5 million annual withdrawal, the recent CRA deposit and the performance of financial markets; it has grown by an annual average of 7.8 percent and stood at $293 million at the end of FY2018. Social Security funds have displayed an upward trend, indicating an improving financial position and beneficial financial-market performance. In the case of the Civil Service Pension Fund, despite the same favorable market returns, the figures reflect the drawdown of resources to fund growing benefit payments to civil servants that have reached retirement age. The unfunded liability is significant, and projections indicate the fund will become exhausted in the near future if remedial action is not taken.

**Foreign assets of commercial banks grew rapidly during the tourism boom reflecting large excess liquidity in the system:** Other investments include the foreign assets of commercial banks and public sector external debt. Table 3 indicates a very large rise in the level of commercial bank foreign assets and reflects the large increase in deposits and lack of domestic credit creation—that is, the banks have invested their growing liquidity offshore. However, the large rise in liquidity also reflects increasing retained earnings of the booming tourism sector, large land-lease payments paid by foreign investors to domestic landowners, and possible buildup of funds for future hotel-plant construction. In FY2017, the strong upward trend in commercial bank foreign assets came to an end as the economy contracted, and the tourism boom had run its course. The table indicates the external public debt of government and public entities, which has been discussed in the previous section. Taken overall, the international investment position has improved; rising portfolio investment in the COFA Trust Fund, Social Security, and foreign assets of banks has accumulated faster than foreign direct investment. Since FY2010 the position has improved from a negative $80 million to -$31 million in FY2018.

# 4. Fiscal Developments

**Palau has generally maintained a prudent fiscal policy. Between FY2005 and FY2013, it recorded a fiscal balance in the range of -2.1 to 1.6 percent of GDP. As the economy boomed in FY2014, a large surplus of 3.6 percent was recorded, with an even-larger surplus in the next four years, reaching 4.5 percent in FY2017.**

- In 2010 agreement was reached with the US for a further extension of the Compact with economic provisions for a further 15 year period. The new arrangement is known as the Compact Review Agreement. However, it was not until 2018 that funding was eventually secured in the US Congress. Further funding was provided for the COFA Trust Fund, direct assistance and infrastructure.
- The Palau tax system is reliant on an outmoded regime designed and largely unaltered since Trust Territory days. The Gross Receipts Tax, although elastic, is highly distortionary. Import taxes are highly inelastic, and while the wages tax performs well, it is not a substitute for a personal income tax. The system is overdue for reform.
- Grants comprise a major item in Palau's fiscal equation and are largely fixed in nominal terms and are a declining share of GDP. Tourism based taxes, the Pristine Paradise Environmental Fee and hotel occupancy tax, have provided a growing source of revenues, but declined with the drop in visitor arrivals. Non tax revenues, both fishing fees derived from sale of vessel days under the Parties to the Nauru Agreement and other charges have performed well.
- On the expense side, total expense has largely remained stationary as a share of GDP. However, payroll has declined with a largely static number of employees but adjusted through an annual wage increase. Other expense, transfers to government units, especial the state governments and PAN funds has grown rapidly.
- Outlays on public infrastructure were at high levels during the early 2000's with the construction of the Compact road and capitol complex. Since that time investment in fixed assets has fallen from 10 percent of GDP percent to 2 percent in FY2018, and is a cause for concern.
- On the financing side the major transactions have in recent years been an increasing level of external borrowing for on-lending to the SOE sector. The operation of large fiscal surpluses has resulted in a significant accumulation of cash balances at the commercial banks.

# 4. Fiscal Developments

## A. Institutional Arrangements

### PROVISIONS OF THE COMPACT

**Original Compact entailed a 15-year period with a series of grants and creation of the COFA Trust Fund:** The Republic of Palau and the United States entered into the original Compact on October 1, 1994, for a 50-year period, through the close of FY2044. The structure of the Compact entailed an initial 15-year period through FY2009 with a series of economic provisions. The Compact also specified that these provisions would be undertaken in accordance with a national development plan, which might be amended from time to time. An annual requirement was stipulated that Palau would report to the president of the US and Congress on the implementation of the plan and on the use of the financial provisions. Provision was further made for a bilateral annual economic-consultation process. Section 432 of the Compact called for reviews at the 15th, 30th and 40th anniversaries in 2010, 2025 and 2035.

**Compact Review Agreement (CRA) signed in 2010 for a further 15 years of assistance:** In September 2010, the US and Palau signed an agreement, known as the Compact Review Agreement (CRA), to extend economic assistance under the Compact for the second 15-year period (through FY2024), but with a set of new economic provisions.

**However, no action taken by Congress until 2018:** The provisions of the CRA had envisaged that the new agreement would commence in FY2011. However, no action was taken by the US Congress until March 2018, when the review agreement was finally authorized, and funds were appropriated. While awaiting passage into law, the US maintained the original Compact grant flows at the levels of the last year of the original Compact, FY2009, without any additional inflation adjustment, from FY2010 through FY2017. During this period, Palau received $6 million plus an inflation adjustment of $4.26 million under the current account 211(a), $2 million in a health-and-education block grant 221(b), and more under the provisions under 211(c) and (d)—in all, totaling $13.147 million annually. Palau continued to draw down $5 million annually from the CTF through FY2017.

The CRA singed in 2010 had a series of provisions but by the time funds had been appropriated, some provisions were obsolete and required revision. The effective outcome of the CRA with subsequent mutual agreement between the parties was as follows:

i. **Compact Trust Fund.** In the original CRA the US was to continue to contribute to the existing Trust Fund 211(f) for a total amount of $30.25 million during the period from FY2013 through FY2023. In 2018 the US allocated $65.25 to the CTF—significantly more than in the original proposal.

ii. **Direct assistance.** The original schedule of annual direct assistance was replaced with one final contribution of $24.574 million in FY2018.

iii. **Trust fund drawdowns.** The original schedule of agreed drawdowns from the CTA were replaced with drawdowns of $5 million in FY2018, $10 million in FY2019, $14.867 million in FY2020 and $15 million thereafter.

    The effect of the contributions and drawdowns from the CTF and final direct assistance grant was that Palau continues to enjoy $18.147 million to fund general budgetary operations through FY2020, the same as it had been receiving in FY2010-FY2017.

iv. **Infrastructure maintenance.** The US will continue to provide $2 million annually through FY2024 for the maintenance of major capital projects funded by the US. Palau will contribute a total of $600,000 annually to the fund starting in FY2019.

v. **Infrastructure projects.** The original allocation of $40 million for mutually agreed-upon infrastructure projects was replaced with $20 million in FY2018. Effectively the remaining funds were allocated to the CTF.

vi. **Fiscal-consolidation fund.** The US had agreed to provide $10 million in FY2014 for fiscal consolidation and pay-down of arrears. These resources were reprogrammed into the CTF.

**Creation of Economic Advisory Group:** A major change in the provisions of the CRA is the establishment of an advisory group: *"The purpose of the Advisory Group is to contribute to the long-term economic sustainability of Palau by recommending economic, financial, and management reforms."* There are to be five members in the group: two appointed by the US, two from Palau and a fifth member mutually acceptable to the two parties. There will be two meetings a year, one in Palau and the other in Honolulu. The advisory group will recommend economic, financial and management reforms and a timeline for implementation. The advisory group will report on progress with implementation of the recommended reforms to the annual bilateral economic consultations. Examples quoted as significant reforms stated in the CRA included:

- improvements in fiscal management,
- elimination of operating deficits,
- reduction in the operating budget,
- reduction in the number of civil servants,
- reduction in the proportion of the budget allocated to salaries,
- reduction in subsidies to the utilities, and
- tax reform.

In the event that the US determines that Palau has not made significant progress, the US may delay payment of the assistance; however, the payments to which this may apply would appear to have already been transferred to Palau.

**Creation of Economic Advisory Group is under formulation:** At the current time of writing the creation of the EAG is under formulation and its mode of operations will be established by the two parties. Whether the significant reforms stated in the CRA remain relevant and appropriate will no doubt be addressed during the original EAG meetings.

## FISCAL PROCEDURES

**Balanced budget requirement:** Fiscal policy in Palau is conducted under the constitutional requirement of a balanced budget. This, of course, does not guarantee that the final outcome will also be balanced: either revenue may fall short or expenditures may exceed budget estimates. The execution of the budget operations is performed through a series of separate funds, the most important being the general fund. Expenditures from this fund are largely unrestricted, but there is limited flexibility or authority to use monies from the other funds.

**Resources under CRA to be used for education, health, or administration of justice and public safety, but is not a binding constraint:** During the initial 15 years of the Compact, a major part of the external assistance under the current-account provisions provided revenue to the general fund and thus was unrestricted. Under the CRA, use of funds derived from the direct-assistance provision or from the CTF ($15 million) must be allocated to education, health, or administration of justice and public safety. In FY2018, the total use of funds under the Ministries of Education, Health and Justice was $28.9 million. The earmarking of the direct-assistance grants and CTF monies is thus not a binding constraint on the functional allocation of funds by the government.

**GFS presentation:** The fiscal accounts and analysis in the following sections have adopted an International Monetary Fund (IMF) Government Finance Statistics (GFS 2014) presentation. The GFS accounts present a consolidation of the various funds presented in the annual single audit and classified as part of the central government. The fungible, or interchangeable, nature of the various funds results in the GFS providing a clear and unambiguous statement of government operations. The statistical tables in the appendix show fiscal performance of the central government (excluding the Compact Trust Fund, which is now treated as an extra budgetary unit), and the presentation follows the standard GFS format.

**Institutional structure of government:** The government in Palau consists of the national government, 16 state governments, a group of extrabudgetary agencies, and the Social Security and Civil Service Pension Funds, but no local governments. At present, the state governments provide services in such areas as administration, police and garbage collection. Under the RoP Constitution, powers to raise taxes rest with the national government, but state governments may raise taxes provided that the measures have been authorized in law by the national government. The powers of the state governments are prescribed in the constitution. Fiscally, the state governments are small in size, with the exception of Koror State. Koror State's revenues have grown very rapidly in recent years with the expansion in the tourism industry and were equivalent to 28 percent of national-government domestic revenues in FY2015, but fell in FY2018 to 13 percent, reflecting the downturn in visitor arrivals and the disappearance of jellyfish in the Rock Islands, a major tourist attraction.

**Audits generally timely:** Palau has generally had a good record of timeliness in the preparation and publication of the annual single audits. Audits have been delayed but are now timely.

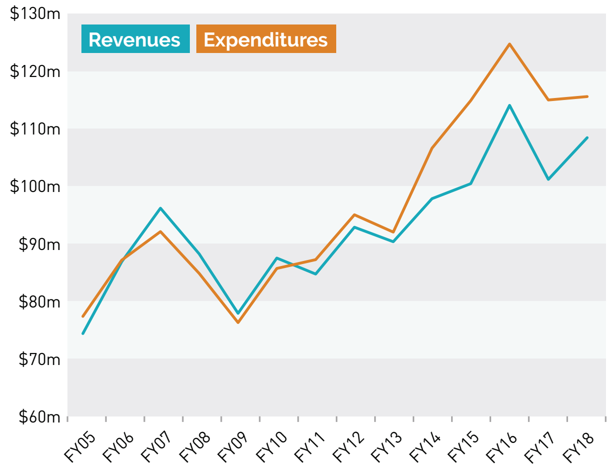
## B. Recent Fiscal Performance[1]

### FISCAL BALANCE

**Fiscal performance FY2005–FY2007.** Figure 30 indicates recent trends in the fiscal position. During the first three years (between FY2005 and FY2007), both revenues and expenditures grew rapidly, although the growth in expenditures outstripped that of revenue. The overall fiscal position switched from one of a surplus of 1.6 percent of GDP in FY2005 to one of a deficit of −2.1 percent in FY2007, representing a 3.7 percent deterioration.

**FY2008–FY2009:** international recession. In the following two years, there was a significant contraction in both revenues and expenditures. Not only did this period coincide with the onset of the international financial crisis, but the former large increase in grant revenues ended. Reflecting the financial crisis, tax revenues declined, although less than the fall in nominal GDP. With the significant reduction in revenue, there was need for fiscal adjustment. Payroll increases were modest, outlays on goods and services fell, and other expenses contracted significantly. While the overall fiscal outturn improved compared with FY2007, the outturn for FY2009 was a small deficit of less than 0.9 percent of GDP. Given the fiscal pressures during this period, the outturn was a good result.

**Figure 30**
External debt and debt service projections, FY2019-FY2035




**FY2010–FY2013:** economic recovery. The following four years saw recovery in the economy, with growth in revenues and expenditures of 4.8 and 4.7 percent on an annualized basis, respectively. Tax revenue grew even stronger at an annual average rate of 9.1 percent, reflecting the expansion in the economy and growth in tourism. On the expense side, the government maintained control of payroll costs, with use of goods and services growing at an annual rate of 4.3 percent, but there was significant growth in other expense, reflecting the buoyancy in revenues. Overall the period saw expansion in government, with the deficit moving into surplus from −0.9 to 0.7 percent of GDP.

1 FY2018 data based on unaudited estimates.

**FY2014–FY2015:** tourist boom. The next two-year period saw the emergence of a new fiscal environment and the development of significant fiscal surpluses. The economy grew by an average of 7.2 percent during this period, and tax revenues were even more buoyant, growing at an annual rate of 17 percent. Wage taxes picked up momentum with increases in hiring, and both growth in the gross-receipts tax and import duties were strong. Increases in duties on tobacco led to a significant increase in revenues as did tourist-departure taxes, reflecting the large number of additional visitors. Historically, fishing-fee revenue has been low in Palau, but it rose from $0.9 million in FY2013 to $6.2 million in FY2015. The increase in Vessel Day Scheme (VDS) rates of the Parties to the Nauru Agreement (PNA) rose from a minimum of $5,000 a day in 2013 to $8,000 in 2015 with effective rates of over $10,000.

**While revenues grew strongly, expenditures grew at a slower pace.** Payroll and use of goods and services grew between 2 and 4 percent per annum. The overall result was the emergence of a growing fiscal surplus. From 0.7 percent of GDP in FY2013, the fiscal position improved to a surplus of 3.6 percent in FY2014 and 5.1 percent in FY2015.

**FY2016–FY2018:** tourism-led growth comes to an end, but revenues unexpectedly hold up. In FY2016, the major taxes on wages, gross receipts and imports continued to grow by 7.2 percent, despite weak economic performance and reductions in tourism. By FY2017, the reductions in tourism filtered through into the economy and this group of taxes fell by 2.1 percent and again by 1.9 in FY2018. Tourism-related taxes collapsed during the period reflecting the decline in visitor arrivals (hotel-occupancy tax and departure taxes), but the PPEF increased in FY2018 due to a doubling of the departure tax rate from $50 to $100. VDS collections which have increased rapidly in recent years recorded a level of $8.5 million in FY2018.
Fiscal outturn remains positive despite weak economic performance: While the strong fiscal outturn may have caught the government by surprise in FY2015, there was a stronger response in FY2016, and expense grew 12 percent, outstripping revenue growth of 9 percent. Payroll expense grew by 9 percent in an election year but use of goods and services also expanded by 6 percent. In FY2017, the need for adjustment was apparent and the rapid growth in expense of the previous years was constrained to 5 percent. In FY2018, expense grew strongly by 12 percent reflecting large transfers to state governments, PAN funds and PPUC for water outstripping stagnant revenues. Over the period fiscal balance was maintained perhaps surprisingly given the declining economy. A fiscal surplus of 3.6 was attained in FY2016 rising to 4.8 percent in FY2017 and declining to 2.5 percent in FY2018[1,2].

## THE FISCAL STRUCTURE

**Grants declined as a share of GDP while taxes increased reflecting increased taxes on tourism:** Table 4 provides a summary of the structure of the fiscal account, and most items are represented in terms of GDP. Grants have shown a significant declining trend as a percentage of GDP in recent years, although they have shown considerable variation from year to year, depending on whether Palau has been the recipient of capital grants for infrastructure purposes during a particular period. As a percentage of total revenues, grants also represent a declining trend, falling from 49 to 35 percent during the period. While Palau has developed a significant tourism economy based on private sector development, the fiscal sector remains heavily dependent on grants from the US and other donors. Tax revenues represented 17 percent of GDP during FY2005–FY2010, but they have grown since that time and represented 21 percent in FY2018, mainly as a result of discretionary increases in tourism related taxes and taxes on tobacco. While tax effort is similar to that in the RMI and above that in the FSM, it is below that of the majority of other Pacific Island economies and below the rate prevailing in the US.

1 Estimates for FY2018 are unaudited and subject to revision.

2 In FY2018 the government received a large payment under the CRA of which $11.4 million was receipt of funds to be allocated to FY2019. This has been excluded from the estimates of grant revenues to provide a more accurate measure of the underlying fiscal position.

**Public expense largely static as a share of GDP, but wages show a declining trend:** Public expenditure, including outlays on nonfinancial assets as a percentage of GDP, has shown a declining trend, falling by 2.0 percent per annum since FY2000, although this largely reflects the decline in grant-funded capital works during the period. Expense, which excludes nonfinancial assets, has also shown a trend that is declining, 0.6 percent per annum, but is for all intents and purposes stagnant. Payroll expense has also shown a declining trend, 1.9 percent per annum, reflecting constant levels of staffing as GDP has risen with moderate annual adjustment in wage levels. Fixed assets, fluctuating dependent on the investment cycle, have fallen significantly during the period. In FY2000-FY2002 fixed assets averaged 10 percent of GDP as the Compact road and new capitol were constructed but has fallen to a low averaging of 3 percent in last three years. The overall balance as a percentage of GDP averaged −0.1 percent of GDP during FY2005–FY2013 but rose significantly during the last four years, averaging 3.9 percent.

## REVENUES

**The gross receipts tax is highly inefficient but is elastic with respect to GDP:** The tax regime in Palau is based on a tax system inherited from, and largely unaltered since, Trust Territory days. The major source of tax revenue is the business gross-receipts tax (BGRT), levied at 4 percent of business turnover. While the tax is intended to be used as a proxy income tax, the incidence is comparable to that of a sales tax. The tax suffers from the well-known cascading effect, such that each sale from one business to another multiplies the tax yield and distorts resource allocation. Taxpayers are entitled to a deduction for the cost of wages for local citizens. This deduction is designed to encourage the use of local labor. The BGRT has maintained its share in relation to GDP since FY2005: the BGRT has grown by 66 percent, compared with nominal GDP growth of 54 percent. In FY2018, the BGRT raised $15.0 million in tax revenue.

**Import taxes have provided a very inelastic form of revenue:** The second-most significant tax is customs duties, which are levied on the usual range of "sin" goods and perfumery products. Motor vehicles are taxed at 5 percent and $250 per unit. Fuel imports are taxed at 5¢ per gallon. There is a general rate of duty of 3 percent, except on medical supplies and foodstuffs, which are duty free. However, the import tax collects a surprisingly low level of duty, $1.6 million in FY2018. This reflects the low base of the tax after fuel, food imports, special concessions, and alcohol and tobacco have been deducted. Import taxes are levied free on board and the government is exempt. From January 1, 2014, taxes on tobacco were increased from $2.00 to $3.50, and again to $5.00 from the start of 2015. Tobacco-tax collections increased from a level of $2.7 million in FY2013 to $7.7 million in FY2016, a significant increase. Import taxes have not been a buoyant form of revenue, and collections removing tobacco taxes from the total are 7 percent lower in FY2018 ($7.4 million) than in FY2005 ($8.0 million). Clearly, a very inelastic tax base.

**Table 4** Comparaitve analysis of the fiscal structure, FY2000-FY2018

| | FY00 | FY01 | FY02 | FY03 | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 | FY12 | FY13 | FY14 | FY15 | FY16 | FY17 | FY18 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Grants as % of GDP | 22% | 14% | 18% | 25% | 25% | 22% | 27% | 29% | 23% | 23% | 27% | 24% | 23% | 19% | 19% | 16% | 16% | 13% | 14% |
| Current grants % of GDP | 21% | 14% | 17% | 18% | 17% | 15% | 15% | 16% | 15% | 16% | 16% | 16% | 14% | 13% | 14% | 11% | 10% | 11% | 11% |
| Capital grants % GDP | 0% | 0% | 1% | 8% | 8% | 7% | 12% | 13% | 8% | 6% | 11% | 8% | 8% | 5% | 6% | 5% | 6% | 2% | 2% |
| Grants as % of Total Revenue | 49% | 41% | 50% | 56% | 56% | 53% | 58% | 61% | 55% | 55% | 58% | 53% | 51% | 46% | 44% | 38% | 39% | 32% | 30% |
| Tax Revenue as % of GDP | 16% | 16% | 14% | 16% | 17% | 17% | 17% | 16% | 17% | 16% | 17% | 18% | 18% | 19% | 19% | 20% | 20% | 20% | 21% |
| Domestic Rev. as % of GDP | 23% | 20% | 18% | 20% | 19% | 20% | 19% | 19% | 19% | 19% | 20% | 21% | 22% | 22% | 24% | 25% | 25% | 27% | 27% |
| Expense % GDP | 48% | 41% | 36% | 38% | 38% | 33% | 35% | 37% | 37% | 37% | 37% | 36% | 36% | 36% | 36% | 31% | 32% | 32% | 37% |
| Total Expenditure as % of GDP | 57% | 50% | 48% | 48% | 49% | 40% | 46% | 49% | 45% | 42% | 48% | 44% | 44% | 40% | 40% | 36% | 38% | 35% | 38% |
| Wages as % of GDP | 20% | 19% | 19% | 21% | 19% | 17% | 17% | 17% | 18% | 19% | 18% | 18% | 16% | 16% | 15% | 13% | 14% | 15% | 15% |
| Wages as % of Expenditures | 43% | 47% | 52% | 54% | 50% | 52% | 49% | 47% | 48% | 51% | 50% | 49% | 46% | 45% | 42% | 43% | 42% | 46% | 42% |
| Fixed assets % GDP | 9% | 9% | 12% | 9% | 11% | 7% | 11% | 13% | 8% | 6% | 11% | 8% | 8% | 4% | 5% | 5% | 6% | 3% | 2% |
| Current Balance as % of GDP | -4% | -8% | 0% | 7% | 6% | 9% | 11% | 10% | 6% | 5% | 10% | 9% | 9% | 5% | 8% | 10% | 9% | 8% | 8% |
| Overall Balance as % of GDP | -13% | -17% | -13% | -2% | -5% | 2% | 0% | -2% | -2% | -1% | -1% | 1% | 1% | 1% | 4% | 5% | 4% | 5% | 7% |

**Wage tax has been an efficient and elastic source of revenue:** The next important tax is the wages-and-salary tax levied on wages earned, but the responsibility for collection resides with the employer. Wage earners pay 6 percent of income up to a threshold of $8,000, and, above that, 12 percent. The wages tax grew by 61 percent between FY2005 and FY2018, slightly above nominal GDP growth of 54 percent. Total collections in FY2018 were $11.1 million.

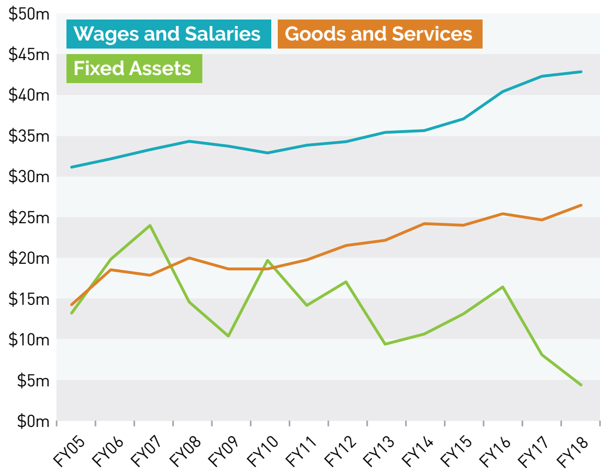
**Rapid rise in revenues from the Pristine Paradise Environment Fee (PPEF):** The other significant tax has been taxes collected on departing passengers (now known as the Pristine Paradise Environment Fee) at the airport. The rate for citizens is $20, and until the start of 2018 was $50 for non-citizens. At the start of 2018, the rate was increased to $100 but collected from ticket purchases through the airlines. Under the new arrangements, effective from the start of 2018, $10 of the fee will be allocated to fisheries protection, $12.5 to the state governments, $25 to the Palau International Airport (PIA)[1], $30 for Protected Area Networks (PAN) funds, and the remainder $22.50 to the general fund. Collections under this item have grown significantly in recent years because of both the growth in tourism and discretionary changes in the tax rate. In FY2005, collections were $1.7 million, and in FY2018, they had reached $9.1 million. The increase in the fee from $50 to $100 has of course significantly increased revenues from this source. Other minor taxes include an export tax on transshipped fish and fees for business licenses.

**Non tax revenues including fishing fees have performed well:** Nontax revenues include fishing fees, sales and fees of government departments, and interest and dividend earnings. Fishing fees are relatively minor in Palau compared to other Pacific-island nations that are more favorably located near the main fishing grounds. In Palau, 85 percent of fishing-fee revenue collected on fish caught in Palau waters is passed on to the state governments. Palau is a member of the Partners to the Nauru Agreement (PNA) and has benefited from the sale of fishing days under the Vessel Day Scheme (VDS). Since these revenues are collected on fish caught in international waters, they are not shared with the state governments. The level of fishing fees rose from $0.2 million in FY2005 to $8.5 million in FY2018 largely as a result of recent booming VDS collections. Overall, nontax revenues have provided a buoyant form of revenue, growing from $4.7 million in FY2005 to $16.5 million in FY2018, with most of the increases occurring since FY2010.

## EXPENDITURES

**Growth in payroll cost and use of goods and services has been modest and sustainable:** Figure 31 indicates the major elements of expenditure. Payroll costs, currently representing about 42 percent of total expenditures, have grown modestly during the period, by 37 percent since FY2005, at an average annual rate of 2.5 percent, despite the uptick in payroll in the last few years. Palau has maintained a responsible civil servant employment policy by limiting new hires and keeping annual wage increases within cost-of-living increases. This has eased fiscal pressure during recent periods of financial stress. Use of goods and services has grown at similar rates to payroll, growing by 42 percent

**Figure 31**
Expenditures on payroll, goods and services, and nonfinancial assets




1 In the original Bill, the $25 was to have been allocated to the ailing Civil Service Pension Fund. However, in order to maintain compliance with IATA rules the $25 was diverted to the airport with the provision that monies that would have been appropriated for the PIA will now be allocated to the ailing Civil Service Pension Fund.

since FY2006, an annual rate of 3.0 percent. While the trend has been upward, expenditures on goods and services have been compressed during times of fiscal pressure and buoyant on the upturn. They have thus provided a simple means of fiscal adjustment to differing phases of the economic cycle.

**Transfer of water and sewer operations to the PPUC requires significant subsides:** The burden of debt service has been minor, and interest payments were $0.4 million in FY2018. In FY2013, the water and sewer operations of government were transferred to the Palau Public Utilities Corporation (PPUC), and they incurred an explicit transfer[1] of $1.2 million in FY2013 and of $1.7 million in FY2014. In FY2015 and FY2016, the transfer grew strongly to reflect the operating costs of operations, to $3.4 million in both years, respectively. In FY2017 no transfer was made but in FY2018 a reduced amount of $1.9 million was transferred. It is anticipated that an annual transfer will be required going forward until water and sewer rates are raised to cover long-run costs.

**Transfers to other layers of government, non-profits and households has grown rapidly in recent years:** Government grants to other layers of government are represented by transfers to the state governments and payments to such entities as the Palau Community College, the Community Action Agency and the Visitors Authority. These were relatively static between FY2005 and FY2012, averaging $9.2 million, but rose significantly thereafter reaching $26.4 million in FY2018 with large increases in transfers to the PAN funds, and current and capital grants to state governments. Finally, other expenses include student grants, transfers to nonprofit groups and other miscellaneous outlays. These have been erratic but have also grown significantly since FY2013. The large increases in both grants and other expense reflects the increased fiscal space and boom in tourism.

**Investment in public infrastructure displays a downward trend and fell to the lowest level on record in FY2018:** Figure 31 also indicates the level of outlays on nonfinancial assets or infrastructure. The graph reveals a downward trend and significant variations from one period to the next, reflecting the bulky nature of infrastructure projects. In the FY2005–FY2007 period, the capitol complex was completed and was followed by some smaller projects, including the cross-insular Babeldaob road. By FY2018, the level of public infrastructure projects fell to the lowest level of the period, but the FY2018 estimates are based on pre-audited figures and may be subject to revision.

## FINANCING[2]

**Financing has grown in importance with accumulation of fiscal surpluses, large external borrowing, and on-lending to the SOE sector:** The deficit/surplus is financed through changes in financial assets and liabilities. The major asset classes of significance comprise domestic currency and deposits and accounts receivable (on-lending to the SOE sector). On the liabilities side, the major category has been foreign loans. Financing of the deficit/surplus (the changes in the balance sheet from one year to the next) was until FY2013 associated with minor transactions at least in comparison with movements in revenues and expenses. However, since that time the finance account has grown in importance as the emerging fiscal surpluses have accumulated in deposits with the banking system and with incurrence of external debt and on-lending to the SOE sector.

**In FY2012 Government borrows from the ADB which was allocated to paydown of accounts payable and fund the NDBP:** In FY2012, the government drew down $9.6 million from the ADB, which, net of repayments, was reflected in an $8.3 million increase in foreign liabilities. The ADB loan was used to reduce domestic accounts

1 The water and sewer operations of PPUC are treated as nonmarket and thus are considered as transfers and not subsidies under the national accounts and GFS. As tariffs for water and sewer services move toward full cost recovery, they will need to be reclassified as market operations and the transfers will be reclassified as subsidies.

2 Analysis of the FY2018 outturn will follow the release of the final audit.

payable, which improved by $2.2 million, and $4 million was loaned to the NDBP for on-lending to the private sector and the PNCC (domestic accounts payable). The government further drew down $2 million from the CTF, which violated the CTF agreement with the US. The result of these various transactions was that domestic deposits rose by $4.5 million (banking statistics record an increase of $5.1 million).

**Financing in FY2013 and FY2014:** In FY2013, the NDBP repaid to the government $3 million that was to have been on-lent to the PNCC for fiber optics. The $2 million (excess) drawdown from the CTF was also repaid. With an overall fiscal surplus of $1.7 million, domestic deposits fell by $4.9 million (banking statistics record a reduction of $3.8 million). In the case of FY2014, the major transaction was the second tranche drawdown under the ADB water-and-sewer loan of $6.2 million. The strong fiscal position and surplus of $8.8 million enabled a further reduction of domestic accounts payable and benefited from a large increase in accounts receivable. Overall domestic deposits, the effective residual, rose by $3.4 million (banking statistics record an increase of $5.7 million).

**Fiscal surplus in FY2015 used to reduce liabilities and build bank balances:** In FY2015, the fiscal account recorded a record $14 million surplus. These resources were used to further reduce liabilities by $5 million, of which accounts payable was reduced by $3 million and national-government external debt by $2 million. Domestic and foreign accounts receivable rose by $1 and $2 million, respectively. Overall domestic bank balances, the effective residual, rose by $9 million (banking statistics record an increase of $7 million).

**In FY2016 government borrows from Taiwan for on-lending to the NDBP and continues to build bank balances:** In FY2016, the major flows included government borrowing of $10 million from Taiwan to finance housing and agriculture loans in Babeldaob, of which $7.5 million was on-lent to the NDBP and the Housing Authority. A further $12 million was borrowed from the ADB and on-lent to the PPUC and the PNCC for funding of the Koror-Airai Sanitation Project (KASP) and new fiber optic cable at the PNCC. Net of repayments, foreign liabilities rose by $15 million. Taking account of the overall fiscal surplus of $11 million, government deposits rose by $10 million (banking statistics record an increase of $13 million).

**In FY2017 external borrowing from the ADB funds on-lending to the SOEs and fiscal surplus is accumulated in bank deposits:** The government drew down a further $9.8 million of foreign loans from the ADB for on-lending to SOEs of $10.9 million. Foreign investments declined by $3.3 million and the government repaid foreign accounts payable rose by $5.1 million. With an overall fiscal balance of $13.8 million government deposits rose by $10.8 million (banking statistics record an increase of $7.6 million).

## THE FISCAL OUTLOOK

**Government accumulates short-term debts to fund operations during financial recession:** While the overall outturn of the fiscal account was relatively balanced through FY2013, this masked an underlying stressed fiscal position during the FY2008–FY2010 period arising from the financial recession, reduction in tourist numbers and negative growth in the economy. As a result, the government accumulated a sizeable array of short-term debts to Social Security, the Civil Service Pension Fund and the Palau National Communication Corporation. With the support of the ADB Water and Sewer Improvement Program loan, rapid strong growth in the economy and buoyant revenues, these were paid down.

**Strong fiscal performance accompanies tourism boom and continues despite the weak economy:** Reflecting the economic growth in FY2014 and FY2015, Palau entered an era of substantial fiscal surpluses. Strong fiscal performance continued in FY2016 and even through FY2018 as the economy plateaued and turned negative. In FY2016, tax revenue remained buoyant despite the weak economic performance, and the fiscal outturn remained favorable. In FY2017 and FY2018, despite the reductions in tax revenues, fishing fees were favorable, and coupled with prudential adjustment of expenditures further surpluses were attained.

**Unreserved general fund balance turns negative during financial recession but moves into a strong position with sustained fiscal surplus:** These trends are reflected in the unreserved fund balances, a measure of the financial resources freely available. In FY2007, unreserved/unassigned fund balances stood at −$0.6 million, which deteriorated to −$25.5 million in FY2009, but they improved to $21.2 million in FY2015 and further to $27.5 million and $36 million in FY2016 and FY2017, respectively (data for FY2018 awaiting audit).

**Outlook in the near-term remains weak and fiscal position will tighten while significant fiscal threats are on the horizon:** Looking ahead, growth prospects remain weak but fiscal balance is expected to be maintained. However, there are significant threats on the horizon: the collapsing funds status of the Civil Service Pension Fund, the need to service the Koror-Airai Sanitation Project repayments and the real reductions in Compact transfers. With a continued prudential fiscal stance and suitable combination of policy reforms, these challenges can be accommodated. These factors are the subjects of the following chapters.

# 5. Public Sector Management

**Financial management in Palau has generally been well managed. Fiscal policy has been prudent, payroll has declined as a share of GDP, while total current expense has been stationary. However, the overall system of public management is outdated, and Palau would benefit from the adoption of modern PFM practices.**

- With ADB support Palau commissioned the development of a fiscal strategy and a fiscal responsibility framework. The framework is anticipated to include (i) the principles of fiscal responsibility as informed by international best practice adapted to the RoP, and (ii) transparent and accountable budget formulation, reporting and monitoring processes.
- Previous initiatives to reform the inefficient and outmoded tax regime have failed to gather sufficient support. However, in late 2017 a renewed attempt to reignite the earlier tax reform efforts was set in motion. Palau would benefit from a modern tax system more appropriately suited to a tourism economy. A Value-Added Tax (VAT), the centerpiece of the proposed reforms, is exactly what is needed.
- Public sector payroll has generally been well managed declining as both a share of total expenditures and GDP. The size of the public service has remained largely static growing only modestly by 0.2 percent since FY2002. Wage rates grew by 2.8 percent annually over the period, but real wages have fallen by 0.4 percent annually.
- An overall measure of financial performance developed in this review, a composite index of short-term cyclical measures and longer-term structural issues, shows gradual improvement since FY2003. Financial health deteriorated during the financial recession but has subsequently improved as the economy generated surpluses.
- Palau has adopted the PEFA framework but progress with implementation has been slow. An external assessment is planned for FY2019 and the development of a roadmap to improve the overall score is anticipated.
- The Compact Review Agreement has now been authorized and funds were fully appropriated by the US Congress in FY2018. The CRA calls for the formation of an economic advisory group to monitor reform implementation. A set of limited policy targets were proposed in the CRA, but these need modification and extension.

# 5. Public Sector Management

## A. Fiscal and Financial Management

### FISCAL STRATEGY AND RESPONSIBILITY

**Conduct of fiscal policy:** The operation of financial policy in Palau is governed by the Palau National Code Title 40 (PNC40), "Revenue and Taxation." PNC40 regulates many aspects of fiscal management and the budget. Chapter 3 of PNC30, "Annual National Budget," specifies that the content and timing of the budget call for a funds-availability analysis over the medium term (last year, this year and the following two years) and similar projections for expenditures made during the same period. The president is required to submit an annual appropriations bill and budget documentation to the OEK by April 15 of each year. The budget is required to be balanced, meaning that expenditures must cover revenues, which may include financing items in addition to taxes, other current revenues and grants. The president is required to submit a funding analysis over the medium term and an appropriations bill at the same time. Department performance reports are also due when the budget is submitted.

**Need for a long-term fiscal strategy and fiscal responsibility framework:** However, there is no law requiring a budget-policy statement or that the formulation and conduct of budgetary and fiscal policy be medium term in nature. In many jurisdictions, such a perspective is legislated through a "fiscal responsibility act." The primary objective is to entrench sound fiscal policies and make it difficult for future administrations to deviate from them through two main provisions:

> *The first main provision involves setting fiscal objectives in a two-step process by requiring adherence to "Principles of Responsible Fiscal Management" and mandating preparation of an annual Budget Policy Statement by government. The "Principles of Responsible Fiscal Management" mandate that debt, spending and taxation be maintained at "prudent" levels. Any deviation from the principles requires explanation by the Minister of Finance as well as an explanation as to how and when government will return to the principles. The Budget Policy Statement requirement obligates government to make an annual statement of fiscal intentions for the next three years and their long-term fiscal objectives, as well as the consistency of fiscal intentions and objectives with the "Principles of Responsible Fiscal Management."*[1]

**Objectives of a fiscal strategy for Palau:** Under a recent technical assistance project supported by the ADB[2], a fiscal strategy was outlined for Palau. The following objectives were identified as the major components of the strategy:

- **Economic and financial stability.** Defined as long-term fiscal sustainability such that sustainable revenues are sufficient to finance total expenditures without entailing a reduction in net economic and environmental wealth.
- **Encourage maximum use of resources:** Bring the maximum use of economic resources, including land, capital and labor, into efficient production.
- **Savings and investment:** Encourage generation of savings, and through intermediation of the financial sector channel it into efficient investment to accelerate the rate of economic growth and development.

1 See World Bank, Public Expenditure Management Handbook, Washington, DC, 1998.

2 Asian Development Bank, TA-8581 REG: Strengthening Public Sector Management in the North Pacific, 2018

- **Economic and social equity:** Encourage an equitable distribution of resources and inclusive economic growth among the population.
- **Development of the private sector:** Support private sector development through investment in infrastructure and improvement in the regulatory environment.
- **Taxation:** Development of a tax regime to support the efficient allocation of resources, economic development, savings and investment.

**Fiscal responsibility:** It was proposed the government consider enacting a fiscal-responsibility framework in law, subject to legislative concurrence with the current intent of the executive. That fiscal-responsibility framework would form the foundation of fiscal governance and call for a (rolling) Medium-Term Fiscal Strategy (MTFS). The framework is anticipated to include (i) the principles of responsibility as informed by international best practice adapted to the RoP, and (ii) transparent and accountable budget formulation, reporting and monitoring processes. The principles of fiscal responsibility would commit Palau to manage fiscal risks prudently by applying five principles:

i. **Manage debt prudently:** While external debt has been well managed in Palau, no formal debt framework exists. The fiscal strategy includes a debt-management framework that would be enacted by legislation that provides vetting principles as well as evaluation and monitoring mechanisms.

ii. **Manage the tax regime to best fit the structure of the economy and to allow for predictability over time:** Tax reform is a central piece of the fiscal strategy. The current regime is outdated, inefficient and distortionary. It requires replacement with a modern efficient and equitable system. The main ingredients of the fiscal strategy are the following:

   - **A Palau goods-and-services tax** (PGST), essentially a VAT to replace the existing general import tax on goods at the c.i.f. level and bring consumption of services into the net.
   - **A net-profits tax** (NPT) would be introduced for all registered businesses above a threshold ($100,000) to replace the gross-receipts tax (GRT).
   - Special rates of **excise taxes** would be levied on alcohol and tobacco both on imports and local production and would replace the current special import taxes.
   - The current **wages tax** would be reformed to restructure the current thresholds and introduce a higher rate for high-wage earners.

iii. **Manage capital expenditures to achieve rising national net worth over time:** Palau has adopted a policy of financing capital expenditures from grant aid or debt. This has resulted in infrastructure investment declining as a share of GDP. The fiscal strategy includes the following:

   - Establishment of an infrastructure reserve fund dedicated to capital projects to be funded from domestic revenues.
   - Palau has recently developed two projects for funding and operation under private-public partnerships (PPP). While PPPs can provide a valuable means to support the development of public infrastructure, they have also been controversial, often with unforeseen risks and unspecified contingent liabilities. Palau needs to consider developing a suitable framework for the evaluation and regulation of PPPs.
   - The large pool of unused savings in the commercial banking system suggests the possibility for the development of a domestic bond market. However, new instruments would need to be compliant with FDIC regulations and the government would need to provide confidence to the market before new instruments would be attractive to investors. This would likely entail a request to international credit rating agencies for an assessment and benchmark.
   - Palau might wish to consider the establishment of a Palau asset-

management authority (PAMA) to appraise new projects and monitor progress against objectives and contracts. However, such authorities can concentrate management decision-making within a single agency, which may be a drawback in a small nation such as Palau.

- Updating the infrastructure-development plan and adding an asset-management plan

iv. Manage reserves and insurance coverage to offset cyclical volatility, natural disasters and the impact of climate change: Palau currently allocates 2 percent of domestic funds and the unreserved general-fund balance to a general reserve fund to support downturns in the economic cycle and natural disasters. While the current policy is laudable, it has no limit or upper bound and may thus be inefficient and exclude other important objectives such as establishing a reserve for investment. The fiscal strategy thus suggests that Palau restate this objective in terms of maintaining a target level of funds over time, which would enable accumulated savings to be set aside for other purposes such as capital investment.

v. Keep recurrent expenditures within available revenues over time: It is further anticipated that the fifth principle would, over time, evolve such that the RoP would manage recurrent revenues within "domestic revenues." To do so now would imply replacement of US-funded federal programs and services and use of Taiwanese resources entirely for capital expenditures. The glide path to this modified principle could very well be long. This will also entail a flexible and modern tax regime and shifting the use of all sources of grant aid entirely to nonrecurrent projects and purposes.

**Palau's special needs were also to be isolated in the strategy:**

- **SOE policy:** A current policy framework for SOE management has been adopted that requires commercialization of SOEs and adoption of full cost recovery with defined community-service obligations (CSO) where the need exists. The fiscal strategy proposes the enactment of the SOE policy into law.
- **COFA Trust Fund to be a perpetual fund:** The current CTF was established as a sinking fund that would provide resources through the 50-year Compact term. The fiscal strategy proposes that the CTF be converted into a perpetual fund that guarantees, with a high degree of confidence, a fixed flow of real resources in perpetuity. Two options are under consideration:
    a. On implementation of the tax-reform initiative, sufficient resources are generated that they compensate for reduced drawdowns from the CTF but that distributions are maintained in real terms to achieve perpetual status.
    b. Nominal drawdowns are maintained at the current level of $15 million, allowing the corpus to grow until such time as drawdowns may be safely switched to generate a real sustained flow consistent with maintaining a perpetual fund. This event is not projected to occur until FY2033, requiring a prolonged period of declining real distributions.
- **Civil Service Pension Fund:** The CSPF poses a major fiscal threat of collapse in the near term. The fiscal strategy includes reform of the CSPF to ensure long-run sustainability.

**The budget process is anticipated to follow a cycle along the following lines:**

i. Use of the Long-Term Economic and Fiscal Framework (see Chapter 10) to establish a fiscal envelope on an annual basis

ii. The budget call

iii. An annual economic and fiscal update, including economic and fiscal forecasts, statement of tax policy changes, and key assumptions under which the budget was formulated

iv. Fiscal and economic components of the president's State of the Republic Address, delivered to the Olbiil Era Kelulau (OEK)

v. An annual budget statement updating

the medium-term fiscal strategy with assessment of the achievement of the principles of fiscal responsibility, presented at the time of budget delivery

vi. Half-yearly economic and fiscal update of key fiscal tables to inform late-year budget adjustments, if any

## TAX REFORM

**Palau has inherited an outdated tax regime that is in need of reform:** Palau has inherited an outdated tax regime from Trust Territory days that has many weaknesses, including an inefficient and outmoded tax structure, distortionary taxes such as the business gross-receipts tax, and outdated institutional administration. The tax system is clearly in need of reform enabling it to provide Palau with a modern and efficient system suited to the structure of the tourism-led economy and providing a yield tailored to the long-term needs of the nation to raise revenue to compensate for declining Compact revenues with minimum distortion.

**Need for tax reform suited to a tourism-led economy:** Tourism arrivals have grown rapidly in recent years, and the industry now dominates the economy. Developing a tax regime that is suited to the tourism economy without incurring distortions is important. However, in recent years the national government and Koror State have significantly raised taxes on the industry. A $100 departure tax ($70 of which is known as the Pristine Paradise Environmental Fee, or PPFF) is levied as tourists leave the country. Koror State has imposed a Rock Island fee of $50 and a Jellyfish Lake fee of $100 per tourist. The hotel-occupancy room tax now stands at 12 percent. These taxes and fees summed to 10.2 percent of GDP in FY2015 when Jellyfish Lake was operating but by FY2018 had dropped back to 6.6 percent of GDP. However, much of industry is very lightly taxed. Tourist expenditure represented 40 percent of GDP in FY2018 (down from 50 percent in FY2015 at the peak), and apart from the hotel-occupancy room tax is lightly taxed at the 4 percent GRT rate. There is no business or corporate income tax, and hotels (local or foreign) escape the tax net. The adoption of a modern tax regime would ensure the tourist economy is taxed fairly over a broad base, which would encourage enhanced revenue effort and could enable reduction of some of the high rates recently introduced on specific items, such as the hotel-occupancy tax.

**Tax reform initiatives have been initiated but await implementation:** Palau has at various times in the past considered tax reform and asked the IMF to prepare a review of the existing regime and recommend suitable reforms. Missions were fielded in 1998 and 2006 and recommended (i) eliminating import-tax exemptions, (ii) valuing imports on a cost, insurance, freight (c.i.f.) valuation basis, (iii) replacing the distortionary gross-revenue tax with a corporate income tax, and (iv) shifting from taxing imports to taxing consumption. However, the proposed reforms were not implemented, and Palau remained with the existing outmoded system. In early 2013, a bill to implement a VAT was introduced into the senate and reignited the debate on and interest in tax reform. As a consequence, the IMF was requested to return and again review the system and propose a reform agenda. An IMF mission was fielded in August 2013,[1] but there was insufficient support in the senate of the OEK to further advance the reforms. At the start of 2018 and again in 2019, the president, in his State of the Republic Address (SORA), indicated his desire and that of the administration to reinitiate the reforms. In lieu of the renewed interest in tax reform, the following discussion, based on the former recommendations of the IMF missions, is considered a critically important component of the reform agenda.

## TAX-REFORM PRINCIPLES

The following tax-reform principles outlined in the review are summarized:

1. **Economic efficiency/neutrality.** Taxes affect levels of economic activity, and for this reason tax rates need to be as low as

1 IMF, Fiscal Affairs Department, Republic of Palau, *Tax Policy Reform and Transition Plan*, Margret Cotton, Lee Burns, Neil Motteram, August 2013.

possible, given revenue objectives. Also, taxes should (as far as possible) be raised in a non-distorting way: economic choices should be similar to what they would have been without the tax. For this reason, tax exemptions and "tax holidays" should be avoided.

2. **Simplicity and transparency.** Simple taxes are good taxes, for all can understand them and they are harder to evade. A tax with simple rules, few and low rates, minimal exemptions, and a clear, wide and measurable base provides more revenue and less opportunity for evasion. Furthermore, the tax system should be based on few such taxes in order to avoid the proliferation of small, inefficient taxes that represent heavy administrative costs and provide opportunities for corruption.
3. **Equity/fairness.** Although countries may hold widely different views on equity, it is generally suggested that (i) people with similar capacity to pay should be taxed similarly (horizontal equity) and (ii) people earning more income should pay more taxes (vertical equity).
4. **High revenue-generating capacity.** The tax system should be able to supply the government with the resources it needs to meet its spending obligations on a sustainable basis. Furthermore, as tax revenues from different taxes might fluctuate, the tax system should rely on a mix of a few taxes to lower the risk of wide annual fluctuations in overall tax revenue.
5. **Harmonization/coordination with other systems.** Tax harmonization and coordination with economic partners or geographical neighbors will help prevent opportunities for various forms of tax avoidance and/or evasion and avoid incentives for tax competition that could lead to revenue loss.
6. **Greater reliance on domestic taxes.** Reduced reliance on trade taxes, and greater reliance on domestic taxes such as VAT and excises that tax all goods and services irrespective of origin, positions countries to obtain the benefits of free and open trade.
7. **Feasibility.** The design of taxes should be aligned with the capacity of the tax administration to actually implement and collect tax revenue.
8. **Integration.** All main taxes should be consistent, in terms of thresholds, rates and registration, to ensure fair treatment of all taxpayers and minimize administrative costs.

## EVALUATION OF THE EXISTING TAX REGIME (SEE FIGURE 32)

1. **Gross-receipts tax.** The GRT is a highly distortionary tax biasing economic

**Figure 32** Expenditures on payroll, goods and services, and nonfinancial assets

| | | Existing taxes | | | Tax Reform | |
|---|---|---|---|---|---|---|
| | | GRT | Import taxes | Wages tax | VAT | Net Profits Tax |
| 1 | Economic Efficiency/Neutrality | x | x | ✓ | ✓ | ✓ |
| 2 | Simplicity and transparency | ✓ | x | ✓ | ✓ | x |
| 3 | Equity/Fairness | x | x | ✓ | x | ✓ |
| 4 | Broad based | ✓ | ✓ | ✓ | ✓ | ✓ |
| 5 | High revenue generating capacity | x | x | x | ✓ | x |
| 6 | Harmonization/Coordination with international systems | x | ✓ | ✓ | ✓ | ✓ |
| 7 | Greater reliance on domestic taxes | ✓ | x | ✓ | ✓ | ✓ |
| 8 | Feasibility | ✓ | ✓ | ✓ | ✓ | ✓ |
| 9 | Integration (IT systems) | x | x | x | ✓ | ✓ |
| | **Score** | **4** | **3** | **7** | **8** | **7** |

resource allocation. In particular, industries that are not in a country's interest to develop may be taxed less. The GRT thus encourages an inefficient economic system. The system is simple but fails in fairness in that industries with higher profit-to-output ratio pay less tax proportionately. While the GRT raises the most of all taxes in Palau, it cannot be raised to increase yield without exacerbating inefficiencies. It thus has a low revenue-generating capacity. The tax is not harmonized with other countries' tax systems but is neutral in relation to trade taxes. It is simple to administer but currently not integrated with the other Palauan taxes.

2. **Import taxes.** Import taxes are generally economically distortionary: they favor domestic production over exports and encourage an inefficient allocation of resources. However, unlike the GRT, import taxes are frequently not transparent, as they have many exemptions and large volumes of manuals are required for importers. They are frequently set to benefit particular interest groups and are thus not equitable. High revenue yields cannot be attained without violating economic efficiency and are not compliant with international trade arrangements such as the WTO or the Pacific trade agreements. They are simple to administer, but at this time are not integrated into the other parts of Palau's tax regime.
3. **Wage-and-salaries tax.** The wage-and-salaries tax does not distort resource allocation and in its current form is simple, transparent and fair. While the tax base is large (about $100 million) and tax rates could in principle be raised, this would be very unpopular. It is thus unlikely, given political realities, that basic rates of the wages tax can be raised significantly from their current levels. Clearly, the wage-and-salary tax is a domestic tax and is simple to administer, but at present it is not integrated in the tax system.

## THE TAX-REFORM PROPOSAL

The March 2013 IMF report recommended two options for tax reform. Option 1 was to remove exemptions from trade taxes and to switch to a c.i.f. valuation of imports to align with international standards. While higher rates of import tax on alcohol and tobacco would be retained, excises should be levied where domestic production competes with imports, as with beer and bottled water. A net-profit tax (NPT) of 20 percent should be levied on commercial banks, and an upper band on the wage-and-salary tax introduced to make the system more progressive.

While option 1 was intended to propose a few modest changes to the system that would improve tax efficiency and equity, the main proposal was outlined under option 2. This is summarized as follows:

- A VAT replaces the existing general import tax on imported goods at the c.i.f. level and applies also to domestic production and distribution of goods.
- The VAT extends to consumption of services and replaces the GRT. The hotel-room tax, which also taxes services, would be retained to support the VAT tax base. Likewise, the departure tax is retained.
- Only the largest businesses above a certain threshold would be liable to register for VAT.
- An NPT would be introduced for all registered businesses.
- Some income tax would apply to businesses not registered, based on a percentage of turnover, while "micro" businesses would not be subject to income tax.
- Special rates of import taxes on alcohol and tobacco would remain, and domestic excises would be levied at similar rates on competing industries.
- A higher band on wages and salaries is introduced for equity purposes.

4. **The value-added tax.** Referring back to Figure 32, it can be seen that the assessment of the tax-reform proposal has many of the desired features of a well-structured tax regime. The VAT scores highly on all fronts with the exception of fairness, where the well-known "regressive" nature of the tax disadvantages low-income households. It is thus usually proposed that some relief is given to vulnerable groups to compensate for the additional tax burden. The VAT is economically efficient in that its impact is neutral on the economic system, on the basis that a "clean" VAT is introduced with no exemptions. The system is simple and transparent once the public is made aware of how the system works. The tax base is large: $311 million in Palau, representing 115 percent of GDP, comprising households, tourism and government. In comparison, the wage-and-salary tax base is $160 million (56 percent of GDP), and the NPT base is $62 million (22 percent of GDP). The VAT thus has a high revenue-generating ability, and more so in a tourist economy such as Palau. Finally, the VAT is a domestic tax, administratively simple and compliant with international trade agreements.
5. **Net-profit tax.** Regarding the NPT, the main issue is that there are currently no income taxes on businesses in Palau. Without including the NPT in the system, the tax regime would be inequitable. Revenue yield would be significant and similar to the wage-and-salary tax, although not as great as the VAT. Administratively, the NPT would be the most complex, which is why its introduction would follow the VAT.

## THE CURRENT STATUS OF THE REFORMS

**Insufficient supporting members in the senate to proceed:** Following the IMF mission of March 2013, the existing senate VAT bill was revised to conform to modern standards, and a series of public-awareness meetings was held. There was strong support from the Ways and Means Committee of the senate, and the president endorsed the tax-reform proposal in his 2014 State of the Republic Address (SORA). Meetings were held with the Chamber of Commerce and Belau Tourism Association. Considerable analytical work was undertaken on constructing an overall package that would be both revenue neutral and address the potentially regressive impact of the VAT. However, there were insufficient supporting members in the senate to bring the proposal to the floor.

**Tax reform initiative reignited:** At the start of 2018 and again in the 2019 address, the president in the annual SORA again indicated his desire and that of the administration to reinitiate the reforms. The existing bills of the earlier missions have been re-vetted by the IMF and updated for "best practice." A PFTAC advisor has advised the tax administrative staff on the implementation of a VAT. The coming Economic Symposium is planned to focus on the tax-reform initiative.

## PUBLIC SECTOR PAYROLL

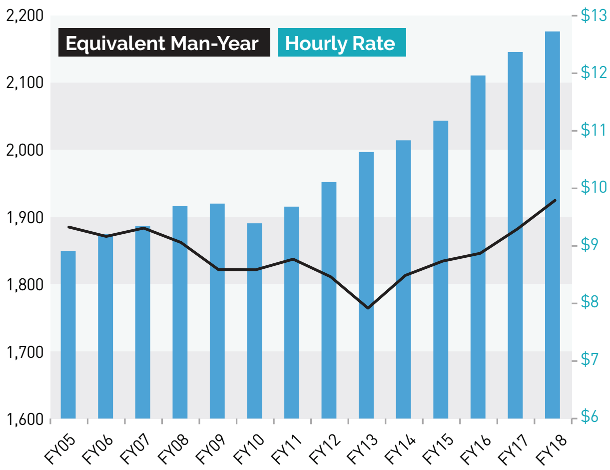
**Public sector payroll falls during the recession, but has subsequently grown:** Recent trends in government payroll, hourly rates and equivalent man-years are indicated in Figure 33 (sourced from the government payroll system). Equivalent man-years[1] worked fell between FY2005 to FY2013 during the period of the international financial recession, recording 1,885 and 1,764 equivalent man-years, respectively, an annual average decline of 0.8 percent.[2] During recent years as the fiscal position eased, public sector employment has grown reaching 1,925 in FY2018, an annual average rate of growth 1.8 percent over the last five years.

**While hourly pay rates have risen as a share of total expenditures and GDP have fallen:** Hourly rates of pay on the other hand, (including benefits) have risen from a level of $8.79 per hour in FY2005 to $12.74 in FY2017,

1 Man-years are based on the number of hours worked divided by the number of hours in the working week and on an assumed 50-week year.

2 Data do not include water operations, which were transferred to PPUC in 2013.

**Figure 33**
Public sector payroll: hourly rates (US$), and equivalent man-years, FY2005-FY2018




an average annual growth rate of 2.8 percent, and have accelerated during the last five years to 3.7 percent. During FY2016, an election year, there was a $25 cost-of-living award per person biweekly, and in FY2017 an increase in minimum wage to $3.50, although only a small number of public servants are employed at this rate. Taken as a whole, the cost of payroll has risen by an annual average rate of 2.9 percent with the majority of the growth occurring in rates rather than the number of civil servants. Finally, as indicated in the discussion on fiscal developments, payroll costs as a percentage of total expenditures fell by 0.8 percent between FY2005-FY2018 but in relation to GDP fell by 1.9 percent.

**Public sector payroll policy has achieved a favorable result:** Given recent economic and fiscal developments, Palau's policy and performance in maintaining payroll constraint would be satisfactory. Palau has avoided pressure to increase the size of the civil service, unlike many other small developing nations with limited economic opportunities. While the nominal value of payroll has grown, as a percentage of expenditures and as a share of GDP it has fallen. Employment in public service on the other hand has remained unchanged, although the recent uptick needs careful monitoring. Taking into account the cost of living as measured by the CPI, real government wages have fallen by an average annual rate of 0.4 percent since FY2005, although much of that decline can be attributed to the reductions in FY2009.

## FISCAL MANAGEMENT PERFORMANCE (BASED ON AUDIT DATA THROUGH FY2017)

**Composite measure of fiscal management performance:** In this section, we present a summary measure of overall fiscal management performance. Ten measures of performance are included, each scored between 1 and 10. The overall measure is the sum of the individual measures with equal weighting. Some of the measures relate to short-term factors reflecting performance at different points of the economic cycle. Others are more long term in nature, reflecting structural issues. It should be noted that fiscal management performance measured here reflects the underlying fiscal policies of the nation rather than measures such as PEFA, which are more system and administrative management oriented, although there is overlap. The current measures are all derived from the annual audit and from economic statistics used in this review.

**Measures of fiscal balance, expenditures to GDP, and tax effort have improved:** Table 8 provides the list of measures used in the assessment and scores. Fiscal balance is the level of fiscal surplus/deficit as defined in the GFS divided by the level of GDP. As the table indicates, the fiscal position deteriorated leading up to the recession but has improved significantly since then. The ratio of expenditures including fixed assets to GDP has also improved (a higher score indicates a lower ratio). While the size of government in terms of service delivery has fallen as the economy has grown, the cost of providing these services has risen with inflation and in nominal terms. Dependency is a measure of how much revenue is derived from grants relative to total taxes. The ratio has also improved significantly over time reflecting that Compact grants are maintained in nominal terms and taxes have increased because of both the growth in the economy and discretionary tax changes. Tax effort is simply the ratio of taxes to GDP, and in this instance an increase in the ratio has been taken as positive. The tax regime in Palau is inherited from Trust Territory days, and tax effort has traditionally been weak. The need for tax reform and modernization was addressed in the previous section.

**Indebtedness and debt/asset ratios remain stationary but increase in the last two years, fund balances have improved:** Indebtedness is the ratio of national-government debt to GDP. This was generally near 10 percent of GDP but has risen in the last two years with large new borrowing from the ADB which is on-lent to the SOE sector. Fund balances reflects the level of unrestricted funds of the government and is a key measure for finance officers in US public accounting systems. During the financial crisis fund balances deteriorated but since FY2013 as Palau generated significant surpluses fund balances improved significant. The score is short term in nature but reflects the degree of fiscal discipline. The debt-to-asset ratio reflects how much of the government's balance sheet is represented by issuance of debt. In Palau, this has been low: about 10 percent but has risen in the last few years with the ADB borrowing. This is more of a structural indicator, and the ratio has changed little during the period.

**Liquidity ratios reflect trends on the cycle, but the Civil Service Pension Fund is close to collapse:** The capital-asset condition is an indicator of useful life of the fixed assets of the government. It is based on the ratio of the total value of depreciated assets to original cost. In Palau's case, the construction of the Compact Road is the major component, although the capitol building, and airport are other important fixed assets. The ratio shows a declining trend, although infrastructure in Palau has generally been well maintained. Liquidity is measured two ways: the ratios of current assets to current liabilities and of cash to current liabilities. This is a short-term measure, and the trend reflects the point of the economic cycle. Lastly, the Civil Service Pension Fund is included, and its performance is measured by the ratio of assets to unfunded liability. The table indicates the rapid deterioration of the status of the fund.

**Overall score suggests Palau's financial performance has performed satisfactorily:** Finally, the overall results are indicated in Table 5 The results indicate that Palau has scored between 51 and 63 and that the trend deteriorated during the recession but that since then there has been a significant improvement. The results clearly indicate the trends over time and that Palau has been performing well. The overall score was stable through FY2013, it rose in FY2014 and FY2015 with the rise in fiscal surplus and has stabilize since that time as Palau has taken on more debt.

## B. Public Financial Management

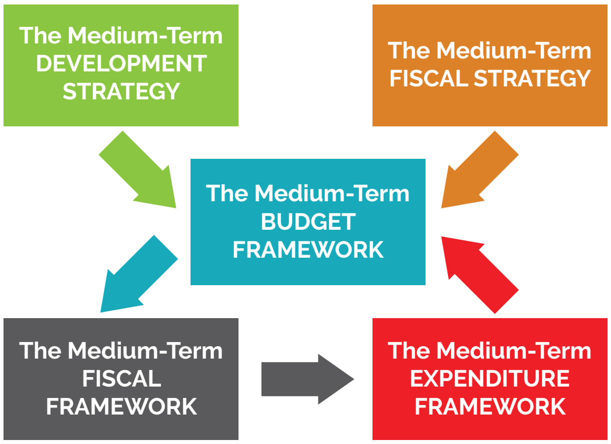
### THE PALAU PLANNING AND BUDGET FRAMEWORK

**Preparation of a Development Strategy: (MTDS):** As part of the ADB Facility for Economic and Infrastructure Management (FEIM), a medium-term development strategy (MTDS) was prepared in 2008. The MTDS set out key strategies and actions to help achieve economic, social, environmental and cultural goals over the five-year period from 2009 to 2014. This document, in essence a five-year development plan, provided the basis for economic policy and budget formulation during the period. However, while the MTDS was a comprehensive document covering the major development issues, there was little focus on implementing the plan after the change in administration in 2009. In 2013, with a further change in administration—a return of the one that commissioned the plan—the MTDS again became the centerpiece of the planning effort. Upon attaining office, the returning administration prepared a management action plan (MAP) to serve as the road map, which was renewed for a second term when the administration was re-elected. The MAP indicates the government's intention to implement the fiscal strategy (known as the MTFS), as discussed in the first section of this chapter.

**The structure of the Medium-Term Budget Framework (MTBF):** In 2010, under a further ADB TA,[1] an effort was made to develop and institutionalize a medium-term budget framework (MTBF). The objective was to

1 ADB TA No. 7421, Implementing a Medium-Term Budget Framework.

**Figure 34**
The Palau planning and budget system




incorporate the two strategic documents (MTDS and MTFS) into a medium-term budgetary framework see Figure 34 for a diagrammatic representation of Palau's planning and budget system. The MTFS would guide the formulation of a medium-term fiscal framework (MTFF): the projection of the fiscal envelope and identification of fiscal risks and pressures. The MTDS would provide the direction for line ministries and departmental expenditures on activities and outputs through another document: the medium-term expenditure framework (MTEF).

The TA initiated a series of efforts to improve public financial management (PFM). These included the development of the MTFF and implementation of a new performance-reporting and results-based framework (RBF) at the line-ministry level to assist in the development of the MTEF. The TA proposed the adoption of an MTBF document, bringing together the economic and fiscal projections, line-ministry expenditure ceilings, and performance data—all to be presented at the time of the budget, thereby fulfilling part of the fiscal-responsibility act discussed above.

**Initial implementation of the MTBF was not successful:** However, the implementation of the MTBF cannot be said to have been a success; the program was commissioned by one administration but implemented under another. The TA final report indicates a series of weaknesses: While the minister of finance supported the reforms, other parts of government did not. There was a lack of resource availability in the ministry, availability of accurate financial data was problematic, the forecasting committee had not been convened throughout the TA, and the RBF was not approved by either the administration or the OEK.

**Renewed ADB support for the fiscal strategy and budget manuals:** A further effort to improve the planning framework was initiated at the start of 2018 with support from the ADB: (i) revision and update of the fiscal strategy (MTFS) and (ii) update of budgeting and planning procedures with provision of manuals. The update of the fiscal strategy, given the recent changes incurred with implementation of the CRA, is especially important as Palau plans for the future through

**Table 5** Fiscal management performance, FY2003-FY2017

| | | FY03 | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 | FY12 | FY13 | FY14 | FY15 | FY16 | FY17 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Fiscal balance | 4 | 3 | 6 | 5 | 4 | 4 | 5 | 5 | 6 | 6 | 5 | 7 | 8 | 7 | 7 |
| 2 | Size of government | 5 | 5 | 6 | 5 | 5 | 6 | 6 | 5 | 6 | 6 | 6 | 6 | 6 | 6 | 6 |
| 3 | Dependency: revenue indepenence | 4 | 4 | 5 | 4 | 4 | 5 | 5 | 4 | 5 | 5 | 5 | 6 | 6 | 6 | 7 |
| 4 | Tax effort | 3 | 3 | 4 | 3 | 3 | 3 | 3 | 4 | 4 | 4 | 4 | 5 | 5 | 5 | 5 |
| 5 | Indebtedness | 7 | 8 | 8 | 8 | 8 | 8 | 8 | 8 | 8 | 8 | 8 | 8 | 8 | 7 | 6 |
| 6 | Fund Balances | 4 | 4 | 5 | 5 | 5 | 4 | 4 | 4 | 4 | 4 | 4 | 5 | 6 | 6 | 7 |
| 7 | Debt/Asset | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 8 | 8 |
| 8 | Capital Asset Condition | 7 | 7 | 6 | 6 | 7 | 7 | 7 | 6 | 5 | 5 | 4 | 4 | 3 | 3 | 3 |
| 9 | Liquidity | 5 | 4 | 5 | 5 | 5 | 4 | 3 | 3 | 3 | 5 | 5 | 9 | 10 | 10 | 10 |
| 10 | Pension Fund Health | 5 | 5 | 5 | 5 | 4 | 4 | 4 | 4 | 3 | 3 | 2 | 2 | 1 | 1 | 1 |
| | **Overall** | **53** | **52** | **58** | **56** | **53** | **55** | **52** | **51** | **53** | **54** | **54** | **59** | **63** | **59** | **61** |

the end of the CRA and into the COFA Trust Fund period with declining real resource transfers. Implementation of an effective and efficient budgetary process as the fiscal envelope tightens is a natural companion to the fiscal strategy to conserve and ensure the efficient use of public resources. Both of these efforts are ongoing, but it is too early at this stage to indicate the results or direction of thinking.

### PUBLIC EXPENDITURE AND FINANCIAL ACCOUNTABILITY

**Palau adopts PEFA:** 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 PEFA is a framework for the assessment of public financial management (PFM) developed by the World Bank and a group of international donors in 2005, one that has subsequently been updated.[1] It has been implemented in many countries in the world and provides an objective yardstick by which countries can assess and improve their PFM performance. The framework has seven broad categories:

i. Budget reliability
ii. Transparency of public finances
iii. Management of assets and liabilities
iv. Policy-based fiscal strategy and budgeting
v. Predictability and control in budget execution
vi. Accounting and reporting
vii. External scrutiny and audit

Each of the seven major areas is divided into 32 high-level indicators, which, in turn, are further subdivided. The scoring system is based on international standards and provides a precise measurement system.

**External assessment planned for 2019:** The next stage in the PEFA process is for Palau to undergo a formal or external assessment: this is planned for 2019. With the external assessment complete, Palau will be eligible to request that PFTAC assist in the preparation of a road map to improve the PEFA score. The road map will identify areas in PFM in need of improvement and reform and focus efforts on the more critical components. Clearly, many of the areas addressed in this chapter of the review are covered in the PEFA framework. The PEFA provides a very desirable method to assess reform effort over time. Palau has been making slow progress.

## C. Compact Review Agreement Oversight Mechanism

The Compact Review Agreement, now authorized and appropriated by the US Congress, calls for establishing an Economic Advisory Group (EAG) “to contribute to the long-term economic sustainability of Palau by recommending economic, financial and management reforms.” At the time of writing the EAG Is currently under formation. The agreement offers several examples of relevant reform issues, including:

i. meaningful improvements of fiscal management, including the elimination and prevention of operating deficits;
ii. a meaningful reduction in the national operating budget from the previous fiscal year;
iii. a meaningful reduction in the number of government employees from the level of the previous fiscal year;
iv. a meaningful reduction in the annual amount the national operating budget dedicated to government salaries from the previous fiscal year;
v. demonstrable reduction of government subsidization of utilities, and
vi. meaningful tax reform.

In addition, there are many reform issues that the EAG might wish to monitor: As described in the policy section of this review, there are many potential reform issues in addition to the items

1 Public Expenditure and Financial Accountability (PEFA), PEFA Secretariat, Washington, DC, 2011 revised. See also https://pefa.org.

listed in the CRA. In fact, the CRA list is limited and may require modification. No doubt the advisory group/annual economic consultative process will want to reconsider and broaden the list, Clearly, the PEFA provides a useful checklist of PFM performance. However, the PEFA focuses on systems rather than reforms, and the advisory group/annual economic consultative process would likely wish to monitor the implementation of many of the areas covered in this review and the "policy sore card" presented in Appendix 1. Furthermore, the Compact fails to mention reforms to encourage private sector development or monitoring mechanisms such as the World Bank's Ease of Doing Business Survey, which is discussed in chapter 8. It would be desirable for Palau to take a proactive approach in preparing a template reform-monitoring matrix for consideration by the EAG/annual economic consultative process before it first convenes.

However, as the renewed Compact specifically mentions a number of public sector issues, these are discussed below:

i. **Improvements of fiscal management, elimination of operating deficits:** The focus of this chapter of the Review provides a list of areas that would be important elements to monitor fiscal performance: progress with implementation of the fiscal strategy, the financial performance framework developed above, and PEFA. The potential list is a long one and key areas would need to be the focus. Regarding operating deficits Palau has in fact eliminated operating deficits since FY2013. However, a more suitable measure would be the overall deficit which has also been in surplus since FY2011.

ii. **Reduction in the operating budget:** This measure would be better captured by a reduction in the size of government defined by total expenditures in relation to GDP. As discussed in the chapter on fiscal developments, the trend in expenditures as a share of GDP has been declining since FY2000.

iii. **Reduction in the number of government employees:** As discussed in the section above, the number of government employees measured in terms of man-years has remained largely static since FY2005, growing by a modest 0.2 percent. Given the declining share of expenditures to GDP, a static target of government employees may be more desirable to maintain essential services but provided it is accompanied by productivity or efficiency gains in service delivery.

iv. **Reduction in the annual amount the national operating budget dedicated to government salaries:** as noted above the share of payroll in expenditures and GDP has been falling since FY2005.

v. **Reduction of government subsidization of utilities:** The provision of government subsidies to the SOE sector has traditionally been very modest. The recent transfer of water and sewer operations to the PPUC has made transparent the implicit level of support to the provision of water and sewer. While a policy has been established to eliminate subsides and attain full cost-recovery this is yet to be achieved. It should be noted that the recently announced policy to subsidize future increases in utility prices due to fuel price rises is not in accord with elimination of subsidies or the principle of full cost-recovery. Progress with implementation of the SOE policy framework discussed in the following chapter would, perhaps, provide a better means of assessment of SOE performance.

vi. **Tax reform:** As noted in the above section while there have been various efforts to initiate comprehensive tax reform none have so far come to fruition; however, Palau's tax effort, as measured by tax revenue as a share of GDP has increased markedly from 16.0 percent in FY2009 to an estimated 21.4 percent in FY2018.

# 6. State-Owned-Enterprises and Public Infrastructure

**The SOE sector in Palau like many others in the region performs poorly reflecting its public ownership and political interest. SOEs are typically not required to operate at full cost recovery and maintain cash flow balance through erosion of the capital base. In order to improve performance, the President issued an SOE policy with a primary objective that SOEs should operate on a commercial basis with recovery of all costs. However, the policy has yet to be drafted into legal framework to support commercial operations.**

- Until recently, Palau has operated a highly inefficient and costly ICT sector. Recent reforms, including a fiber optic connection to the Internet backbone, have significantly improved services. The creation of the Belau Submarine Cable Company to operate and maintain the fiber coupled with the new Telecom Regulatory Framework and creation of an independent regulator lay the foundation for the establishment of a competitive ICT market
- The provision of power generation and distribution is provided by the sole provider: the Palau Public Utilities Corporation. In most years both net operating and net income are negative reflecting the lack of full cost recovery. The government operates a small subsidy to low income households. Of greater concern is the current intent to subsidize future increases in fuel prices to stabilize tariffs to households. Significant increases in fuel prices would place a severe burden on government finances.
- The provision of both water and sewer services was formerly provided through a government department but has now been transferred to PPUC. With program support from the ADB under a water sector improvement program the government committed to operate the sector on a full cost recovery basis. Tariffs have tripled from a very low basis but remain well under the target.
- With further support from the ADB under the Koror Airai sanitation project, a $29 million loan was provided to support refurbishment, renovation and extension of the sewer system to serve the needs to the nation and tourism industry. However, the debt service will require further increase in tariffs to achieve full cost recovery, an objective that is not currently being met. A further project KASP II is in the pipeline to cover cost overruns and to fully rehabilitate the system.

# 6. State-Owned-Enterprises and Public Infrastructure

## A. Introduction

**Structure of the SOE sector:** State-owned enterprises (SOEs) are not large in number in comparison to other Micronesian and Pacific economies, and Palau has avoided the pitfalls experienced in the RMI, in particular. There are four major SOEs, one newly created: the Palau National Communications Corporation (PNCC), the Palau Public Utilities Corporation (PPUC), the National Development Bank of Palau, and the Belau Submarine Cable Company (BSCC). Until recently, water and sewer services had been provided by government, but these functions have now been merged with the PPUC. The newly created BSCC will manage the fiber optic connection to the internet backbone and provide wholesale bandwidth to ISPs in Palau. The provision of airport operations remains, however, a government department, as does 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 is being contracted to a public–private partnership (PPP) through JICA and a private Japanese corporation. However, information on the structure, financing and commitments of government is not yet publicly available. Operations of the runway and associated services will remain with government.

### SOE POLICY

**The recent private sector assessment of Palau[1] noted the poor performance of the SOE sector in Palau and described numerous contributing factors:**

i. There exists no legal framework to support the commercial operations of the sector. The appointment of politicians to the boards of the SOEs by the president and subject to confirmation by the OEK leads to a lack of experience of the functions of the SOEs and operations of the board.

ii. There is no requirement that SOEs operate at profitable levels or at full cost recovery, with the exception of the water and sewer management of PPUC. The role of directors focuses on legal compliance, while directors are rarely held accountable for the financial performance of the sector.

iii. There is no monitoring mechanism for the performance of the sector outside of the SOEs' need to submit their annual audits to the OEK. Corporate planning is weak, and there is no role for the Ministry of Finance in evaluating performance of directors.

iv. SOEs typically set prices at "affordable" prices specified in their enabling legislation.

v. The lack of adequate pricing and profitability results in a lack of maintenance of assets and in disruption to service when the infrastructure fails.

vi. SOEs are typically run very inefficiently, reflecting their public ownership. In Palau, the PPUC has about half the labor productivity of other utilities in the region. In effect, scarce resources of labor and capital are underperforming and represent a deadweight loss to the economy.

**SOE policy issued in 2014:** To improve the performance of the SOE sector, the president issued an SOE policy in August 2014 with the following primary objective: "The Primary Objective of each SOE is to operate as a successful business and, to that end, to recover all of its costs, including the costs of capital." A

1 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.

set of policy principles was outlined to support the primary objective:

i. **Community-service obligations (CSOs).** All CSOs delivered by SOEs shall be transparently identified and costed. SOEs will be required to deliver CSOs without violating the primary objective, through direct subsidy from government, cross subsidy or agreed-upon lower rate of return.

ii. **Minister of finance appointed as responsible minister.** The minister will have financial and operational oversight of SOEs, recommend directors, and so on.

iii. **Qualified directors.** Directors will be those most qualified to assist the SOE in meeting the primary objective.

iv. **Elected and public officials not appointed to boards.** Civil servants are also to be limited.

v. **SOEs to prepare annual corporate statement of intent (CSI).** The CSI will include performance targets, a forecast of financial performance, community service obligations, and so on.

vi. **Annual audit statements**

vii. **Creation of monitoring unit.** A monitoring unit is to be created in the Ministry of Finance to help the minister discharge his or her duties regarding the SOEs.

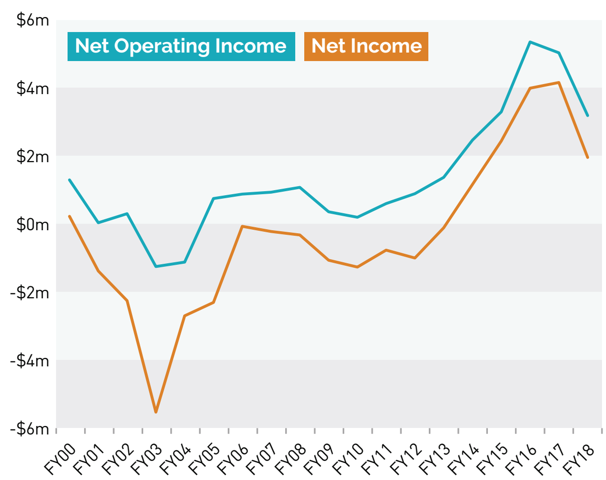
**Need for the SOE policy to be drafted into law:** The SOE policy statement is in accord with best practice, but at this time is only implemented through executive order. The intent of the order is the eventual adoption of legislation to permanently implement the principles and best practices embodied in the executive order. As yet, no bill has been drafted and the primary objective and policies have not been implemented in any form.

## TELECOM

**Cell phone market and internet services grow rapidly with the introduction of new services:** The telecom sector in Palau consists of one main provider, the Palau National Communications Corporation, and two wifi service providers, Palau Telecom and Palau WiFi. The PNCC is a state-owned enterprise, while the latter two are private entities. The PNCC provides GSM mobile, fixed-line, internet and digital TV services. During 2007–2018, the cell phone market grew strongly, from 9,424 customers to 26,524, an annual rate of growth of 9 percent. This represents a coverage of 151 percent of the estimated population in 2018—a very high percentage—but may include a significant number of visitors. The rate of penetration would suggest the market is largely saturated. As may be expected with the introduction of modern digital and internet services, fixed-line business has fallen from 7,474 subscribers in 2007 to 7,166 over the same period. Internet coverage has grown from 1,194 to 3,651, an annual average growth rate of 11 percent, with a significant increase since the introduction of the HomeNet service in 2011.

**PNCC achieves a healthy level of profitability with the introduction of new services:** Figure 35 indicates the net operating profit and net income of the PNCC and the significant and sustained improvement from FY2014 through FY2018. Since FY2005, the SOE has achieved a positive net operating profit, but net income, after allowing for interest payments on debt and other costs, was negative until FY2014. In FY2018 after the introduction of the new fiber connection, PNCC was required to maintain both the old expensive satellite connectivity as backup as well pay for the new internet

**Figure 35**
PNCC, net operating profit and net income



connection. As a result, costs rose by $2.4 million eroding profitability. As an SOE, the PNCC serves the public interest of Palau and is not required to operate at full cost recovery. The PNCC carries a large external debt to the US Rural Utilities Service (RUS) that stood at $19.8 million at the end of 2018. Once allowance for interest payments is made, it can be seen that the PNCC had a negative income for many years, not enough to cover principal repayment on loans. In essence, the PNCC was repaying its debt obligations through depreciation of its fixed capital base to remain operational. Since FY2014, however, net income has been positive and has thus been achieving full cost-recovery level.

**Belau Submarine Cable Corporation operationalized:** In 2015, legislation for the creation of the Belau Submarine Cable Corporation was passed by the OEK, and the company is now operational. The financing for fiber cable was provided through a $25 million loan from the ADB, although the costs of the fiber came in below target at about $20 million, leaving additional resources for ICT infrastructure improvement. Palau is participating in the new SEA-US (South East Asia–United States) submarine cable that links Indonesia, the Philippines, Guam, Honolulu and the US West Coast. The BSCC has invested in a submarine fiber link to the nearby SEA-US cable and contracted with the consortium partners for an indefeasible right of use (IRU) for guaranteed bandwidth from that point onward, understood to be for 25 years. The SEA-US cable system has provided a unique opportunity for Palau to connect to the internet backbone at low cost ($20 million), in a timely manner (early 2018), and with effective cable maintenance because of the international nature of the cable partners. The new fiber connection was ready for service at the end of 2017 and now provides internet service to Palau.

**BSCC owns and maintains new connection and provides open and competitive access to all ICT providers:** The BSCC owns and operates the cable on behalf of the government on a commercial basis of full cost recovery. It is tasked to ensure open access for all ICT service providers so that the benefits of the open fiber optic cable accrue to the benefit of the consumer. For the first 10 years, the company will be publicly owned, and there is no provision of sale of stock to the private sector. To achieve the objectives of a competitively priced IT sector, this provision seems appropriate. Private ownership in a monopolistic situation has not provided competitively priced services elsewhere in the region. However, competition among IT providers purchasing bandwidth from the BSCC should enable fair and efficiently priced services.

**New Telecom Regulatory Framework passed into law for the creation of a competitive ICT market:** The World Bank has played a significant role in facilitating IT reform in the region and an initial TA ($0.6 million) for Palau was prepared to assist implementation. A key ingredient was preparation of draft legislation and regulations for the creation of a competitive ICT market and establishment of an independent regulator. The Telecom Regulatory Framework was passed into law in December 2017. The two pieces of legislation, the BSCC Act and the telecom-reform bill, lay the groundwork for the new ICT environment.

**Law provides for the establishment of a regulator to oversee ICT market:** Key ingredients of the new bill include the establishment of regulatory powers within a newly created Bureau of Communications within the Ministry of Infrastructure, Industries and Commerce. It is understood the new regulatory framework is based on that of the US Federal Communications Commission. Licenses will be issued to the three existing operators, but a moratorium will be put in place for the issue of licenses to new operators until January 1, 2020. The bureau may extend this for a further three years. The policy effectively limits competition and new entrants for this period.

**Levy requires operators to pay universal access obligation of 15 percent:** The law also requires the bureau to establish a universal access policy to ensure provision of ICT to remote areas. Operators will be required to pay universal access obligations (UAO) if specified in law or issue of license. The law specifies an initial levy of 15 percent on bandwidth purchases from BSCC, and funds will be deposited into a revolving fund. The first call on the Universal Access Fund will be periodic payments to pay down the existing PNCC RUS loan, an outstanding debt of $19 million. At this time, it is understood that PNCC has absorbed the cost of the levy on the basis that this will be offset by reductions in debt service. The other two service providers will be required to absorb the cost or increase prices. However, while ISPs will be required to pay the levy, they will not be provided access to the PNCC assets the RUS loan was drawn on to fund.

**Palau in discussion with ADB to provide refinance for the RUS loan:** The RUS loan was contracted to fund the initial copper telecom infrastructure in Palau, but this is now obsolete. As a result, PNCC is in a weak position to compete with other providers not encumbered with legacy equipment. The UAO has in effect been an attempt to level the playing field so that the cost of servicing the debt is spread over all providers. While discussions with RUS have not been successful in granting debt relief, the government is currently in discussion with the ADB to refinance the loan. The new loan is likely to be coupled with sector-reforms and provision of upgrades to the existing network. The lower concessional terms, interest rate and extended term of the refinancing would be financially attractive.

**A second backup fiber connection is under consideration to replace existing expensive satellite bandwidth:** A further issue for Palau telecom providers is that of backup in case of fiber failure and consequent service disruption. At the current time, PNCC purchases backup satellite bandwidth, but at a cost not dissimilar to the new fiber connection, thus imposing a considerable additional burden on the efforts to reduce cost. Purchase of a second fiber to mitigate the risk is under consideration. While the cost under existing contracts of the satellite bandwidth is likely to fall, it is probable that a commercial case can be made for the initiative. With a guarantee of continuous uninterrupted internet connection Palau would become an attractive place to host a new range of ICT services to foreign investors.

**From being one of the most expensive ICT markets in the region Palau is now very competitive:** While legacy telecom services in Palau are largely satisfactory, internet services have been until recently some of the most costly and poorest in the Pacific region. Before the new infrastructure was installed a 256-Kbps line cost $320 a month. At the present time home consumer users can purchase a 20Mbps connection for $120 a month, a massive reduction in cost. By way of comparison, in the FSM, a neighboring Micronesian nation, a 2 Mbps connection costs $75; six times more expensive. From being one of the most expensive suppliers in the region Palau is one of the lowest. However, while consumer products have fallen dramatically in price, there remains considerable room for improvement in the business segment. In the mobile market, 4G LTE data is also very competitively priced.

**Penetration of the home market nearing saturation but improved products and prices needed in the business segment:** Before the introduction of the new fiber connection, services and pricing resulted in a “repressed” market—that is, demand was artificially low because of high pricing. In FY2015, the number of home internet users was 1,500 in comparison with 3,800 digital TV subscribers, a good indicator of market size. By FY2018 the number of home internet users had risen to 3,000 suggesting further penetration in the market was nearing saturation. The major challenge for PNCC going forward will be to penetrate the remainder of the consumer market, introduce new products and tariffs in the business segment while reducing cost.

**PNCC has made significant progress but needs maintain the momentum to compete as new entrants enter the market:** PNCC has made significant advances but needs to continue to improve its business model so that it can sustain its position in the face of new entrants that will likely come with the adoption of the new legislation designed to encourage a competitive and efficient ICT market.

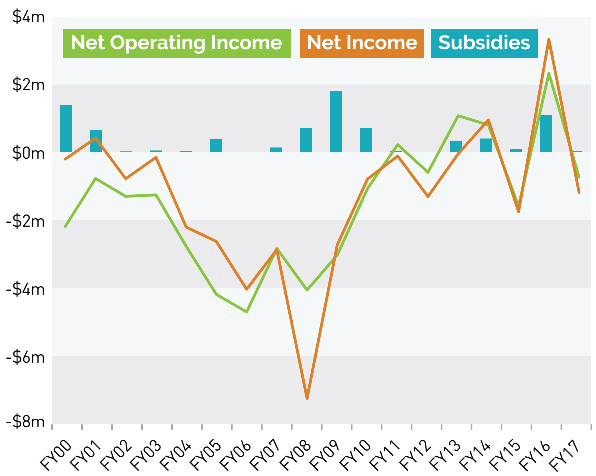
## UTILITIES: ELECTRICITY
(BASED ON FY2017 DATA)

**The Palau Public Utilities Corporation (PPUC) is the sole provider of electricity in Palau.** In a recent restructuring of the utilities sector, the PPUC now provides water and sewer services, which were formerly (until June 2013) provided through a government department. The discussion in this section relates to power generation, and the following section deals with water and sewer.

**Financial performance improving but losses incurred in many years:** The PPUC has provided a mixed level of service, with disruptions at times due to lack of maintenance of generating capacity. Figure 36 provides a picture of the financial operation of the utility. The PPUC recorded a negative net operating income in many years, but its financial position has clearly been improving since a disastrous year in FY2008, when fuel prices peaked. On a net-income basis (excluding capital grants), the utility has also made a loss in many years. Net income turned negative in FY2015, achieved a positive performance in FY2016 with favorable fuel prices, but again dipped into deficit as fuel prices started to rise in FY2017. Figure 36 also indicates the level of current subsidies received from the national government and other donors.

**PUC operates at less than full cost recovery:** The weak financial performance of the PPUC is attributed to a variety of interrelated factors. Most important, the utility has not been allowed to operate at full cost recovery. Political considerations have resulted in the establishment of a suboptimal tariff structure, which has constrained setting aside a reserve for plant replacement. This, in turn, has led to increased costs for more frequent maintenance. In FY2008, with the spike in fuel prices, very significant losses were recorded. At the end of 2012, a new tariff structure was introduced that has placed the utility in a better financial position. Improvements in efficiency have also been achieved, which has helped reduce cost with the introduction of more efficient generators in 2014, but the utility still operates below full cost recovery. With support from the ADB, a study was conducted in 2018 specifically to design a new tariff structure based on full-cost-recovery principles for both the electricity and water/wastewater operations. If adopted, this should move the PPUC towards self-reliant and efficient production, enabling timely replacement of depreciating assets and a more reliable service.

**Figure 36**
PPUC electricity, net operating profit and net income



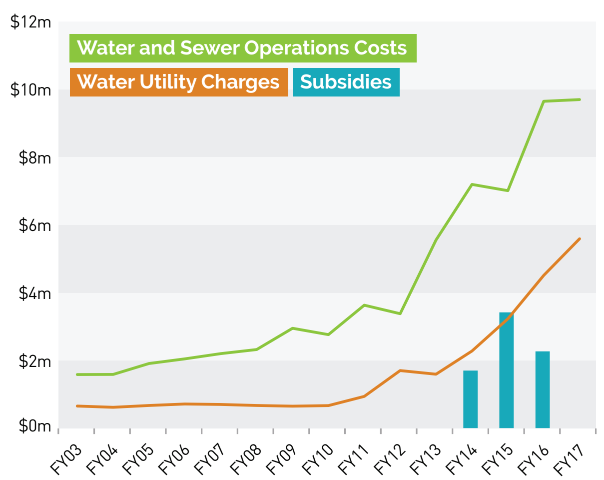

**Financial performance:** At the end of FY2017, the utility is estimated to have had $5.9 million in outstanding loans, with debt-services payments (interest and principal) of $1.1 million. The ratio of cash to current liabilities (quick ratio) was 138 percent, indicating a not-unfavorable position, better than that of many other regional power providers. The utility has been able to maintain a positive cash flow by funding operations through the erosion of the capital base. During FY2015, international fuel prices dropped dramatically and the PPUC passed on much of the reduction to consumers. Rates fell for consumers from 43¢ a unit in 2014 to 30¢ at the start of 2016, and currently stand at 32¢, a 26 percent reduction. The reduced fuel costs have improved the financial position of PPUC in the last few years. However, the more recent increases in international fuel prices, will result in a less favorable outcome.

**Government intentions to subsidize fuel price rises is of concern:** Recent budgets include provision for a low-income subsidy for households that are below a certain threshold for the first 150 units consumed per month. The threshold is determined from the recent HIES conducted in FY2014, and applicants must apply to government with proof of income. At present, the number of households applying for the subsidy has been limited, and an annual total cost of about $200,000 has been estimated. Of more concern has been government's intention to subsidy electricity prices as fuel prices rise. Current prices for consumers remain at 32¢ a unit despite significant increase in fuel prices, implying the need for subsidy. Should prices increase significantly this would impose a large financial burden on government.

## THE WATER AND WASTEWATER SECTOR (BASED ON FY2017 DATA)

**Water and sewer services record losses in all years since merger with PUC:** Water and sewer operations merged with PUC: The provision of water and sewer services was, until the merger with PPUC in June 2013, provided by the public works department of the Ministry of Infrastructure, Industry and Commerce. Figure 37 indicates the financial performance concerning the provision of services. Up to the merger in FY2013, the cost of providing water and sewer operations, while under government control, was in excess of revenues; the figure indicates a significant level of implicit subsidy. In FY2014, after the merger was complete and the full cost of services is fully recorded, the true financial position of operations is revealed. Despite the increase in charges for sewerage as required under the WSIP (see below), the cost of operation remains significantly above revenues. Subsidies of $1.7 million, $3.4 million and $2.3 million were received by PUC in FY2014, FY2015 and FY2016, respectively. There were no subsidies in FY2017. However, the subsidies were inadequate to cover the cost of operations, and an income loss was recorded in each year. Effectively, water operations have been consuming capital (depreciation) to maintain cash flow.

**Figure 37**
PPUC water and sewer operation, revenues, expense and subsidies.




**ADB program loan supports reforms in the provision of water and sewer services:** To support the government in reforming the sector, the ADB initiated a Water Sector Improvement Program (WSIP) loan. A loan of $16 million was agreed upon, with a $9.873 million first tranche and a second tranche of $6.2 million. As a program loan, the funds were not earmarked for specific purposes but were provided to assist the government with the transition, subject to a set of conditions. The conditions for first tranche release included were

- a law creating a power, water and sewer company to run water and sewer operations (it was later agreed that the PPUC would be split into two divisions: one for electricity generation and the second for water and sewer);
- the initiation of tariff increases for water supplied toward full cost recovery; and
- a stipulation that the government would allocate a specific subsidy in the budget.

**Tripling of water and sewer rates from current levels required to achieve commercial viability:** In FY2012, the loan became effective and the first tranche was released. At the start of FY2014, a review of progress on attainment of the loan covenants was undertaken and sufficient progress was achieved for release of the second tranche of $6.2 million. The second tranche included an additional set of conditions and further tariff charges. Since the commencement of the reforms, household and business rates have trebled, although from very low base rates. The ADB-supported tariff review of the PPUC discussed above was also commissioned to provide further revisions of water and wastewater rates to achieve commercial viability. The tariff review indicates that a further doubling of rates is needed. This is consistent with covering operating costs displayed in Figure 37 to eliminate the subsidy and cover capital depreciation.

**Full rate increase required under ADB program yet to be implemented:** There is no doubt that if the Water Sector Improvement Program is fully implemented in compliance with the conditions, then it will provide a reformed efficient SOE that operates at full cost recovery.

The WSIP will encourage moderation in water usage, and the ADB project documents indicate that expansion in the tourism industry can occur without the need for additional investment before the end of 2020.

### THE ADB KOROR-AIRAI SANITATION PROJECT (KASP)

**Need for refurbishment of Koror's sewer system:** Koror's centralized sewerage system and sewage treatment plant (STP) is over 30 years old and badly in need of refurbishment, renovation and extension if it is to continue to serve the needs of the nation. Available sewer-treatment capacity effectively places a constraint on future growth of Koror and the tourism industry.[1]

> *The sewerage network comprises 40 kilometers of gravity mains, 13 kilometers of force (pumped) mains, 48 pump stations, and a sewage treatment plant (STP) located on the island of Malakal. For the most part, the commercial sector of the city is located at the crest of the ridge, and the residential hamlets stretch down to the coast. Sewage is pumped up to the ridge and flows to the STP. Two other islands, connected by causeways, are part of the network. While the STP and some pump stations have been refurbished in the last 10 years, these have not been maintained or operated as designed.*
>
> *The current sewerage flow exceeds the design capacity of the network and the STP. This causes overflows at the low-lying pump stations and subsequent discharge of effluent to the natural and built-up environment, including through people's homes and taro patches and into the lagoon. There are an increasing number of overflows as the network deteriorates. The problem is exacerbated by (i) poor maintenance, (ii) inadequate emergency-response capability, (iii) groundwater infiltration, and (iv) illegal storm-water connections.*

The KASP loan proposal goes on to describe a series of environmental and health issues, and the potential adverse impact on the economy of system degradation and failure. Two major outputs for the project were identified:

i. ***Effective, efficient and sustainable sewage-collection systems in Koror and Airai.*** *The sewerage network in Koror will be rehabilitated and augmented to (i) minimize the frequency and severity of uncontrolled sewage overflows; (ii) reduce the energy requirement to operate the network; (iii) improve the operation of the network through real-time system monitoring; and (iv) enable rapid response to disruptions in sewerage services resulting from system failures. A sewerage network will be constructed at Kesebelau (Airai) connecting the residential and commercial dwellings to an STP.*

ii. ***Sewage treatment and disposal meets Palau's environmental standards.*** *Sewage collected in the Koror and Airai sewerage networks will be treated at new STPs to be constructed at Koror and Airai. Effluent from the new STPs will meet Palau's environmental-discharge quality standards. The STP in Koror will be consolidated on a much smaller footprint further from the coast than the existing STP, protecting the infrastructure from future storm-surge damage and releasing land for tourism development.*

**ADB project loan of $29 million under disbursement to renovate the Koror Airai water and sewer system:** A project loan of $30 million, of which $28.8 million is being provided through ADB loan resources, was proposed to remedy the situation. The original loan package was presented to the board of the ADB in October 2013, but after loan effectivity the project was very slow to get off the ground. However, momentum has now picked up and close to $18 million was disbursed by the end of the first quarter of 2019. Project works are scheduled for completion and commissioning during 2019.

**KASP II with funding of $25 million required to complete renovations:** A recent review of the project indicated significant cost overruns of

1 See ADB, Proposed Loan, Republic of Palau: Koror-Airai Sanitation Project, Project Number 42439, October 2013.

$11 million and the need for an additional $15 million to fully rehabilitate the Koror sewerage network. As a result, the ADB has designed a second phase for the KASP of $25 million to fully complete the project. At the present time, the government is awaiting sufficient progress to be achieved with the original project before considering and proceeding to phase II. It is understood, as in the case of phase I, that the additional financing costs will be incurred by government and on-lent to the PPUC.

**If KASP II implemented considerable further tariff increases required to achieve commercial viability:** Clearly, the additional tariff increases required to service KASP phase I plus make up for the current operating income shortfall will be significant. The American Water Works methodology for tariff estimation[1] and projections from a recent financial assessment and strategy[2] suggest that the PPUC's total water and wastewater operations revenues need to rise by a further $1.5 million if only KASP I is completed and by $3.2 million, or 48 percent, if KASP II goes ahead. These are clearly significant increases for a sector that has already been subject to large increases under the WISP program and will require strong political commitment by government.

1 Tariffs are calculated on a cash basis to cover all cash expenditures including such commitments as debt service. Noncash items such as depreciation are not included.

2 See PPUC TA-8565, Financial Assessment and Strategy, Koror Palau 2018.

# 7. The Financial Sector

**The commercial banking sector after a period of bank closures and collapse in the early 2000's has subsequently consolidated and is now well regulated by the Financial Institutions Commission. Social protection is afforded through the Social Security Administration and Civil Service Pension Fund. The Social Security System although fragile is well managed and sustainable. The CSPF on the other hand is underfunded and projected to collapse**

- The deposit base of the commercial bank system has risen rapidly in recent years reflecting the booming tourism sector, enhanced profitability and large inward foreign investment flows. Public sector deposits have also grown reflecting the substantial fiscal surpluses at the national government and receipts from the State park in Koror.
- Commercial bank lending in Palau has, however, been very weak with a loans-to-deposit ratio of a mere 13 percent. Lending to the commercial sector is even more disappointing with only 3 percent of deposit liabilities being lent out. The result has been financial disintermediation and a large build-up of foreign assets.
- The Social Security system currently operates with a funded ratio (assets to liabilities) of 34 percent. Benefits are projected above contributions, but earnings on investments are projected to cover the shortfall and thus, while fragile, is likely to remain sustainable subject to market risk.
- With a funded ratio of only 9 percent Palau's Civil Service Pension Fund (CSPF) presents a significant challenge. Without reform, the CSPF is projected to collapse in the late-2020s, at which time the cost to government is projected to be 1.3 percent of GDP annually, or approximately $6.0 million annually. Reforms are urgently needed and proposals have been made, but to date only minimal actions have been taken.

# 7. The Financial Sector

## A. Money and Banking

**The use of US currency in Palau limits macroeconomic policy adjustment to fiscal policy:** With the adoption of the US currency in Palau, macroeconomic policy and adjustment has been limited to fiscal policy. The use of a foreign currency is practiced in many other small-island economies of the Pacific and has served Palau well. While the range of macroeconomic policy options is limited, the use of US currency has removed the potential to use inflationary monetary policy to adjust to changes and reductions in Compact funding. Consequently, Palau has no means of adjusting to reduced levels of resource transfers, other than the more politically painful policy of directly cutting government expenditures, reducing public sector employment and wages, and increasing domestic revenues. Furthermore, the use of a foreign currency has removed exchange rate realignment, encouraging the export and traded-goods sectors of the economy. At this stage of economic development in Palau, with many underlying structural impediments, exchange rate adjustment without accompanying supporting policies would be unlikely to have encouraged a favorable supply response in traded-goods production.

**The banking system in Palau is regulated by the Financial Institutions Commission** (FIC), which is governed by a board appointed by the president of Palau. The FIC is managed by an executive commissioner and is staffed by a bank examiner and administrative staff. The bank examiner conducts off-site and on-site bank examinations, which include, but are not limited to, quarterly and annual analyses of individual bank and sector-wide financial returns and financial-sector statistics. There are five licensed banks in Palau, three of which are FDIC approved (Bank Pacific, Bank of Guam and Bank of Hawaii) and two of which are not (Asia Pacific Commercial Bank and the Palau Construction Bank). While the FDIC banks provide a full range of banking services, the non-FDIC banks are restricted to operating savings accounts only. Legislation to permit the National Development Bank of Palau (NDBP) to take deposits has now come into force, and once licensed, the bank would come under the regulatory inspection of the FIC. Before being granting a license, the bank will be required to meet all the normal capital-adequacy and regulatory requirements commercial banks are required to fulfill. In the early part of the 2000s, there were eight banks operating, three of which have subsequently gone out of business and had operations shut down. After a turbulent period of restructuring, the sector has settled down and now operates under an effective regulatory environment. Given the historical perspective, the sector requires a well-developed supervisory capability and careful monitoring. Given the establishment of the FIC at the end of 2009, the current statistical series and analysis is restricted to the period since that date.

**Deposit interest rates mirror US rates, but lending rates are considerably higher reflecting the risk of doing business in Palau:** Since there is no independent monetary policy, domestic interest rates are closely aligned with those in the United States. Deposit interest rates are broadly equivalent to those throughout the US. In FY2010 the average three-month deposit rate was 0.7 percent (see statistical appendix). It increased in subsequent quarters but fell to 0.2 percent by the end of FY2012 and remained at that level through FY2018. As in many developing countries, financial intermediation is accompanied by a substantial spread between lending and deposit rates, and lending rates are significantly higher, reflecting the additional risk and costs of doing business in Palau. Interest rates on loans and overdrafts have been relatively stable during the period of available statistics, ranging from a high of 12.5 percent to a low of 9.7 percent, where they stood at the end of FY2018. Rates for individual-based loans (predominantly consumer) have fallen over recent years from 13.5 percent at the end of 2009 and stood at 10.7 percent at the end of FY2018. Rates on mortgage-backed lending, which is only a small part of the commercial banks' portfolio, stood at 15 percent at the end of FY2018, and are relatively high perhaps because of the longer term coupled with the perceived difficulty of foreclosure.

**Deposits rose rapidly during the tourism boom reflecting profit growth and FDI inflows, but subsequent flattening as the economy weakened:** Major trends in lending, deposits and foreign assets in the RoP banking sector from FY2010 are shown in Figure 38. The figure indicates that after modest increase in deposits through FY2013, there was a rapid increase through FY2016, and subsequent flattening as the economy weakened. During the period, deposits grew by an annual average of 14 percent. The rapid rise in deposits since FY2013 reflects a set of driving forces. Nonfinancial corporations' deposits had grown very rapidly, reflecting a build-up of profits from the booming tourism industry and possibly working capital to finance hotel construction. However, after FY2016 nonfinancial-corporation deposits fell, reflecting the decline in the economy. For the national government deposits rose through FY2017 but then leveled off in FY2018 reflecting the tightening fiscal position. For Koror state deposits grew exponentially with the rising receipts from the State park through FY2016. In the last few years deposits have contracted reflecting the need of the State to finance operations from reserves as visitors contracted and with the closure of Jellyfish lake. Individual deposit accounts have grown consistently through FY2018 by 9.5 percent reflecting increasing small-business profitability and receipt of large land-lease payments from overseas investors.

**Lending to the private sector is weak in Palau and the loans-to-deposit ratio declined during the period:** On the lending side, performance is weak and far from satisfactory. The level of outstanding credit increased from $27 million FY2010 and rose to $37 million in FY2018. The difference between loans and deposits indicates the large level of liquidity in the Palauan banking system and is another example of a widely observed phenomenon in the Pacific Islands region: capital is not a factor of production in short supply. Reflecting the trends described above, the loans-to-deposit ratio fell from 28 to 13 percent. The large difference between deposits and loans is invested offshore, and, mirroring the difference in the trends in deposits and credit, the level of foreign assets rose from $75 million in FY2010 to $254 million by the end of the period.

**While consumer lending has grown modestly lending to the commercial sector is very weak:** Figure 39 indicates the extension of credit to the private sector in the consumer and

**Figure 38**
Commercial bank loans and depositis (end of period)

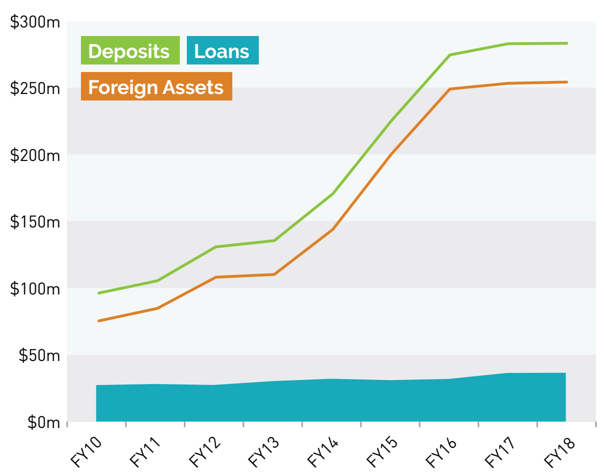
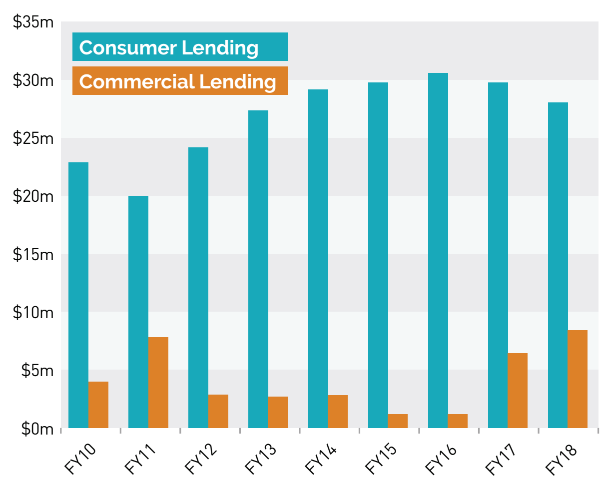



**Figure 39**
Commercial bank credit by sector (end of period)



commercial markets. Consumer credit fell at the start of the period as banks reduced lending reflecting a lack of confidence in the economy and the impact of the recession. However, as the economy improved and confidence returned, consumer credit picked up growing by an average rate of 9 percent through FY2016. In the last two years consumer credit has fallen reflecting the weakening economy. The picture for commercial credit is nearly all unfavorable. The level is exceedingly low: averaging $4.2 million during the period and was only 3.0 percent of current deposit liabilities in FY2018. The recent increase in commercial credit in the last two years is a favorable development if it is sustained into the future.

**Rather than acting as a basis for financial intermediation, the banking system in Palau disintermediates:** it acts as a source of funds, and the proceeds are invested in Guam or the US mainland, where risk is lower. While the banking sector is clearly risk averse, there are many other impediments to lending. The lack of ability to prepare business plans, scarcity of equity and inability to maintain financial statements (in the absence of any requirement to submit financial statements for business income tax purposes) hinder development of bankable projects. A series of reforms is required, including revisions of the bankruptcy law, commercial code, and land-lease statutes. These issues are taken up in greater detail in chapter 8 on private sector development.

## B. Social Protection

### SOCIAL SECURITY

Unfunded liability falls from 46 to 34 percent, but remains above others in the region: Based on the actuarial evaluation[1] completed in October 2014 relating to FY2013 and updated for 2014 and 2015, Table 6 indicates the status of the Social Security Fund. The accrued liability, with respect to active workers, inactive workers, and retirees and other beneficiaries was $202 million in 2013 and rose to $268 million by 2015. The value of the assets of the fund was $93 million in 2013 but fell to $91 million in 2015, indicating an unfunded liability of $108 million rising to $177 million in 2015. The funded ratio of assets to liabilities fell from 46 percent to 34 percent over the period. Despite the significant loss in fund status, when compared with other social security funds in the region the situation is less unfavorable.

**Law changed to improve Social Security financial viability, but subsequent increase in benefits undermines long-term stability:** Effective October 1, 2013, the law was amended to improve the viability of the fund and adjust the benefits for changes since the last legislative action taken by the OEK. Taxable earnings were raised from $5,000 to $6,000 per quarter effective October 2015 and to $8,000 effective October 2017. The taxable limit was to be removed in October 2020. The retirement age of 60 was raised to 62 as of October 2015 and will be raised to 63 from October 2020 forward. Other significant financial changes include an increase in the basic benefit from $98 per quarter to $148. As part of the FY2017 budget, an additional benefit of $50 per month was awarded to beneficiaries and the government transferred $2 million to support the payment. At the start of 2018, the 6 percent contribution rate for both employees and employers was raised to 7 percent to pay for the increase in benefits and the cap on taxable wages removed. While these changes significantly improved the status of the fund, a further monthly benefit of $50 was awarded in 2018, thus returning the viability of the fund to where it was before the increase in contribution rates. To maintain the solvency of the fund further transfers or possibly increases in tax rates will be required.

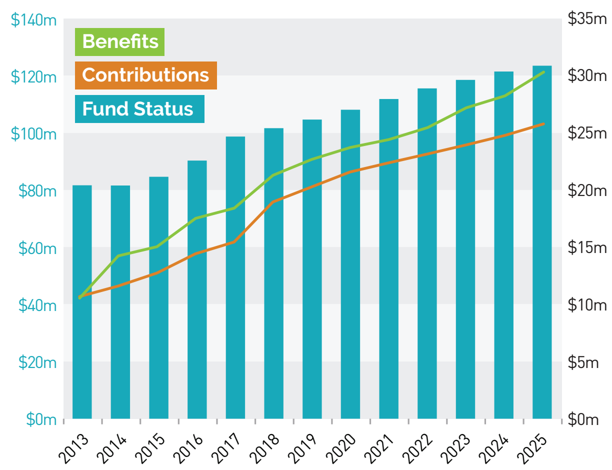
**An SS projection and assumptions:** A projection of a likely growth of the contributions, benefits and fund status is shown in Figure 40. The estimate for benefits adopts the projections in the 2014 actuarial report, while the value of contributions uses the projections of compensation of employees indicated in the long-term projection section of this review. The annual change in wages is estimated at 3.5 percent, which is below the actuarial assumption of 5 percent. The recent two increases of $50 per

1 Wilshire Associates, Inc., Actuarial Valuation as of October 1, 2013, Santa Monica, CA.

month per beneficiary at the start of 2017 and 2018, respectively, and increase in contributions rate from 6 to 7 percent at the start of 2018 have been included. A market rate of return of 6.5 percent was adopted, below the 7.5 percent used in the actuarial report, to reflect current market sentiments. This is below the projected return on the COFA Trust Fund simulations in chapter 9, but the same as the actual Social Security performance.

**Projections indicate benefits greater than contributions requiring financing from investments but fund remains sustainable:** As Figure 40 indicates, projected benefits are above contributions, and use of fund earnings on investments is required to fill the gap. The 2014 actuarial study is now dated and was updated in FY2017. This will enable revised projections to be made, which will better reflect the current viability of the fund in the long term. The projections are of course subject to market risk, which may result in a less favorable outcome.

**Figure 40**
Social Security projected fund balance, contributions and benefits




## CIVIL SERVICE PENSION FUND

**Funded ratio falls to 9 percent, indicating the fund is not sustainable:** The financial position of the Civil Service Pension Fund has been far less favorable. The net pension liability stood at $182 million at the end of FY2014 and has risen rapidly to $259 million at the end of FY2018. The funded ratio of CSPF investments to total pension liability has fallen from 15 percent to 9 percent. Both employees and the public sector contribute 6 percent of earnings to the fund, and changes in law during 2013 eliminated mandatory retirement after 30 years of service, allowing employees to extend their career, increase contributions and delay benefits.

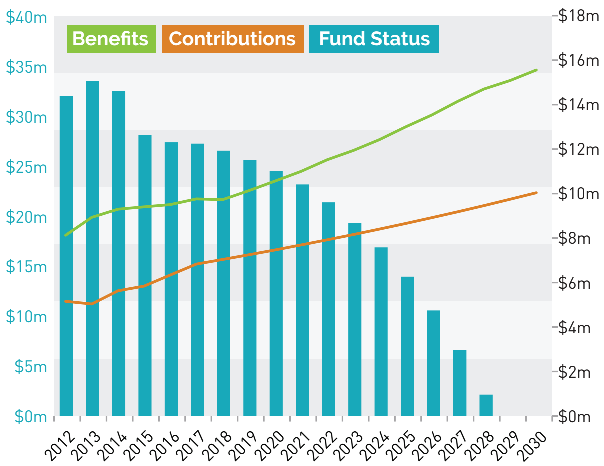
**CSPF projected to collapse in late 2020's:** Figure 41 provides a projection of the CSPF over the medium to long term indicating likely trends in contributions, benefits and fund balance. Contributions are estimated from the projections of the civil service from the LTEFF of chapter 10 of 3.5 percent growth per annum, slower than the recent historical average of 4.2 percent. Benefits are projected in line with those projected by a recent actuarial assessment[1] at 3.3 percent per annum. An investment strategy has been assumed with a 6 percent return consistent with conservative management of

**Table 6** Social Security valuation for 2013-2015 (US$ millions)

| | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|
| Active Workers Earning Benefits | 106.1 | | | |
| Retirees, Spouses, Children, and Disabled Workers | 74.8 | | | |
| Fully or Service Insured Inactive Workers | 20.6 | | | |
| Total Accrued Actuarial Liability | 201.5 | 240.5 | 267.8 | |
| Market Value of Assets | 93.2 | 98.0 | 90.8 | |
| Unfunded Actuarial Accrued Liability | 108.3 | 142.5 | 177.0 | |
| Funded Percent | -46% | -41% | -34% | |

1 See Cavanaugh MacDonald Consulting LLC, "Republic of Palau Civil Service Pension Plan: Actuarial Study, October 1, 2017

**Figure 41**
Civil Service Pension Scheme projected fund balance, contributions and benefits.




a portfolio in imminent danger of collapse. The results indicate a declining fund balance as benefits outstrip contributions with fund collapse projected for late 2020's. While the timing of the eventual collapse cannot be known with surety the basic facts imply a system under threat and the projections emphasize the urgent need for remedial action.

**CSPF management proposes reforms:** Several reforms have been proposed by the board and fund management to increase contributions from the current 6 percent to 10 percent for both employees and employers. It was also proposed to increase the mandatory retirement age from 60 to 62, although none have been actively taken up. As part of the marine-sanctuary bill passed in 2015, the law provided for a further $50 increase in the PPEF, of which $25 was to be devoted to the CSPF. The marine sanctuary act was subsequently revised and in order to maintain compliance with IATA rules, the $25 reserved for the CSPF was reallocated to the Palau International Airport. However, the law also stated that monies that otherwise would have been appropriated for the PIA would be allotted to the CSPF. However, in FY2018 only $534,650 was allotted.

**Actuarial study commissioned to recommend viable options for comprehensive reform:** The study recommended (i) no changes to current beneficiaries, (ii) increase the retirement age to 65 over a period of time, (iii) implementation of a defined contribution scheme in tandem with the existing defined benefit plan and reallocate the existing 2 percent benefit to 1 percent each under both DB and DC schemes, and (iv) invite private sector participation. Contribution rates were set to remain at the existing levels. The details provided in the FY2018 CSPF audit are insufficient to estimate financial viability of the proposals.

**Proposal to use tax policy to fund the CSPF not appropriate, but reforms are long overdue:** As a general principle, it would not be appropriate to use tax policy to fund expenditures related to civil servants (even though the PPEF is levied on non-citizens). More appropriate would be an increase in contributions. However, the proposed rate increase is large and perhaps a combination of both might be more appropriate. Less desirable have been changes in law creating a 4 percent remittance tax on transfers to be earmarked for the fund. This tax is not applicable to commercial bank transfers, acts as a tax on money-transfer agencies, and is effectively a distortionary tax on low-income foreign workers. In FY2018, the tax provided $0.4 million to the fund, and although the CSPF needs every penny it can get, the tax is demonstrably inequitable.

# 8. Private Sector Development

**The World Bank's Doing Business Survey paints a weak environment for private sector development. Out of 190 countries, Palau currently scores 133, 70 percent down the list, indicating that there is much room for improvement. However, despite the poor ranking Palau has an active and thriving private sector that created prosperity and has been the engine of growth of the economy.**

- In late 2013, Palau convened its first economic symposium and as a result it was agreed to form an Economic Advisory Group, tasked to provide advice to the government on a wide range of issues relating to private sector development. Since the original symposium a further three symposiums have been convened but the absence of follow up meetings since the last in early 2017 is indicative of a loss of momentum.
- Like many Pacific island nations and developing countries land has been identified as a significant constraint to development. Land can only be owned by Palauans, and as a result cannot be used as collateral by foreign owned banks. However, long-term leases up to 99 years are permissible and have allowed significant foreign participation in the economy.
- Commercial lending in Palau is a weakness of the banking system which has one of the lowest loans-to-deposit ratios in the region. The current usury law prohibits lending at rates greater than 4 percent above corporate loans at large US banks. This is an unusual application of usury prohibitions and effectively represses more risky lending to businesses at rates that would be above the permitted ceiling. It is thus not surprising that few commercial loans are made in Palau. The lack of financial information held by businesses has also been identified as a major constraint in preparing loan applications.
- The foreign investment legislation in Palau has recently been amended and is implemented through a Foreign Investment Board. The law prohibits foreign investment from restricted areas of economic activity. The application process is lengthy and requires a level of evaluation expertise that the FIB has yet to acquire. The prevalence of "front" businesses in Palau is reportedly widespread, but enforcement of the law has proven difficult.
- There are many other areas of weakness in the regulatory environment for the private sector including the need for reform of the companies act, creation of a modern on-line corporate registry, centralization of licensing, and implementation of a bankruptcy statute. A "one-stop" shop approach has been proposed and would likely be welcomed by potential investors.

# 8. Private Sector Development

## THE ECONOMIC ADVISORY GROUP AND ANNUAL ECONOMIC SYMPOSIUM

**Economic Advisory Group formed, and Economic Symposium convened:** In November 2013, Palau convened its first economic symposium with two major objectives: to formalize public sector–private sector dialogue, and to attain consensus on specific actions (derived from the medium-term development strategy) to be implemented over the following year. The symposium agreed that similar meetings would be held annually to facilitate dialogue between the private and public sectors, and three subsequent meetings have been convened: in November of 2014 and 2015, and February 2017. As a result of the first symposium, it was agreed that the Economic Advisory Group (EAG)[1] would be formed, and this was subsequently accepted by the president. In practice, the economic symposium sets the agenda and priorities for the work of the EAG.

**EAG covers wide area of private sector policy issues:** A long list of important areas of economic policy has been raised at the economic symposiums and has been followed up on by the EAG. The areas include such items as tax reform and introduction of a VAT, adoption of an SOE policy and a national investment policy, update of the fiscal strategy, development of a micro-, small- and medium-enterprise policy, and changes in labor policy, land-use planning, tourism policy, corporations law and bankruptcy law, to name a few. Overall, the symposium and EAG have highlighted and encouraged a lively debate on critical policy areas that need to be addressed and provided a venue for an open private sector–public sector dialogue. A further symposium was planned for 2018 with the main topic of tax reform. However, the symposium was postponed and although still planned has failed to materialize. This is unfortunate as the venue provided a beneficial forum for private-public dialogue and discussion of important policy issues.

## LAND POLICY [2]

**Structure of land holding is problematic and inhibits economic development:** Land issues have long been identified as a significant constraint to private sector development in Pacific nations, and Palau is no exception. Palauan culture has evolved over centuries, and land rights and land use are interwoven with national identity. In Palau, land may only be owned by Palauan citizens and is owned by individuals, clans and the government. During the period of Japanese occupation, the country was surveyed, but many documents were destroyed, and by the end of 2014 about 14,000 parcels had been processed out of a total of 18,000.[3] The lack of clarity on land rights has led to a large number of disputes, which are adjudicated by the land court. Land can be bought and sold by Palauans without any form of transfer tax. A particular problem 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. This can be overcome through the use of trusts, although this is rarely used. In effect, the only institution that can issue mortgages against land or land leases is the National Development Bank of Palau.

1 The EAG is jointly chaired by the minister of finance and the Chamber of Commerce. Its members consist of the chairmen of the Ways and Means Committees in each house of the OEK: directors of finance, infrastructure and tourism; members of the Chamber of Commerce; and other directors of government departments who attend on an as-needed basis.

2 This section and those following draw heavily on the excellent private sector assessment (PSA) of Palau: Policies for Sustainable Growth Revisited: A Private Sector Assessment for Palau, Pacific Private Sector Initiative, Sydney, Australia, 2017.

3 See PSA for Palau.

**Long-term land leases are available:** Lease terms can be issued up to 99 years, and limited duration is not a problem in Palau. However, the entry into long-term leases through a large single upfront payment can disadvantage future generations of both clans and individuals. The PSA for Palau also raises the issue that leases should be structured in such a way that the lessor has an incentive to ensure the lessee operates a successful business. This could be achieved through linking a portion of the lease payment to the revenues of the business. While the PSA indicates that the land court operates effectively, significant problems arise when a land dispute is initiated over a parcel of land already on lease and the lessee may not know who the rightful owner is. The PSA proposes a provision in law for a 90-day period after issue of lease beyond which claims would be prohibited.

**The lack of effective land-use planning in Palau is a serious weakness.** This is especially so in a tourism-based economy, where the major means to effective implementation of policy and attainment of the high-value tourism objective would be through efficient land-use planning. There is some planning in Koror State, where most of the tourism infrastructure resides, but this is the exception, and most of the nation is unregulated. There is also a lack of clarity of legal jurisdiction between the states and the national government. Development of an effective land-planning capacity in relation to tourism and the environment is one of the most critical factors to ensure development proceeds in line with policy.

## COMMERCIAL BANK LENDING

**Usury law places cap on interest rates and inhibits lending:** As outlined in chapter 7, the lack of lending by the commercial banks in Palau to the private sector is striking. The loans-to-deposit ratio was a mere 13 percent at the end of FY2018, and 77 percent of loans were in the consumer segment. Business loans were a minuscule 3.0 percent of deposits, while the excess liquidity was invested offshore and bank foreign assets were 90 percent of deposits. There are many impediments to commercial bank lending in developing economies, but the Palau experience is extreme. A major reason cited by the PSA is the 18 percent lending cap set on consumer lending and cap on business lending at 4 percent above corporate loans at large US money-center banks. At the end of FY2015, the PSA quoted a prime US rate of 3.25 percent, implying a maximum lending rate of 7.25 percent. A survey of internet lenders revealed average rates of between 8 and 40 percent for small-business loans, rates exceeding the maximum rate permitted under the usury laws of Palau. It is thus not surprising that few commercial loans are made in Palau.

**Lack of business financial information is discouraged by outdated tax regime:** A further major issue is the lack of information on which banks would be able to underwrite loan applications. Information practices of small businesses are weak in Palau and not encouraged by the existing tax system. The current tax regime requires no record keeping of the kind that is mandatory in other economies that have business and value-added taxes. In Palau, tax filers are only required to state their gross receipts, which are not an indicator of profitability. Since most commercial banks base lending decisions on cash flow and ability to service the debt, information that would support applications is frequently missing.

**Secure transactions implemented but not widely used:** Palau introduced a new secured-transactions framework in 2012 for chattel mortgages, and in January 2013 an electronic registry was launched whereby lenders can check on the existence of loans and liens. However, take-up of the scheme has been limited, with just 663 secured interests by end of 2015. The PSA indicates that reasons for slow take-up of the scheme are that banks are already effectively limited by the usury laws, and many consumer loans are unsecured in any case. Further, foreign banks' credit decisions are determined by head-office regulations, which do not recognize the local registry. The secured-transactions framework, while an important development, has had limited impact on bank lending capacity.

## THE REGULATORY ENVIRONMENT

**Palau lacks a Uniform Commercial Code to govern commercial transactions:** Palau's legal system is based on its constitution, customary law and common law as applied in the United States.[1] In practice, since many commercial issues are not addressed under the constitution or customary law, they refer to US customary law. This is problematic since in the US, commercial transactions are governed by the Uniform Commercial Code (UCC), which was adopted in 1953. Since Palau has no UCC, courts are forced to search for precedents in US customary law prior to the adoption of the UCC. To improve commercial transactions and dealings with foreign businesses, parties need to know whom they are dealing with so that parties have recourse to a modern legal system that is able to enforce contract provisions. The current legal system as it relates to commerce in Palau is thus under urgent need of reform so the nation may engage on a secure basis with the international economy.

**Reform of Companies Act is needed along with creation of a modern on-line electronic corporate registry:** The PSA review indicates that the current Companies Act is not suited to modern commerce, and the company registry is functioning poorly. The law contains only guidelines, with important details delegated to the regulations. Many of the provisions are outdated, such as the requirement that three incorporators must appear before the clerk of the supreme court to sign documents and that all new companies must be approved by the president of the nation. A modern approach adopted in the South Pacific is a law that clearly states the requirements for creating a company. Standard forms are available for online filing and checked by the registrar for compliance. Current procedures for searches require a time-consuming submission in writing of paper documents in a poorly maintained filing system. A modern, electronically maintained system provides publicly available information about shareholders, directors and company officers in an efficient manner. This would enable the public to know who is authorized to enter into agreements on behalf of the company and would provide addresses to which legal documents can be delivered. Palau has draft legislation for a new reformed Companies Bill,[2] which would create a modern electronic framework, but this has yet to be considered by the OEK.

**Centralized licensing needed.** The PSA indicated the large number of requirements, permits, and licenses a business is required to fulfill to operate in Palau. Many of these problems could be reduced through centralizing the system and creating the electronic corporate registry and administrative merger of the different agencies currently granting approvals into one office.

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

## FOREIGN DIRECT INVESTMENT

**Foreign investment act amended:** Foreign investment in Palau is governed by the Foreign Investment Act, which has been recently extensively amended. The initial section of the reformed law indicates the general intent of the legislation:

> *The Olbiil Era Kelulau finds that one of the best available means to encourage the expansion of Palau's private economic sector so as to help create a more broad-based and sustainable economy is to modernize and incentivize the Foreign Investment Act. The creation of a broad-based sustainable private sector economy in Palau will help lessen our people's dependence on government as the preferred and primary source of employment and livelihood in Palau by creating alternative, private sector jobs and other business opportunities for Palauan citizens and residents.*
>
> *The Olbiil Era Kelulau further finds that private business within the Republic of Palau must be protected. In effect, a proper balance must be found that encourages foreigners to invest*

1 See PSA for Palau.

2 The Private Sector Development Initiative has provided advice to the government on the draft bill.

> *money in the Republic of Palau to create a vibrant economy and lift up the livelihoods of all, while at the same time protecting Palauans from foreigners who could swallow up their ability to compete. This bill maintains the local ownership requirements set forth in 28 PNC § 105, while expanding the incentives for foreigners to invest and easing the bureaucracy toward obtaining a license.*

**FDI governed by the Foreign Investment Board:** All non-citizens wishing to operate a business in Palau must obtain approval from the Foreign Investment Board (FIB). The functions of the board are (i) to review, evaluate and approve applications and proposals for foreign investment; (ii) to monitor and enforce compliance with the terms and conditions of any foreign-investment approval; and (iii) to monitor and perform spot inspections of any business enterprises by the board or its designees to enforce compliance with the FDI law.

**Wide spread use of front-business in Palau:** An issue of particular concern in Palau has been that of "front" businesses: businesses that are legally owned by a Palauan but effectively operated by non-citizens. The prevalence of fronts is reported to be widespread and has led to significant parts of the economy being operated illegally by foreigners. However, the true prevalence of fronts is not known with any accuracy. The amended foreign-investment law was thus designed in part to establish a mechanism to tighten the rules on fronts and bring enforcement of the law within the FDI Act.

**FDI law restricts investment in specified sectors of the economy:** The FDI law specifies certain sectors in the economy that may be operated by non-citizens provided there is a Palauan partner. These include handicrafts, bakeries, bar services outside hotels, manufacturing in industries already under Palauan operation, rentals, harvesting farm-raised fish, and any others deemed allowable by the FIB. A second list relates to businesses that can only be operated by Palauans: wholesale and retail trade, land transportation, water-based tours, travel and tour agencies, commercial fishing (other than migratory) and any others deemed as such by the FIB. In effect, the law restricts entry into agriculture, fishing and ancillary tourism services.

**A substantial list of requirements is specified, including the following:**

i. Minimum investment must be $500,000, or $5 million if the investment is in the hotel sector, an investment that must be certified annually by a certified public accountant.

ii. A minimum of 20 percent of the workforce must be Palauans, unless the FIB sets an alternative.

iii. No more than 5 percent of ownership of a business may be transferred in any year.

iv. One board meeting must be held each year in Palau.

v. An annual fee of $500 per employment of non-Palauans.

**Criteria for FDI approval are frequently inappropriate:** Clearly, the requirements for foreign investors are high. The minimum-investment requirements are high for businesses that may not require significant capitalization. The 20 percent rule is difficult to achieve in an economy where Palauan labor is fully employed. As the PSA indicates, the requirement to hold annual meetings in Palau and limitations on sale or transfer of equity for large foreign companies (in Palau's case, large hotel operators) would likely be seen as highly restrictive to foreign investors. The $500 fee for employment of foreign nationals may seem appropriate in a developing economy where there is unemployed local labor; in Palau, there is not.

**Law requires approval process that FIB does not have the capacity to implement:** In addition to the requirements for any foreign investor, the FDI law lists a long set of criteria the FIB should consider in evaluating any application (a limited set of the 14 criteria is included here):

i. economic need for the proposed activity in the republic;

ii. the likely impact on same or similar activities currently being carried on by citizens;

iii. the overall benefit to the national economy;

iv. the bona fides, financial capacity, experience and expertise of the applicant;

v. the technical and economic viability of the proposed project;

vi. the overall contributions to the national economy;

vii. the extent of direct and indirect employment generation; and

viii. whether the capital investment and technical and managerial skills required for a business activity are such as to be within the capacity of citizens.

**Evaluation criteria best assessed by private sector investors not public servants:** The abbreviated list provides a flavor of the evaluation criteria, which would require local capacity and skills of the FIB that do not exist in Palau even with the enlarged FY2017 budget. More importantly, these types of questions are beyond the purview of public servants. They belong to the private sector, whose function is to take risk and invest accordingly. In addition to the evaluation criteria of the FIB, there is an equally long list of information that foreign investors are required to submit to the board to obtain a license and as part of the annual reporting requirements.

**The FDI law also provides powers to the FIB to establish whether a Palauan business is acting as a front:** The law includes a long list of factors that indicate but do not necessarily identify a front business. As mentioned above under the functions of the FIB, capacity to undertake unannounced spot checks is high on the agenda. Finally, the board is able to impose penalties on the local and foreign partners of fronts and revoke business licenses issued to the Palauan partner.

**FDI law reflects old style approach. However, despite unattractive regime business community thrives:** Rather than what is now considered "best practice," where simplicity is the rule and the role for discretion of civil servants is kept to a minimum, the provisions of the amended FDI law are extensive and reflect an old-style approach to FDI. As the PSA indicates, implementation of the original FDI regime was ineffectual, but whether the amended law will be any more successful remains to be seen. Failure to implement the law has encouraged the wrong type of investor—namely, the type prepared to flout the law—and encouraged good investors prepared to respect the law to look elsewhere rather than fulfill a long list of onerous requirements. As a result, legislators have tried to tighten the requirements, but if the law continues to be flouted, it will further encourage fronts as good investors move elsewhere when put off by the onerous provisions of law. Palau has been fortunate to have a vibrant business community, and the growth in the economy reflects this, despite an unattractive FDI regime.

## THE WORLD BANK DOING BUSINESS SURVEY

**Palau scores 133th out of 190 nations survey by the World Bank indicating substantial**

**Table 7** Ease of Doing Business, World Bank ranking

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|
| Ease of doing business overall rank | 116 | 111 | 113 | 136 | 136 | 130 | 133 |
| Starting a business | 124 | 130 | 111 | 116 | 120 | 124 | 129 |
| Dealing with construction permits | 39 | 44 | 66 | 101 | 98 | 85 | 95 |
| Getting electricity | 80 | 78 | 98 | 138 | 138 | 140 | 149 |
| Registering property | 20 | 17 | 21 | 46 | 44 | 43 | 43 |
| Getting credit | 182 | 185 | 71 | 79 | 82 | 90 | 99 |
| Protecting investors | 174 | 177 | 183 | 182 | 179 | 177 | 180 |
| Paying taxes | 97 | 83 | 132 | 131 | 118 | 107 | 106 |
| Trading across borders | 124 | 108 | 105 | 155 | 163 | 133 | 137 |
| Enforcing contracts | 144 | 146 | 127 | 130 | 126 | 126 | 126 |
| Resolving insolvency | 61 | 71 | 167 | 166 | 166 | 166 | 166 |

**room for improvement:** As indicated in the symposium's list of initiatives, reducing Palau's ranking in the World Bank's Doing Business Survey was an important objective. Table 7 indicates Palau's ranking for each of the 10 major categories, which changed little between 2012 and 2014, lost a lot of ground in 2015 and remained unchanged through 2018. Overall, Palau currently scores 133th out of a total of 190 countries, 70 percent down the list, suggesting there is much room for improvement. Palau fares better than the FSM and RMI, which are ranked 160th and 150th, respectively, but is substantially worse than most of the South Pacific nations. Tonga is ranked 91st, Samoa 90th, Vanuatu 94th, Fiji 101st, and Papua New Guinea 108th.

**For most categories Palau scores in the bottom 1/3rd and only in the top half in one category for registering property:** Overall, Palau's scores are generally weak. Protection for investors is particularly poor, but it is interesting to note that the ranking for getting credit improved in 2014 from 185th to 99th by 2018. The improvement probably reflects the establishment of the secure-transactions registry in January 2013, although the level of outstanding credit to the private sector remained at very low levels in FY2018: $8.4 million. This is just 3 percent of GDP and indicates while the conditions for lending to the private sector may have improved, the commercial bank sector remains exceptionally weak. Ease of paying taxes has been improving now ranking 106th despite there being no changes in the tax regime or regulations, implying that the scores of other countries have deteriorated. Also, the score for resolving insolvency deteriorated significantly in 2014 without any apparent changes in Palau. While the World Bank's Doing Business Survey is a useful metric and overall country scores accord with intuition, individual rankings of the particular categories would appear subject to a wide margin of variation from year to year for no apparent reason.

# 9. The COFA Trust Fund

**An enlightened feature of the original Compact was the creation of a Compact Trust Fund (CTF). The CTF was designed as a sinking fund to provide $15 million annually in nominal terms through the 50th year of the Compact (FY2044); this approach differs from the Trust Funds created later for the amended Compacts with the FSM and the 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 of the end of the initial 15-year period (the end of FY2009), the trust fund value of $144 million reflected an average rate of growth of 7.47 percent. Thus, the Compact Review Agreement (CRA) included reductions in planned withdrawals and additional CTF deposits over the period FY2010–FY2023, in order to achieve the CTF's original objectives.**

- Palau has a stated objective of converting the CTF into a perpetual fund.
- Over the CTF's 23.67-year period through the end of FY2018 the CTF value of $293.3 million reflects deposits of $66 million in 1995, $4 million in 1997, and $62.5 million at the end of FY2018 (pursuant to the CRA) coupled with an internal rate of return of 7.8 percent annually over the whole period.
- A stochastic simulation of the CTF through FY2044 has been used to model market risk, and to evaluate various rules designed to attain a perpetual fund with a high degree of confidence.
- Three objectives of the CTF have been identified:
  - Protecting the real value of the corpus;
  - Protecting the real value of distributions, and
  - Protecting against fund collapse.

A scoring mechanism is proposed for each of the objectives to evaluate the performance of the different rules. Four different rules are evaluated:

- The COFA arrangements with a nominal drawdown of $15 million per annum;
- Modified arrangements with a real drawdown of $15 million per annum;
- The Sustainability Adjustment for Enhanced Reliability rule (SAFER), with adjustments for tail risk; and
- RoP++, under which Palau makes additional contributions equivalent to 2.5 percent of GDP.

The first two variants produce performance results of 78 and 80, respectively, while SAFER attains a score of 85, still below the target of 95. The final variant, ROP++, with additional contributions to the CTF, exceeds the target with a score of 96.

# 9. The COFA Trust Fund

## A. Compact Trust Fund Performance (Analysis Based on Data through FY2018)

### BACKGROUND

**The assumption of a sustained CTF growth rate of 12.5 percent per annum proved to be utterly unachievable:** An important feature of the original Compact of Free Association was the Compact Trust Fund (CTF), which had the mutually agreed objective of providing $5 million annually from FY1999 to FY2009 and then $15 million annually for Palau's government operations through FY2044 (the end of the 50-year period of the Compact). For reasons difficult to definitively discern, the assumed rate of return for the CTF was 12.5 percent annually. This assumption was surely influenced by the high interest rates prevailing at the time of the original negotiations; however, by the time the CTF was actually invested in February 1995, such a sustained rate of return over an extended period was clearly going to be difficult, if not impossible, to achieve using a prudent investment policy. As it turns out, and as described below, the CTF has performed satisfactorily relative to US market benchmarks for stock and bond returns during the 14 years and 8 months from February 1995 through the end of FY2009 and the 23 years and 8 months through the end of FY2018.

**The current board-governance mechanism for the CTF has proven itself effective:** This review will not comment extensively on the governance of the CTF. However, it should be noted that the management of the fund has clearly been consistent with the Compact and subsidiary-agreement requirements, with the possible exception that oversight and reporting to the US government has been less robust than was anticipated. For most of its life, the CTF has been managed by a board of trustees, under RoP statutory authority, that set the initial investment policy and enacted modifications of that policy on four subsequent occasions, as detailed below. For the seven years through mid-FY2014, the management was more or less by an ad hoc committee made up of the minister of finance and the chairs of the relevant committees in the House and Senate of the OEK. Since mid-FY2014, the CTF has once again come under a statutory board-governance mechanism. This seems appropriate when considering the following two factors: (i) the relative importance of the CTF to Palau's future fiscal stability; and (ii) concern about the lack of transparency of certain withdrawals made in FY2011 and FY2012. Those withdrawals, while arguably consistent with the letter of the Compact law and its subsidiary Trust Fund Agreement, certainly did exceed the Compact-assumed annual withdrawal level of $5 million annually by $2 million in each year. Fortunately, Palau restored the excess withdrawals as of the second quarter of FY2013; however, there was a recognized need for greater transparency and improved control mechanisms in the day-to-day management and broader investment-policy oversight of the CTF as embodied in the re-established board-governance mechanism.

**Palau increased diversification and lowered total cost of investing:** Starting in January 2014, the CTF Advisory Committee revised the Investment Policy Statement, and this was further revised and officially confirmed by the CTF Committee in April 2014. The five separate strategic asset allocations that have been in place from the outset are detailed in Table 8. It should be noted that the substantial transition to the new investment strategy, including a shift from the more expensive investment-advisory and custody arrangements that prevailed from the outset through early 2014, is deemed for the purposes of this review to have started on April 1, 2014. In fact, the transition began as early as February 2014 and was not fully implemented until June 1, 2014.

## CTF PERFORMANCE

**CTF growth performance has been well-managed with growth greater than that forecasted going forward:** Switching to a review of CTF performance, Figure 42 shows the projected values using the originally projected investment rate of return of 12.5 percent, juxtaposed with the actual results through both FY2009 and FY2018. Over the 23.67-year period, the actual final value through the end of FY2018 of $293.3 million reflects deposits of $66 million in 1995, $4 million in 1997, and $62.5 million at the very end of FY2018 coupled with an internal rate of return—also known as the asset-weighted growth rate—of 7.8 percent annually. Notably this is slightly higher than the nominal growth rate implicit in the forecasts for the CTF period going forward.

**The shortfall in the CTF at the end of FY2009 was unavoidable and would have been worse absent Palau's discipline:** As of the end of the initial 15-year period (the end of FY2009), the trust

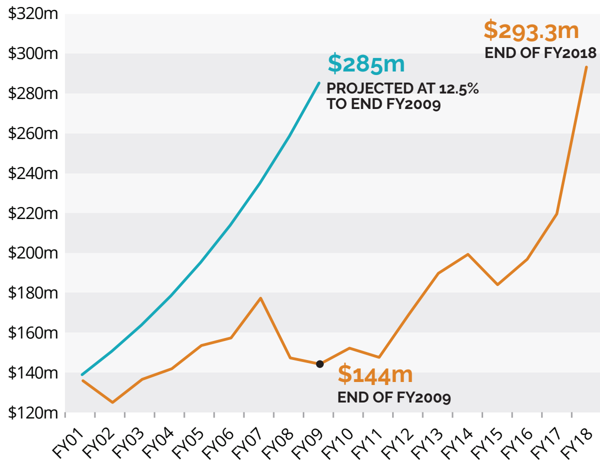
**Table 8** COFA Trust Fund Investment Strategic Asset Allocation Strategies, FY1995- present

(Estimates derived from Government of Palau Investment Policy Statements and Fund reports: 1995, 2000, 2003, 2014, 2017)

| | Benchmark Index | 02/01/95 - 01/31/00 | 02/01/00 - 05/31/03 | 06/01/03 - 3/31/14 | 04/01/14 - 03/31/17 | 04/01/17 - present |
|---|---|---|---|---|---|---|
| **US Public Equities** | | **60.0%** | **65.0%** | **65.0%** | **38.0%** | **38.0%** |
| Large Cap | S & P 500 | 60.0% | 65.0% | 50.0% | | |
| Large Cap Value | Russell 1000 Value | | | | 8.0% | 8.0% |
| Large Cap Core | S & P 500 | | | | 8.0% | 8.0% |
| Large Cap Growth | Russell 1000 Growth | | | | 8.0% | 8.0% |
| Small Cap | Russell 2000 | | | 15.0% | 14.0% | 14.0% |
| **Non-US Equities** | | **0.0%** | **0.0%** | **0.0%** | **25.0%** | **25.0%** |
| Developed Markets | MSCI EAFE | | | | 18.0% | 18.0% |
| Emerging Markets | Morningstar/MSCI Emerging Mkts | | | | 7.0% | 7.0% |
| **Fixed Income/Cash** | | **40.0%** | **35.0%** | **35.0%** | **19.0%** | **25.0%** |
| US Core | Barclays US Aggregate Bond | 40.0% | 35.0% | 35.0% | 6.5% | 8.5% |
| US Intermediate | Barclays US Govt/Credit Intmdt | | | | 6.5% | 7.5% |
| US High Yield | Barclays US Corp High Yield | | | | 3.0% | |
| US High Yield | BofA/ML BB-B US High Yield | | | | | 3.0% |
| US Convertibles | BofA/ML All US Convertibles | | | | | 3.0% |
| Global | Citi WGBI ex-US | | | | 3.0% | |
| Global | FTSE WGBI ex-US | | | | | 3.0% |
| **Alternative** | | **0.0%** | **0.0%** | **0.0%** | **18.0%** | **12.0%** |
| Commodities | UBS Bloomberg CM Commodity | | | | 3.0% | |
| Master Ltd Partnerships | Alerian MLP | | | | 3.0% | 3.0% |
| Real Estate | NCREIF Property | | | | 6.0% | |
| Real Estate | Wilshire REIT | | | | | 3.0% |
| Global Real Estate | Dow Jones Global Real Estate | | | | | 3.0% |
| Private Equity | MSCI World Gross | | | | 6.0% | 3.0% |
| **Total** | | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** |

Note: All allocations assumed to be re-balanced when funds are deposited/distributed and quarterly.

**Figure 42**
Original projected CTF values vs. actual, FY2001-FY2019 (9/30/18)




fund value of $144 million reflected an average rate of growth of 7.47 percent from investments starting in February 1995. However, that value was far below the original $285 million value assumed by the Compact. This is despite the fact that over that initial period through FY2009, the Palau CTF performance exceeded index performance: 7.47 percent actual growth versus 7.32 percent for the cost-free market-index benchmark for the CTF. It should be noted that Palau prudently chose not to withdraw Compact-allowed amounts of $5 million annually for the four years from FY1999 through FY2002. Without Palau's admirable forbearance, the shortfall of the CTF in comparison to assumptions would have been significantly greater.

## LOOKING FORWARD: THE IMPORTANCE OF THE COMPACT REVIEW AGREEMENT

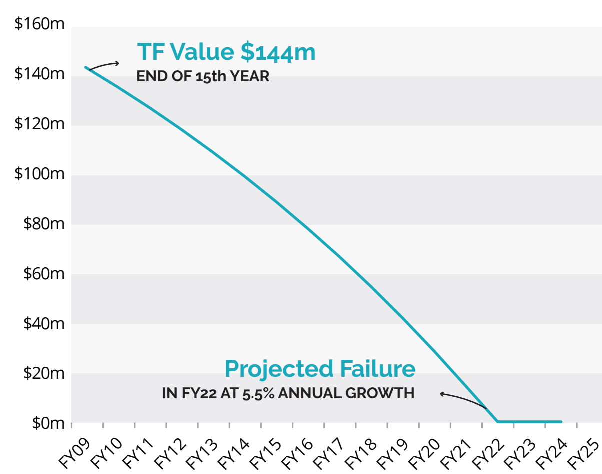
**The Compact-mandated CRA focused primarily on addressing the CTF:** The CTF featured prominently in the Compact Review undertaken by the US and Palau following the end of the 15th year of the Compact. Specifically, section 432 calls for reviews at the 15th, 30th and 40th anniversaries of the Compact. The first review was concluded with the signing of an agreement, in September 2010, to renew the economic-assistance terms of the Compact for the 15-year period from FY2010 through FY2024.

In recognition of the perceived likelihood that the CTF would not assuredly achieve its objective of providing $15 million of annual funding to the government of Palau through FY2044 (the 50th year), substantial changes were built into the agreement for both the supplemental funding of the CTF and for reducing the pace of withdrawals that would otherwise have been taken from the CTF.

**Absent a successful and fully funded CRA, the collapse of the CTF would likely have preceded the next call for review:** Figure 43 shows the nature of the projections that were reviewed after FY2009 with respect to the CTF. If the end-of-FY2009 balance of $144 million had been drawn upon as originally anticipated at $15 million annually starting in FY2010, without any sort of accommodation resulting from the section 432 review, then the results were projected to be dismal. As shown, if the trust fund had delivered returns of 5.5 percent annually, failure would have occurred just prior to FY2022, long before the mutually agreed goal of funding through FY2044, and even before the next scheduled section 432 review after the 30th anniversary of the Compact at the end of FY2024.

**The Compact Review process—tantamount to negotiations—included a systematic approach to ensure the CTF will meet its goals:** Together with other results agreed upon through the section 432 Compact

**Figure 43**
COFA TF at 5.5% from FY2009 pre-Section 432 Compact Review



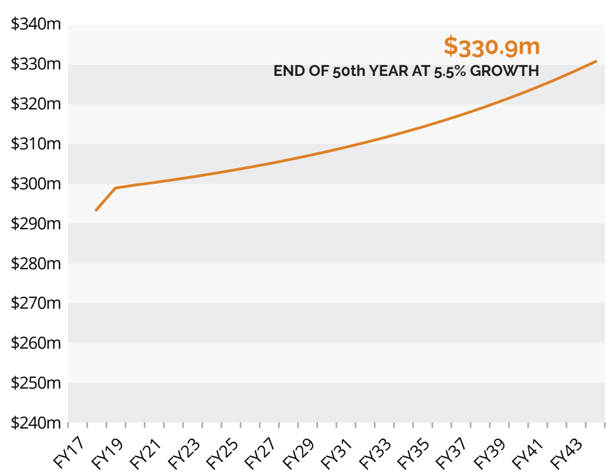
Review process, there was an agreement to "shore up" the CTF so that it would have a much stronger chance of performing through FY2044, as agreed in the original Compact. With respect to strengthening the trust fund, an important methodological agreement was reached between the US government and RoP officials. It was agreed that the earlier mistake of choosing an assumed investment rate of return that was inordinately high would be avoided. Specifically, it was agreed to use a 5.5 percent (net) investment rate of return for all projections guiding the review. As shown in Figure 43, that alone would not have been sufficient. So, in addition, it was agreed that a portion of new (annual) funding would be dedicated to the CTF. Furthermore, a substantial, though declining, flow of annual economic assistance was agreed to be provided, thereby enabling Palau to reduce its annual withdrawal rate from the trust fund. These factors combined to allow for both more reliable and more successful forward projections of the likely ability of the CTF to achieve the agreed-upon objectives through FY2044.

**Palau received the bulk of planned CRA funding during the final days of FY2018:** Following a nearly eight year delay the Compact Review Agreement funding was approved by the US Congress, signed into law by the US President and put into effect by an exchange of notes between the two governments effective on September 19, 2018. Funding was received by Palau on or about September 25, 2018. This included the all-important planned injection of $63.25 million for deposit into the Compact Trust Fund prior to the end of the fiscal year. Other amounts allow for the implementation of the CRA in a manner fairly close to that originally agreed, with modifications made to reflect the delay in timing. Effectively, Palau will have access to $18.147 million of budgetary support for FY2018, FY2019 and FY2020. The source for those funds is the additional $22.106 million provided to Palau in September 2018, plus annual draws from the Trust Fund in FY2018 at 5 million, FY2019 at $10 million and FY2020 at $14.867 million. There will be an Infrastructure Maintenance Fund for Palau can expect $2 million annually from the US for each of the seven years from FY2018-FY2024. Palau is required to match those US contributions at the rate of $150,000 quarterly for each of the six years from FY2019-FY2024. Finally, Palau is expecting a total of $20 million in infrastructure funding that it currently plans to dedicate to several key projects in the next 1-2 years.

**Looking forward, Palau will focus efforts on the daunting task to make the CTF a perpetual fund:** Figure 44 shows that the recent implementation of the Compact Review Agreement gives cause for optimism that the Compact will—under the agreed upon 5.5 percent growth rate—achieve its initial goal and persist beyond FY2044 at a size projected to be $330.9 million. That would also allow for continued drawdowns of $15 million annually. As noted below in this chapter, such a possibility enables the RoP to consider setting as a goal the transformation of the sinking CTF to a perpetual CTF—even if current estimates would require an additional $200 million to achieve that goal with a high degree of confidence. While there are other positive aspects resulting from the long-awaited funding and implementation of the CRA, such as funding for infrastructure projects and maintenance, the successful shoring up of the trust fund is surely the most important outcome to support Palau's fiscal stability and economic security going forward.

In the following section of this chapter, a more sophisticated, risk-inclusive form of analysis is used to analyze the range of outcomes that might prevail given the volatility of market returns and the uncertainty of the sequence of

**Figure 44**
COFA TF at 5.5% with Agreement as implemented in FY2018.



those returns over time. Such stochastic analysis is an important tool to augment projections as to the "success" of the CRA in shoring up the CTF to enable it to reach it's original mutually agreed goal as a sinking fund through (at least) FY2044. For example, the modeling presented below shows there is just a 4 percent chance that the CTF will fail before the end of FY2044; however, in 35 percent of the cases the CTF will be on a downward path at the end of FY2044 and will eventually fail to produce the originally agreed $15 million (nominal) annual distribution. More relevant to Palau's current and strong aspiration to transform the CTF into a perpetual fund that produces $15 million in real, inflation-adjusted terms post FY2024 and in perpetuity, the analysis below shows there is a long way to go to achieve such an admirable goal in pursuit of inter-generational equity and parity with its sister Freely-Associated States.

## B. Simulating the CTF through FY2044 Subject to Market Risk

**Existing COFA Trust Fund designed as a sinking fund:** The analysis in this section switches to examining the sustainability of the CTF over the long term and its ability to provide a secure yield to support the operation of fiscal policy. The CTF was designed as a sinking fund to provide a fixed nominal distribution of $15 million until the fund is exhausted. Firstly, this design implies an annual fiscal adjustment since the drawdowns are not adjusted for inflation. Secondly, at some point in the future the CTF is designed to fail, and at that point an adjustment equivalent to the $15 million will be required. The nature of the design of the existing arrangements is to pass on the entire fiscal adjustment of the $15 million loss onto a future generation of Palauans.

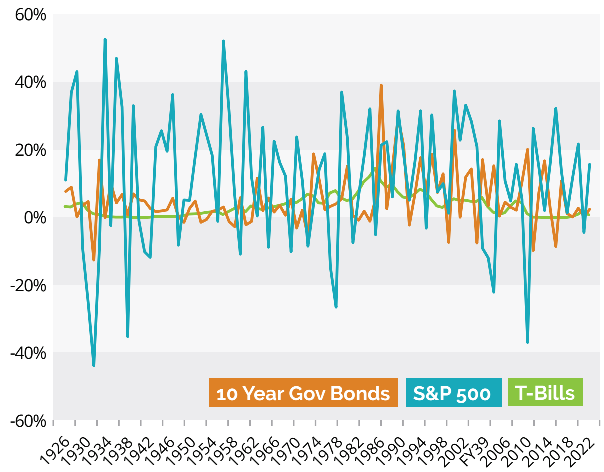
**Analysis concerned with establishing a perpetual fund benefiting both current and future generations:** The following analysis is thus concerned, bearing intergenerational equity in mind, with the policies and adjustments required to maintain a steady real flow of future resources equivalent to the $15 million in FY2024 (the final year of the Compact Review Agreement) and forever thereafter. It is, of course, up to the leaders of Palau to determine whether they wish to pursue such a change in purpose of the CTF. However, this is not an idea simply mooted by the authors. Rather, it is an express desire in various discussions among Palau's leaders at various times in recent years. This analysis identifies the costs of shifting the CTF to a sustainable, perpetual and thus intergenerationally equitable component of Palau's long-term fiscal policy.

**Analysis concerned with market risk:** The analysis is further concerned with subjecting the projections to market risk. International financial markets are subject to a high degree of risk. In the design of the CTF and distributions on which fiscal policy relies, it is critical to ensure market volatility is accounted for. The method deployed follows an approach widely adopted in analyzing market risk, using a Monte Carlo simulation to estimate the impact of market risk based on the characteristics of the investment portfolio adopted.

### MARKET RISK

**Markets subject to a high degree of risk:** Before examining the impact of implementing the CTF arrangements, it is beneficial to inspect the degree of risk investments are exposed to in financial markets. Figure 45 indicates the annual total return of investments in the S&P 500, US government T-bills and US government 10-year

**Figure 45**
Return on investment in US stocks and bonds, 1925–2018



bonds. The S&P 500 index displays large annual fluctuations during the period 1925–2018. US 10-year bonds display less volatility, or risk, while T-bills are more stable but of course accompany much lower returns. On average, the S&P 500 returned 11.8 percent during this period while the yield on the 10-year bonds averaged 5.4 percent. While the average, or mean, return on the S&P 500 index looks favorable, the standard deviation, a measure of dispersion, was 19.8 percent. This implies that two-thirds of the time, one could expect a return ranging between −7.9 to 31.7 percent, a very large range of possible outcomes.

**Measurement of returns:** It is also important to note that the measure of the simple mean rate of return overstates the geometric, or compound, mean rate of return. The geometric rate takes the value of the S&P 500 in 2018 compared with 1925 and calculates the rate of return required to attain the 2018 value. The geometric mean on the S&P 500 during this period was 10.0 percent, some 1.8 percent less than the simple mean.[1] One further needs to account for inflation, which during this period averaged 2.9 percent, implying that real returns on the S&P 500 were 7.1 percent. After allowing for investment management fees (fees of 50 basis points have been assumed in the present analysis), it can be said that an average institutional investor could anticipate a long-run geometric-mean real rate of return of 6.6 percent. In the case of the Compact Trust Funds being investigated in this study, the resources are invested in a balanced portfolio designed to reduce risk, and the portfolio geometric-mean rate of return will be different from that of the S&P 500.

## TRUST FUND PRINCIPLES

**Three principles: It is important at the outset of the analysis to define a set of broad principles the CTF should be designed to maintain:**[2]

1. The real, inflation-adjusted value of the CTF should be protected.
2. The CTF should provide a secure and stable source of real revenues to the national government of the RoP on an annual basis.
3. Annual distributions should entail minimal volatility from period to period, and when volatility is required it should be of known magnitude to limit disruption to the operations of fiscal policy.

The first objective is specified to ensure that future generations of Palauans will benefit from the CTF. The principle is designed to ensure intergenerational equity. The current embodiment of the trust fund in the Compact agreement is not designed to protect the fund's principal, but in this review, redesign of the CTF to achieve this objective is investigated. The second principle indicates that each year, the CTF should provide a constant real level of resources for distribution. Thus, both current and future generations can enjoy an identical relative level of benefit. The current arrangements do ensure an equivalent nominal drawdown each year, but at some point, the future generations could be left without benefit. Finally, the third principle places special focus on avoiding volatility and fund collapse. Downward adjustment in distributions resulting from market volatility places need for fiscal adjustment and disrupts the efficient delivery of government services. Clearly, fund collapse would entail a very large reduction in distribution and pressure on fiscal policy during a specific year and from that point on.

**Inevitable tradeoffs exist between the principles:** Sadly, there is no way in theory or in practice to fully achieve all three of these core principles. Rather, the approach adopted in this review is that the performance of alternative arrangements can be evaluated against the principles outlined. Thus, policy makers can adopt a CTF framework that scores the highest ranking in meeting the objectives.

1 A further improvement can be made through estimating the geometric mean econometrically rather than using end points as in the above explanation.

2 The list of principles is similar to those deployed in the analysis of the FSM and RMI CTFs, in the respective economic reviews. However, the objective to reduce volatility of annual distributions is replaced with the avoidance of fund collapse.

## BENCHMARKS, PERFORMANCE MEASURES AND EVALUATION METHODOLOGY

### BENCHMARKS

**In this section, some useful benchmarks and performance measures to aid the analysis are defined:**

1. **Target distribution.** This is defined as the annual $15 million permissible under the Compact plus inflation adjustment. Switching to an inflation-adjusted level would require US acquiescence since annual distributions would, as soon as the change is to be implemented, exceed $15 million.
2. **Primary target.** The primary-target fund estimate is defined as the value of the CTF required to yield the target distribution in a given year based on the econometrically estimated real geometric portfolio rate of return. Since the primary target is based on a real (inflation-adjusted) rate of return, it also implicitly provides for reinvestment of earnings necessary to maintain the real value of the fund. This measure of the fund is a benchmark that assumes no market risk. In itself, it is not a measure of fund sustainability, since it ignores risk, but nevertheless it provides a useful benchmark.
3. **Sustainability adjustor.** The sustainability adjustor is the empirically estimated percentage above the primary target that the CTF should attain to accommodate an "acceptable" degree of market risk. This is elaborated below.
4. **Sustainability target.** This is defined as the primary target multiplied by the sum of one and the sustainability adjustor.
5. **Initial year.** This is FY2025.
6. **Terminal year.** This is FY2044, the fiftieth and final year of the Compact.
7. **Accumulation period.** This is FY2018–FY2024. Funds are also being withdrawn during this period, but at a rate that allows the fund to accumulate in years of normal market returns.
8. **Drawdown period.** This is the period FY2025–FY2044.

### PERFORMANCE MEASURES

**Performance measures evaluate attainment of the core trust fund principles:** Performance of the CTF is assessed against a series of benchmarks related to the three CTF principles outlined above. The simulations are conducted over the respective accumulation and drawdown periods. The first two core principles have two sub-elements: (i) an average over the drawdown period, and (ii) a value in the terminal year. The focus is thus on both averages over the drawdown period and steady-state values measured in the terminal year. In the context of Monte Carlo analysis with 10,000 cases being run, this results in (i) an average of the observed median value for each year for each of the 10,000 cases, and (ii) an average for the terminal value for each of the 10,000 cases. The third core principle has only one measure relating to fund collapse. The benchmarks are designed to achieve intergenerational equity.[1]

1. **Protecting the corpus**
   a. probability that the FY2044 real value of the CTF is above the FY2024 value
   b. probability of attaining the primary target in FY2044
2. **Protecting distributions**
   a. average distribution in FY2025–FY2044 as a percentage of the target distribution
   b. average distribution as a percentage of the target in FY2044
3. **Protecting against fund collapse**
   a. probability of fund collapse before or in FY2044
   b. Average number of years with reductions from the prior year in real distributions

1 The list of benchmarks is nearly the same as deployed in the analysis of the FSM and RMI CTFs, in the respective economic reviews, to maintain compatibility.

4. **Performance indicator.** The performance indicator is an average of the above three main categories with each submeasure accorded equal weighting. In the case of the measure of fund collapse, for which there is only one submeasure, the score is one minus the indicator. Clearly, the choice of the chosen performance measures is subjective, but those selected are considered fair indicators of the core CTF principles.
5. **Sustainability.** The outcome of any set of simulations that attains a 95 percent performance level is considered sustainable. It will be apparent that setting a lower sustainability target, say 90 percent, would imply reduced caution but increased median levels of distributions from the CTF—a classic tradeoff.

### EVALUATION METHODOLOGY

**The need for an evaluation methodology to compare different Trust Fund rules:** An important and key aspect of the approach adopted in the work is to provide a means to evaluate the performance of different distribution rules that might be considered as alternatives. The various studies conducted by the ADB and GAO have examined a variety of different rules that might be considered but have not developed a methodology for scoring or selecting amongst the various alternatives. The performance indicator provided in this review provides just such a selection of decision rule.

## TRUST FUND SIMULATIONS

**A standard portfolio adopted:** The analysis undertaken in this study follows that in two other recent studies of the amended Compact Trust Funds in the FSM and RMI by the US GAO[1,2], and by the ADB.[3] Both studies deploy Monte Carlo simulation analysis to investigate the likely performance of the two trust funds and their capacity to meet their objectives. The analysis followed here does not depart from this approach. The simulations are based on a simple portfolio composed of equities and bonds. Equities are composed of the S&P 500 (35 percent), a global equities index (25 percent), and emerging markets (5 percent). Bonds are composed of US government bonds (15 percent), US corporate bonds (10 percent) and world government bonds (10 percent). All indices are total-return indices including reinvestment of interest and dividends. Data cover the historical period 1925–2018.[4] Since the inflationary environment projected over FY2013–FY2050 is expected to be lower than the historical series, the simulations have been run in real terms with inflationary expectations added. The inflationary factor is the US GDP deflator, and the simulations adopt the projections made by the US Congressional Budget Office. Further details on the technical aspects of the simulation are provided in appendix 1.

**The simulations start in FY2019 based on the value of the CTF at the end of February FY2019. The simulations are split into two periods:** an accumulation phase of the CRA between FY2018 and FY2024, and the (full) drawdown phase thereafter.

## PROJECTED VALUE OF THE CTF AND DISTRIBUTIONS UNDER THE COFA RULES

**Terms of the Compact Review Agreement:** In March 2018 the US finally authorized and appropriated funds in fulfillment of the Compact Review Agreement reached in 2010. A lump sum payment of $65.250 million was transferred to the COFA Trust Fund late FY2018. As part of the agreement Palau is entitled to drawdown $10 million in FY2019, $14.867 million in FY2020, and thereafter to revert to the annual $15 million drawdown agreed in the original Compact. As of

1 See US Government Accounting Office, Trust Funds for the Micronesian and the Marshall Islands May Not Provide Sustainable Income, GAO-07-513, June 2007, Washington, DC.

2 See US Government Accounting Office, Actions Needed to Prepare for the Transition of Micronesia and the Marshall Islands to Trust Fund Income, GAO-18-415, May 2018, Washington, DC.

3 Asian Development Bank, Trust Funds and Fiscal Risks in the Federated States of Micronesia and the Marshall Islands: Analysis of Trust Fund Rules and Sustainability in an Evolving Aid Relationship, 2015, Manila.

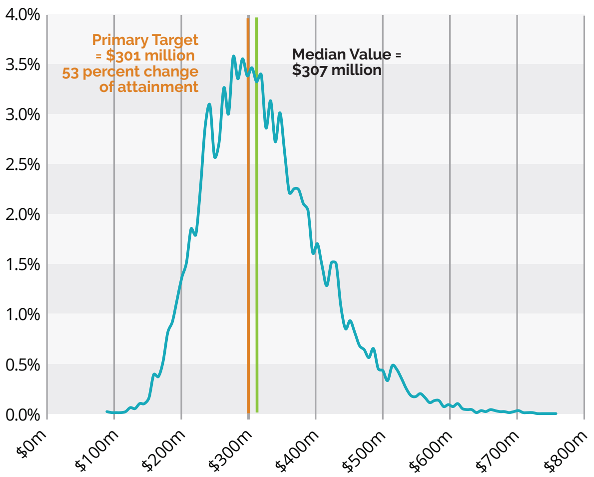
4 See http://www.globalfinancialdata.com, Global Financial Data, San Juan Capistrano, CA.

February 2019, the CTF had attained a value of $287 million.

**Median expected value of CTF in FY2024 matches primary target:** Figure 46 provides a depiction of the simulated CTF value at the end of the renewed Compact period, FY2024. It indicates that from a current value in FY2018 of $287 million, the fund is likely to attain a value of $307 million in FY2024 (the median simulated value). However, the probability of the CTF attaining the level of the primary target is 53 percent. Further, it must be borne in mind that the primary target is only a benchmark and is based on a risk-free assumption. Figure 46 thus indicates that the likely level of the CTF in FY2024 may well be below a level required to provide a sustainable yield to support current levels of government operations in the RoP thereafter.

**Performance of CTF corpus remains little change over the projection period:** Table 9 provides statistics based on the performance criteria defined above for the set of simulations undertaken in this review during the FY2025–FY2044 period. Focusing on the results for the renewed Compact without inflation adjustment, the probability of maintaining the real value of the corpus between FY2025 and FY2044 is 63 percent. The chance of the CTF being above the primary-target value in FY2044 is 63 percent, an improvement over the probability of 53 percent of attaining the primary target in FY2024. All of these measures are in relative proximity, indicating the sustainability of the corpus remains little changed through the period.

**Figure 46**
Probability Distribution of RoP Compact Trust Fund in FY2024




**Probabilities of attaining the target distribution decline over time, but volatility is high while chances of corpus collapse are small.** The second section of Table 9 further indicates the nature of the annual distributions that can be anticipated after FY2024. In terms of attaining the target drawdown level, defined as the inflation-adjusted equivalent of the $15 million, the average drawdown over the period is 82 percent, and the probability of attaining the target in FY2044 is 64 percent. In terms of avoiding downward adjustment, each year under the COFA rules implies an annual real reeducation in distributions and thus COFA scores the poorest outcome possible. Regarding fund collapse, there is a 4 percent chance that the CTF will become exhausted during the period. Finally, the overall performance rating of the CTF under the renewed Compact framework is 62 percent. On its own, this benchmark has little value without comparison to the alternative simulations, which are discussed below.

**Real distributions decline over time as changes of fund collapse increase:** For further illumination, Figure 47 indicates the number of cases of achieving real annual drawdowns in selected ranges. The graph indicates that in FY2025, all simulations attain the target distribution of $15 million. In FY2030, distributions have fallen in real value (by the rate of inflation) because distributions are set in nominal values, but in nearly all cases this level is attained. As time progresses, inflation continues to erode the annual real level of distributions and also the number of zero distributions, and hence the number of occurrences of fund collapse rises. By FY2044, the number of fund collapses has reached 4 percent and the value of the annual distributions has fallen by 48 percent.

**Opting for maintaining real drawdowns increases risk of fund collapse:** Under the second set of simulations displayed in Table 9, the results indicate the outcome if the RoP is allowed to draw down the $15 million (inflation adjusted) from FY2024. Under this scenario, the RoP avoids the need for annual fiscal adjustments. The CTF corpus falls relative to the baseline case without inflation adjustment, but average distributions are improved significantly. However, the lack of reductions in drawdowns due to the indexation dramatically improves this measure of volatility, although it is offset by an increased chance of fund collapse to 9 percent over the 20-year drawdown period. Overall, the combined performance indicator attains 81 percent, significantly better than the base case with no inflation adjustment. This result is obtained through limiting the horizon to FY2044. As the horizon is extended, the probability of fund collapse increases, and the overall performance indicator declines compared with the base case of no inflation adjustment. In effect, maintaining real distributions favors current generations at the expense of future generations.

## THE SUSTAINABILITY-ADJUSTMENT-FOR-ENHANCED-RELIABILITY RULE (SAFER)

**A methodology to define a sustainable drawdown:** From the foregoing analysis, it is clear that the results are not satisfactory: there is a significant probability of fund collapse, and the highest score of the performance indicator of 80 percent falls short of the defined sustainability target of 95 percent. In this section, we consider what size of fund is likely to achieve sustainability and generate a score of over 95 percent on the performance indicator. This problem is also viewed from the perspective of what level of drawdown can be sustainably achieved without jeopardizing the three core principles outlined above.

**Estimating the sustainability adjustment:** To define a sustainable CTF level, the primary-target indicator is used as the benchmark. Simulations are run assuming the CTF is funded at the primary-target level in FY2024. Recall that the primary target is derived through dividing the target distribution by the estimated real portfolio geometric rate of return. Simulations were run assuming CTF levels ranging from 10 to 200 percent of the primary target in FY2024 in increments of 10 percent.

Figure 48 provides the results of the simulations. Clearly, as the level of CTF funding increases, the score of the performance indicator improves. However, as the funding level increases above about 50 percent of the primary target, decreasing returns to additional funding sets in

**Table 9** RoP Compact Trust Fund simulated results and performance under selected rules

| Simulations | COFA rules | | SAFER | SAFER Lte | Fixed draw-down rate @ 3.5% | ROP++ |
|---|---|---|---|---|---|---|
| | CRA, nominal drawdown = $15m | Real Drawdown = $15m | | | | |
| **Corpus results** | | | | | | |
| Probability of real CTF in FY44 > the FY25 value | 62.5% | 52.7% | 77.9% | 61.2% | 74.0% | 86.9% |
| Probability of real CTF value > the Primary Target in FY44 | 63.3% | 55.3% | 77.5% | 62.8% | 73.7% | 90.5% |
| **Distribution results** | | | | | | |
| Average distribution through FY25-FY44 % target | 82.1% | 98.1% | 73.2% | 87.9% | 80.3% | 99.9% |
| Proabability of attaining target distribution in FY44 | 64.9% | 91.4% | 82.7% | 80.0% | 84.1% | 99.9% |
| **CTF volatility** | | | | | | |
| Percent of cases with fund collapse by FY2044 | 4.0% | 9.3% | 0.0% | 4.0% | 0.0% | 0.0% |
| Percent years with reduction in real draw-downs | 99.5% | 0.9% | 3.2% | 64.6% | 30.6% | 0.3% |
| Overall Performance Rating | 61.6% | 81.2% | 84.7% | 70.6% | 80.2% | 96.2% |

**Figure 47**
Distributions (in FY2025 prices) by number of cases falling in selected ranges under the CRA

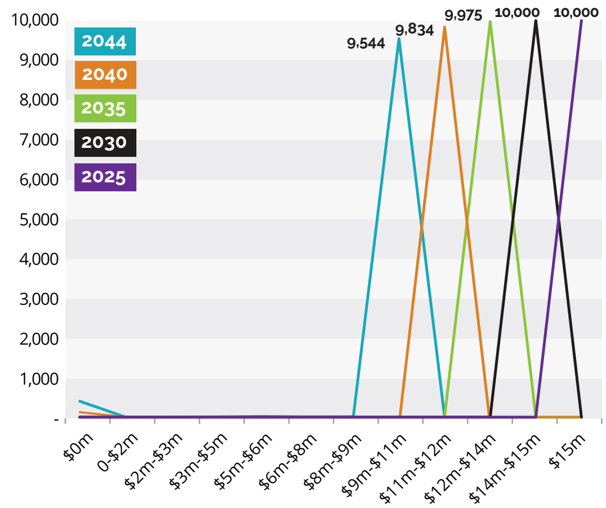
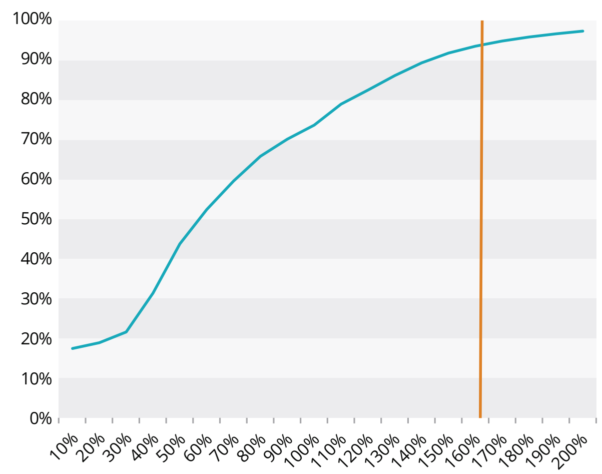



**Figure 48**
Overall CTF performance at diffferent levels of funding relative to the primary target




and the benefit of additional funding declines. While it is not possible to unambiguously specify an optimal target level of performance, a 95 percent target has been adopted. This translates into a funding level of the CTF of 67 percent above the primary target. At this level, the CTF corpus and annual distributions are maintained at healthy levels and volatility is reduced to a minimum. At the 95 percent level, at a strong level of confidence it can be ensured that the CTF will be sustainable in the long run. In our case a sustainability adjustor (SA) 67 percent has thus been selected.

**The SAFER Rule:** The starting point of the SAFER rule is thus defined by a sustainable and initial drawdown level (in FY2025 in our case) as the value of the corpus times the real geometric portfolio yield divided by 1 plus the sustainability adjustor. In effect, this amounts to discounting the portfolio average geometric rate of return of 5 percent by 1 plus the sustainability adjustor of 0.67; this is equivalent to a drawdown rate of 3 percent. The SAFER rule is thus based on drawing down 3 percent of the corpus in FY2025, and fixing drawdowns in future years at this level adjusted for inflation. Our simulations have shown that based on this rule a score of 95 percent of the performance indicator will be achieved.

**Downside tail risk:** In addition to defining a sustainable drawdown or distribution level, SAFER includes two allowances for tail risk, a downside and upside adjustment. In the case of the downside we deploy a moving adjustment mechanism once the corpus falls below the primary target. A downward adjustment, or decrement, of 5 percent of the previous year's distribution will be made if a three-year moving average of the CTF value falls below the primary target.[1] Downward adjustment continues until the reduction in distribution exceeds the CTF shortfall (the ratio of the actual CTF value to primary target). At this point, an upward adjustment, or increment, of 2 percent is made. Adjustment is thus asymmetric: on the downside, adjustment is more rapid, and on the upswing, adjustment is slower in order to allow the CTF to return more rapidly to the primary target. Once the primary target level is restored no further adjustments are made.

**Upside tail risk:** In the case of the upside once the corpus achieves twice the primary target, a 5 percent increment is allowed. This continues until the target distribution of the $15 million adjusted for inflation is attained. At this point future increases in real distributions terminate. Clearly, the initial SAFER drawdown rate of 3 percent is below the market estimated yield

1 See appendix 1 for full specification of the moving adjustment rule.

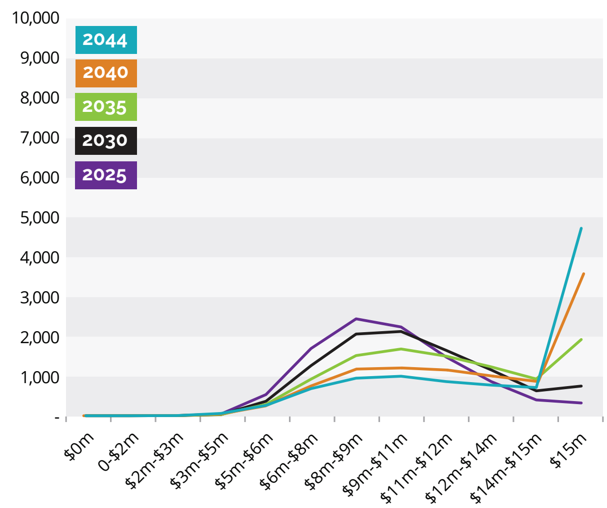
of 5 percent, and thus in the majority of cases when average market returns maybe expected, the corpus is likely to grow. The SAFER rule thus has the unavoidable characteristic that in order to protect the corpus, a lower drawdown rate is chosen in the initial years, but that in the majority of cases over time drawdowns increase. Thus, necessary abstinence on behalf of present generations benefits the wellbeing of future generations.

**SAFER entails large reduction in distributions in FY2025:** Referring to Table 9, the basic metrics for the SAFER simulations are provided. The starting position is the same as under the earlier simulations with the corpus attaining a median value of $307 million. An initial reduction in drawdown from $15 million to $9.1 million is required in the median case to establish a perpetual fund; this is a cut of $5.9 million or 39 percent; a large reduction. However, not surprisingly in terms of protecting the corpus, SAFER produces the best results. In terms of average distributions throughout the 20-year horizon SAFER is the poorest performer, but by FY2044 distributions are improving as indicated by a result that falls mid-way between nominal and real COFA rules. In terms of protecting the corpus the probability of fund collapse is zero, a clear advantage over the other two options. In terms of avoidance of downward adjustment SAFER scores well at 3 percent. Overall SAFER attains the best performance score: 86 percent.

**SAFER distributions improve over time:** Figure 49 provides further insight into the characteristics of SAFER. In FY2025 the curve indicates a bunching of results in the $8-$9 million in range. In subsequent periods the curve flattens, shifts to the right, with an increasing number of cases falling in the maximum target range of $15 million (real terms). The conclusion is that while SAFER entails an initial reduction in distributions the results improve over time.

**Well-designed rules can improve performance:** The adoption of the SAFER rule thus indicates that an improved result can be achieved over time through the adoption of well-designed rules and without additional funding. Clearly, the SAFER rule favors future generations in terms of protecting the CTF corpus and avoids fund collapse. This is achieved, however, through a reduction in annual drawdowns. While SAFER

**Figure 49**
Distributions (in FY2025 prices) by number of cases falling in selected ranges under SAFER




gives the best result so far, distributions are less than target, and overall the performance score is less than the objective of 95 percent.

## SAFER LITE

**SAFER Lite follows CRA nominal, but once the corpus has attained the sustainability target SAFER is adopted:** An alternative to the full COFA specification requiring no fiscal adjustment is specified in the SAFER Lite version. In essence SAFER Lite follows the CRA rule with the nominal drawdown of $15 million until the corpus has grown sufficiently to support implementation of SAFER. In the majority of cases the nominal $15 million drawdown is below average market yields on the portfolio, and the corpus is thus likely to grow. Once the corpus has grown to the sustainability target of $501 million drawdowns from the this point forward adopt the SAFER rule.

**Performance improves over CRA nominal but not as favorable as SAFER:** As Table 9 indicates performance falls in between earlier versions. Protecting the corpus is similar to the nominal CRA version, and distributions are improved due to the indexation permitted once the SAFER threshold is met. Fund collapse remains the same, but the number of reductions on prior years is high due to the lack of indexation in the earlier years. An overall score of 71 is obtained about half way between the nominal CRA version and SAFER.

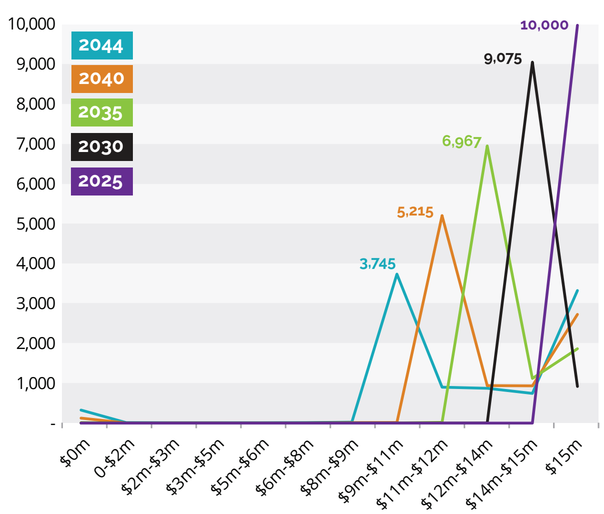
**On average SAFER attained in 13 years:** The structure of SAFER Lite is bought out in Figure 50. In FY2015 in all cases distributions attain $15 million as anticipated. By FY2035 70 percent of cases are in the $12-$14 million range (FY2025 prices), but there are a growing number, 19 percent, attaining the maximum of $15 million (FY2025 prices). This reflects the upward adjustment permissible under SAFER. By FY2044 33 percent have reached maximum. The average number of years to attain the sustainability target is 13.

### FIXED DRAWDOWN RATE OF 3.5 PERCENT

**Fixed drawdown rule provides a simple approach to CTF management:** A rule frequently advocated in many studies and by the financial industry is a rule to draw a fixed percentage based on a moving average of the CTF corpus. The main merit of the rule is its simplicity. In our case we have selected 3.5 percent on a 3-year moving average of the corpus.

**However, downward adjustment in drawdowns occurs frequently and is main drawback of the fixed rule:** As Table 9 indicates performance falls in between earlier versions. Performance is favorable, better than CRA nominal and SAFER Lite, but not as good as CRA real or the full version of SAFER. Protecting the corpus is not as strong as SAFER, but drawdowns are greater. Like SAFER fund collapse is avoided. However, due to the drawdown being based on a moving average, in many years downward adjustments are required.  This is the reason why SAFER performs better than a fixed drawdown rule. SAFER is based on a drawdown of a fixed real amount and only in tail cases is there deviation. SAFER scores 85 on our performance indicator while the fixed yield rule scores 80.

**Figure 50**
Distributions (in FY2025 prices) by number of cases falling in selected ranges under SAFER Lite




### INCREASING REVENUE EFFORT: THE ROP++ RULE

**Tax reform utilized to geneate additional contributions to the CTF:** In chapter 5, a tax-reform strategy was presented including implementation of revenue-neutral tax reforms. The RoP strategy did not propose that the tax reforms should initially be used to augment the Palau CTF. However, in this scenario we examine the case where the RoP chooses to reactivate the tax-reform strategy to generate a revenue effort of 2.5 percent of GDP for contribution to the CTF from FY2020 and onwards.

**A revenue effort of 2.5 percent of GDP is assumed:** The increased revenue effort is projected to yield $7.5 million in FY2020 and to rise thereafter with inflation; no allowance is given for economic growth, which would enhance revenue effort in the long term. The additional revenue effort is used to augment the CTF in the shoring-up phase through FY2024. After this time, it is assumed that the continuing resources are first allocated to any CTF drawdown shortfall to support government operations but that thereafter the remaining surplus continues to augment the CTF until the size of the fund reaches twice the size of the primary target. This rule is known as RoP++.

**ROP++ achieves the performance indicator target of 95:** Figure 51 indicates the probability distribution of the likely size of the CTF in FY2024 with additional RoP contributions. In comparison to Figure 46 (without RoP contributions), the probability of achieving the primary target in FY2024 increases from 53 to 75 percent. The median value also rises: from $307 to $355 million, a significant 16 percent increase. Referring to Table 9, the probability of an increase in the real CTF value over the period rises to 87 percent. In the case of the objective of maintaining the annual distributions, the average distribution hits 100 percent of target and the probability of attaining the target in FY2044 alone is also 100 percent. As expected, the results indicate fund collapse has been eliminated, while reductions in drawdowns are minimal. An overall performance rating of 96 is achieved, above the 95 target.

To complete the story, in comparison to the earlier simulations, Figure 52 indicates the number of cases of distributions that fall into the selected ranges under RoP++ at five yearly intervals. The figure indicates that distributions meet the target in over 95 percent of cases in all the years selected. In fact, the performance in each of the selected years is almost identical.

**Simulations indicate the level of revenue effort required to generate a perpetual fund:** The projections on which this result is based assume a revenue effort equivalent to 2.5 percent of GDP. After several years of inactivity, the tax-reform initiative is now being reconsidered. The simulations conducted in this review indicate the level of revenue effort necessary to resolve the structural fiscal deficit facing the RoP resulting from CTF inadequacy. The RoP++ simulations suggest that a revenue effort of 2.5 percent of GDP to shore up the CTF will resolve this issue.

### EXTENSION OF THE COMPACT BY SPECIFIED INTERVALS WITH ADDITIONAL CONTRIBUTIONS

**An estimate $195 million would be required in FY2024 to attain a perpetual CTF defined as a 95 score of the performance indicator:** In this section we report out the additional contribution required for the Palau CTF to become a perpetual fund. For a lump sum contribution this is defined as amount required to attain a 95 score of the performance measure. The value of the CTF required in FY2024 that attains the 95 score is $502 million, which at median values implies a lump-sum contribution of $195 million.

**A 20-year extension of the Compact would require $11.7 million per annum to attain perpetuality:** In the case of a 20-year extension of the Compact an annual contribution of $11.7 million attains a 95 score. At 15 years $13.8 million is requires and with a 10-year extension an annual contribution of $18.8 million is needed.

**Figure 51**
Probability Distribution of RoP Compact Trust Fund in FY2024

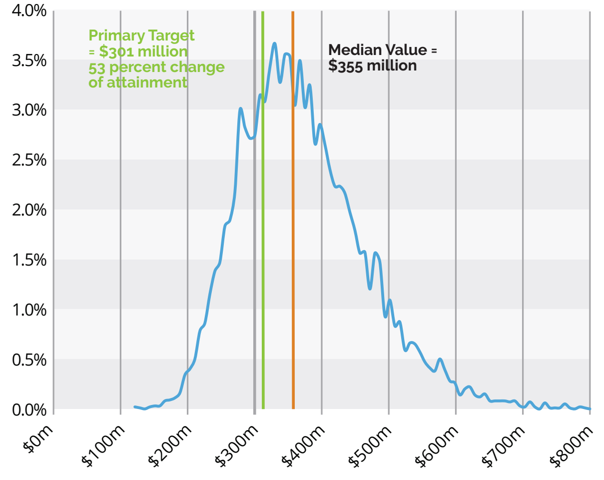
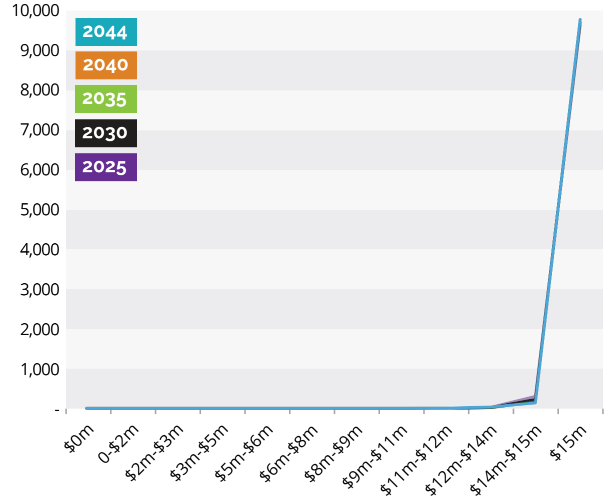



**Figure 52**
Distributions (in FY2025 prices) by number of cases falling in selected ranges under ROP++



## COMPARISON OF THE DIFFERENT RULES

**Different rules compared:** Finally, we compare the performance of the annual distributions under the different rules. Under each rule, it is assumed that the CTF corpus attains a value in FY2025 equal to the median value under the COFA rules; the starting point is thus identical under each rule. In reality, of course, the starting point in FY2025 will reflect market performance between the current position and FY2025. The bands of annual distributions shown in Figure 53 reflect groupings lying between selected percentiles of the simulation outcomes. The upper tail of the distribution greater than 95 percent is not shown.

**Targeting real distributions under the COFA rules results in some cases in fund collapse:** The first case in Figure 53 is the COFA case with inflation adjustment, and it indicates an apparently very favorable result: within the 5th- to 95th-percentile band, all distributions provide the target inflation-adjusted distribution of $15 million in FY2025 values. However, this rosy outcome is not reflected within the range from zero to the fifth percentile, and in FY2037 the fund collapses along the first- or zero-percentile line. Further insight into this result is provided in the second graphic, which provides the probability distribution of the COFA corpus. Along the 50th-percentile trajectory, the real value of the CTF is maintained. However, below this line, COFA values are projected to decline and the CTF is almost exhausted along the 5th-percentile case by FY2044. Below this range, the COFA fund collapses in most cases. For the RoP, the issue is intergenerational: if there is no concern for future generations after the Compact, then the existing arrangements are fine, but if the well-being of future generations is important, then remedial action is required.

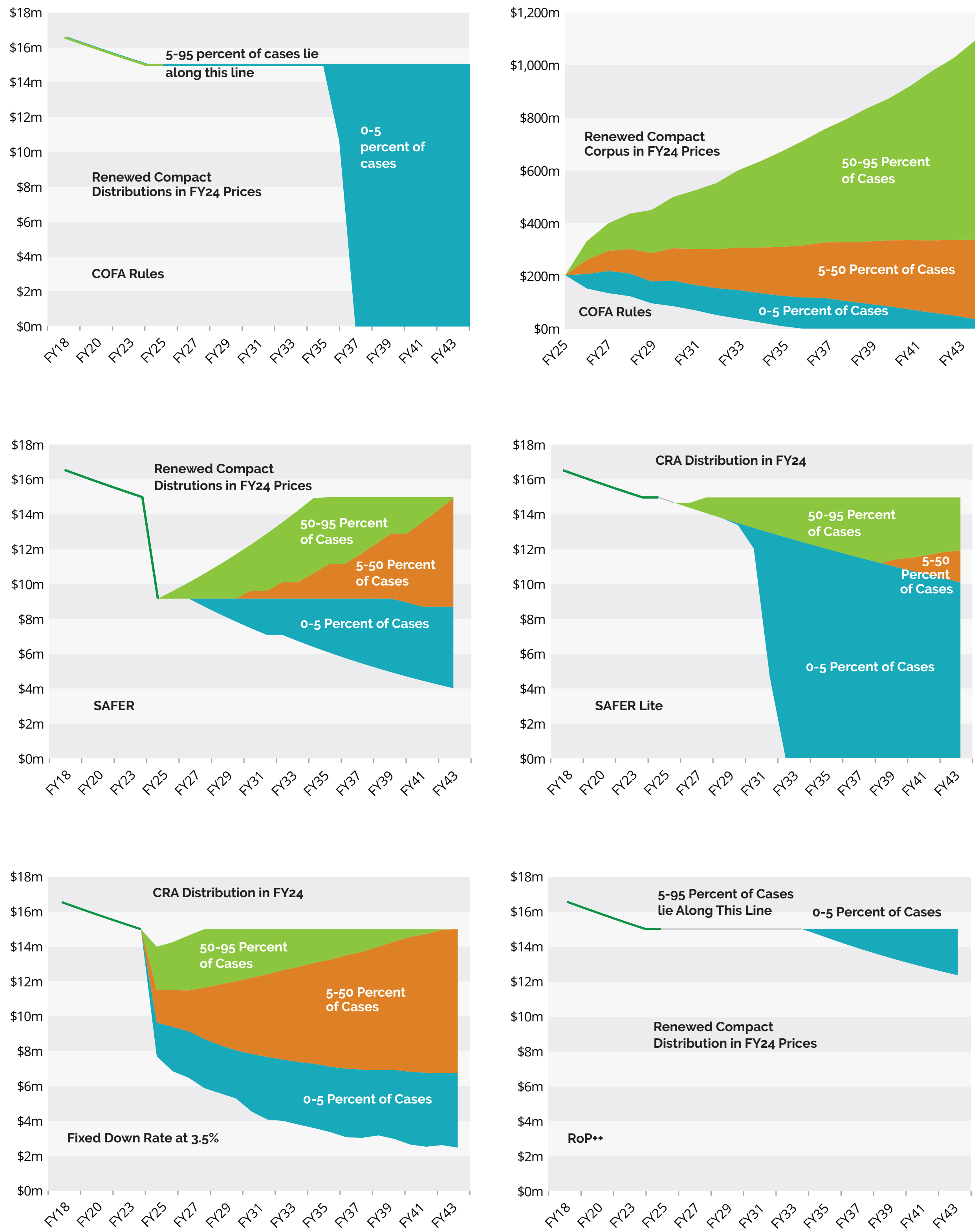
**SAFER rule produces reliable results but with significant initial reduction in drawdowns:** Under the SAFER rule distributions start at $9.2 million but are allowed to rise once the corpus has attained the threshold level. At the fifth-percentile level, distributions are largely steady at the $9.2 million level, but fall off slightly towards the end of the trajectory. However, below that level distributions decline falling to $4 million in the worst case. Along the 50th-percentile trajectory, distributions begin to rise after FY2030 and reach the $15 million cap in FY2044. Similarly, in the 95th-percentile case, distributions start to rise immediately in FY2025 and reach the cap in FY2034.

**SAFER Lite displays elements of CRA real and SAFER:** The area of dispersion under SAFER Lite is far wider than the previous two versions COFER real and SAFER. On the downside it is similar to CRA real, but between the 5 and 95 percentiles distributions range from $10 million to $15 million and would appear more favorable than SAFER. However, the large number of downward adjustments, not captured in this graph penalize this option.

**The fixed drawdown rate rule has wide area of dispersion:** The fixed drawdown rule benefits from allowing high values of distributions which in many cases are greater than COFA. It also performs well in protecting the corpus. However, this rule is penalized for the many downward distributions that result from following a fixed drawdown rate of a 3-year moving average of the corpus. Volatility is inevitable under a rule that is not insulated from market risk although the 3-year moving average dampens oscillations.

**ROP++ attains fiscal stability:** Finally, under the RoP++ rule, distributions are sustained at the target level throughout the period along the fifth percentile line but fall in the lower percentiles after FY2034. The combination of the SAFER rule and an RoP revenue effort of 2.5 percent of GDP hits the goal of attaining 95 on the performance indicator.

**Figure 53**
Comparison of distributions under diifferent rules



# 10. The Long-Term Economic Outlook

**This chapter and the long-term economic projections through FY2030 are based on the Palau Long-Term Economic and Fiscal Framework (LTEFF). Two projections are made: (i) a baseline based on current policy, and (ii) a fiscal strategy and responsibility scenario based on a recent ADB TA.**

- The baseline projection reflects the current policy environment, experience over the last 20 years and revealed preference of the Palau government from the FY2018 fiscal outturn and FY2019 budgets. Growth accelerates in the medium term as the economy improves after the recent contraction in tourism. This reflects both a return of the tourism sector to normal levels of profitability and a large number of public infrastructure projects planned over the medium-term. On the fiscal side the economy is projected to remain in balance.
- However, while fiscal stability is projected there remain many threats and risks on the horizon: the COFA Trust Fund has been designed as a sinking fund, the Civil Service Pension Fund is projected to collapse, the recent reforms to the SOE sector are incomplete and government will be required to maintain significant subsidies. Six reform strategies are included in the scenario:
    - Tax reform
    - Perpetual COFA Trust Fund
    - Civil Service Pension Fund reform
    - SOE reform
    - Infrastructure development
    - General Fund Reserve
- The impact of the reforms reveals the financial position is considerably improved: the CTF becomes perpetual, the CSPF is stabilized, the nation’s infrastructure is improved, and fiscal policy has been protected against cyclical volatility. The nation has implemented an economically efficient tax regime. The impact on the economy and jobs is projected to be minor. The main cost has been a reduction in household real incomes of 5 percent.

# 10. The Long-Term Economic Outlook

**LTEFF forms the basis of the economic projections:** In this chapter of the review, a long-term economic and fiscal framework (LTEFF) is presented that provides a projection of the Palau economy both in the medium-term, the next few years FY2019-FY2021 and through the longer-term FY2022–FY2030. Discussion starts with a baseline projection for the economy. While the future path is highly uncertain after the recent periods of rapid tourism growth and contraction, the baseline assumes the recent volatility subsidies, that the private sector responds positively, and the economy returns after a period of catch up to long-run trends. A reform scenario is the subject of the following section examining the proposals of a recent ADB TA[1] to address long-run fiscal weaknesses. Finally, the issue of the possible impact of the loss of US assistance after the termination of the CRA period is addressed.

**The baseline scenario** is formed from current policies as revealed in prior budgets, recent policy statements and laws, together with the amended provisions of the recent Compact Review Agreement that was agreed during 2018. The recent periods of tourism boom and contraction, restructuring of airline operations make forecasts problematic. The approach has been that the private sector continues to support the current installed capacity and achieves modest profitability. Recent hotel projects in the pipeline and under construction are assumed to be completed and that occupancy rates improve from the current low 30 percent to 50 percent, rates that prevailed during the FY2012-FY2016 period. During the projection period the long-run rate of tourism growth is assumed to be 2.5 percent, which is conservative compared with the growth of 4.3 percent since FY2000. Long-run estimates of tourism demand by the Pacific Asia Travel Association[2] for the Asia Pacific region project a rate of growth of 4.6 percent through 2020. A large volume of public infrastructure projects currently under implementation are assumed to boost economic activity in the near-term.

**A reform scenario** is developed based on the recent ADB TA and outlined at the start of Chapter 10. A fiscal strategy and responsibility framework have been outlined to address key fiscal weaknesses. The main features of the fiscal strategy include the long-standing tax reform initiative, reforming the existing COFA fund into a perpetual fund capable of withstanding market risk as discussed in Chapter 9. Reforms to the ailing CSPF discussed in Chapter 7 are examined to avoid fund collapse together with adoption of full cost recovery in the supply of water and sewer operations also discussed in Chapter 6. Protection of infrastructure investment to avoid sub-optimal levels is considered together with reform of the General Fund Reserve to provide a buffer to fund government operations during periods of cyclical downturn. The impact of a combined reform strategy is compared with the base scenario.

**LTEFF is based on a simple spreadsheet model of the economy:** The modeling structure presented in this review attempts to capture the major economic relationships in Palau. GDP is projected in constant and current prices, together with exogenous price and wage estimates. This forms the basis for the generation of income and includes the estimation of compensating of employees and operating surplus. The household-sector account is modeled in some detail capturing the generation of income and including primary and secondary incomes. This is channeled back into household final consumption. At this stage,

1 85Asian Development Bank, TA-8581 REG: Strengthening Public Sector Management in the North Pacific, 2018

2 See Executive Summary Report of the PATA Asia Pacific Visitor Forecasts 2016–2020, Pacific Asia Travel Association (PATA), PATA.org, April 2016.

estimates of GDE can be made, which in turn determine output levels of some industries. The fiscal sector is dependent on government policy, and revenue estimates are related to the level of economic activity. Estimates of the balance of payments and the monetary account are included. Incurrence of long-run debt, including existing debt commitments, is assumed to flatten out at a fixed ratio of GDP.

328. LTEFF available from the internet: The existing framework is known as the Long-Term Economic and Fiscal Forecasting Framework (LTEFF). A write-up of the LTEFF is provided in appendix 2. A set of projection tables and the spreadsheet model can be downloaded from www.EconMap.org.

## A. Baseline Projection

### ASSUMPTIONS

**Basis of the projections:** The baseline is projected on the basis of the current policy regime and the initiatives revealed in the FY2019 budget and other recent policy statements and laws. Where the policy stance has not been explicitly stated, the baseline assumes a position consistent with the status quo. After a period of rapid growth and subsequent collapse in the tourism industry the basis on which to project the future is highly unclear. In these circumstances it has been decided to assume the economy moves over the next few years through FY2025 to one where normal occupancy rates and private sector profitability prevail and the tourism industry converges on a modest long-run growth.

**Tourism growth.** Under the baseline it has been assumed that the hotel plant under construction is completed and that average hotel occupancy returns to 50 percent by FY2025 (in six years' time). A long-run growth in visitor arrivals of 2.5 percent is further assumed. On these assumptions, the number of visitor arrivals will reach 202,000 by FY2030, implying an average rate of growth in visitors of 4.7 percent during the FY2018-FY2030 period. Looking out further this number grows to 259,000 visitors by FY2040, with an annualized growth rate of 3.7 percent. While the average rates of growth are favorable, they reflect rapid growth in the near-term as the industry returns to normal rates of profitability and occupancy rates and thereafter the modest projection of 2.5 percent in the long-term. The projections are generally consistent with the Responsible Tourism Policy Framework position on protecting the environment and maintaining tourism at sustainable levels.

**Marine sanctuary.** The implementation of the Marine Sanctuary Act in 2020 implies the cessation of commercial fishing in 80 percent of Palau's waters. Under the Vessel Day Scheme of the Parties to the Nauru Agreement, countries are allocated days according to the level of fish biomass and catch, although it is understood that catch is used as a proxy for fish biomass. A seven-year moving average is used for fish catch. It is assumed on a 50:50 basis that Palau will continue to receive days on the basis of fish stocks but that it will lose days on the fish-catch part of the formula. Although the position of the PNA is unclear on this issue it has been assumed that the government will lose half of the current $8.5 million in revenues over a seven-year period. The Marine Sanctuary Act will also imply the termination of the Palau-based long-line industry and revenues from the fish-export tax of $0.8 million from 2020 onwards.

**Allocation of the Pristine Paradise Environmental Fee:** As part of the original Marine Sanctuary Act an environmental impact fee (EIF) of $100 was enacted to replace the existing $50 fee. This was subsequently amended renaming the EIF to the Pristine Paradise Environmental Fee (PPEF) and allocating the $100 as follows: (i) $10 to the fisheries-protection trust (marine surveillance); (ii) $12.50 to be divided among the states (compensation for the loss of fishing-rights fees); (iii) $25 to the Palau International Airport (but with an equivalent amount earmarked for the CSPF); (iv) $30 to remain as the green fee; and (v) $22.50 to the general fund. The new regime was implemented in January 2018, and the PPEF was written into traveler's airline tickets as implemented by most other countries. The actual amount earmarked for the CSPF has been reduced to $12.50.

**Compact Review Agreement.** After a delay of nearly eight years, in March 2018 the U.S. Congress finally authorized and appropriated funds to resource the Compact Review

Agreement (CRA). The funds received by Palau since FY2010 were deducted from the original agreement and the Congress appropriated $123.824 million. With agreement between the parties $65.25 million was allocated to the COFA Trust Fund. A further $24.574 million was provided during FY2018 as grant assistance. Coupled with drawdowns from the CTF of $5 million in FY2018, 10 million in FY2019, $14.867 million in FY2020, the total sum available to support government operations averages to the $18.147 million available to the government during the FY2010-FY2017 period. Thereafter drawdowns from the CTF are to revert to the original Compact agreed amount of $15 million. Finally, the original capital contribution of $40 million for infrastructure was reduced to $20 million. These provisions have been programmed into the LTEFF.

**Subsidies.** Current water and sewer rates charged by PPUC in FY2017 covered 96 percent of total cash operating costs and 74 percent of total costs including depreciation. Based on the recent performance of the PPUC this study estimates that revenues will be insufficient to cover costs excluding depreciation but including debt service for the Koror Airai Sanitation Project (KASP I). During FY2019 through FY2023 during the height of debt service obligations a cash shortfall of $2 million is projected. Under the baseline scenario and current policy, it is assumed that tariffs will not be increased further to achieve full cost recovery as required under the ADB recent water and wastewater programs, and that government will be required to pay a subsidy to cover the deficit. On the basis of non-compliance with loan conditions and failure to achieve full cost recovery, the baseline scenario does not include Phase II of the KASP, although this project was designed to complete the original unfilled objectives of KASP I, including establishing the infrastructure for a developing tourism economy.

**Civil Service Pension Fund.** Our projections indicate the CSPF without support from government is likely to have collapsed by FY2026 assuming normal market rates of 7 percent return. The baseline assumes contributions grow in relation to public sector wages but no change in contribution rates, and that benefits grow at 4.7 percent in line with actuarial projections prepared for the for Social Security Administration. With the current subsidy and transfer of $12.5 from the PPEF, the estimated date of collapse is pushed out to FY2030. From this point forward the CSPF would degenerate into a Pay As You Go (PAYGO) system, but government would be required to make up the shortfall, which is projected to rise to $7.2 million by FY2030 (1.5 percent of GDP). The lack of precision of the likely progression of the benefit curve means the projections are subject to a significant margin of error and point to the urgent need for a comprehensive actuarial study.

**External debt.** The MFFF assumes the government will maintain a ratio of external debt (excluding on-lent loans to SOEs) to GDP of 10 percent, the historical average, and that new borrowing will be used to support infrastructure projects. In the case of the SOEs, it is assumed that the ratio of debt (including on-lent loans from government) to GDP will be maintained at 20 percent of GDP and serviced out of SOE revenues. The long-run external-debt target is thus 30 percent of GDP, a level considered sustainable for an economy such as Palau. The standard IMF Debt Sustainability Assessment (DSA) takes a different approach and projects external debt as the accumulation of fiscal deficits over time. This assumption does not fit the characteristics of an economy such as Palau, which at this time has no access to financial markets to fund a deficit. In the LTEFF, deficits are financed out of government's cash deposits. Once drawdowns are exhausted, the government would be required to make adjustment.

## ECONOMIC ACTIVITY

**After a poor year in FY2019, the economy is projected to return to a higher trajectory over the next 5 years:** The projected growth for the economy of the baseline is shown in Figure 54. The figure indicates weak performance in FY2019 as the economy contracts by 6 percent reflecting the 25 percent decline in visitor arrivals. However, economic growth returns during the next 5 years as the tourism industry recovers and occupancy rates return to normal. After FY2025, however, economic growth converges to the steady-state rate of 1.5 percent. In FY2020 and FY2021 the economy is projected to grow by 5 and 6 percent, respectively, reflecting growth in visitor arrivals of 10 and 20 percent, respectively, as occupancy rates return to more profitable levels and the new hotel plant comes into operation.

**Construction projects boost demand:** A variety of construction projects are also planned for this period including the $30 million airport renewal PPP, the $15 million Japanese funded landfill relocation project, $20 million CRA infrastructure projects, and completion of the KASP I sewer and wastewater project. A variety of smaller projects are also anticipated including a new conference center, Angaur dock and visitor sites. In FY2023 the construction projects are due for completion and economic growth is more modest at 2 percent reflecting continuing growth in tourism of 15 percent. The next three years show continued above normal performance as the tourism economy returns to the levels last achieved in FY2015, ten years previously. From this point forward with no additional stimulus the economy settles down to its long-term trend growth rate.

**Tourism and construction drive the economy:** Figure 55 tells the story from a different viewpoint and looks at the sources of growth over the 12-year horizon. In FY2019 the large drop in tourism demand is counterbalanced by completion of existing hotel projects and commencement of the infrastructure projects. In fact, the large contraction in FY2019 would have been worse if new infrastructure projects had not come online. In the following period through FY2025 growth is strong but from a different interaction of the major sources of demand. FY2020 is projected as a favorable year reflecting modest tourism improvement but strong investment demand for the infrastructure projects. In the following year construction projects peak and are no longer a source of growth with tourism demand becoming the major driver. By FY2022 the level of infrastructure activity falls and is a drain on growth but economic performance remains buoyant due to the continuing growth in tourism. The following three years through FY2025 growth in visitor arrivals keeps the economy above the long-run steady state rate of growth. Throughout the period household consumption mirrors that in the economy at large, and the economy settles down to its long-run steady-state growth of 1.5 percent during the final years of the projection period.

**Private sector is the driving force of economic growth as the public sector declines as a share of GDP:** Figure 56 indicates important information about the performance of both the private and public sectors. The figure indicates an annual average growth in the private sector during the period of 3.8 percent per annum, compared with an average for the economy of 3.0 percent. The public sector (a combination of government and SOEs) on the other hand appears stationary although it grows by a modest 1.0 percent. This reflects both the

**Figure 54**
Baseline projection GDP and tourism growth

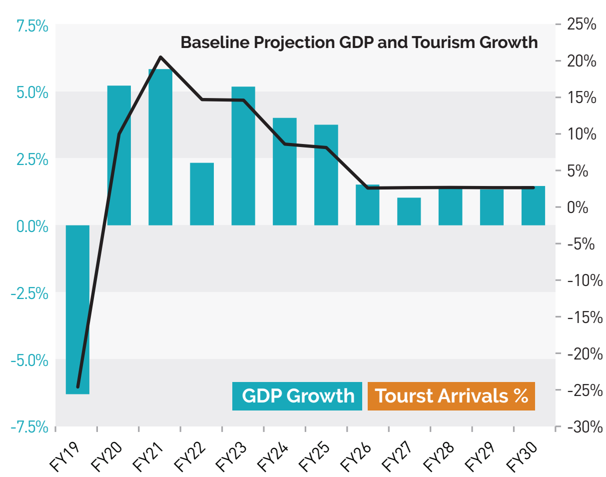



**Figure 55**
Sources of growth under the baseline

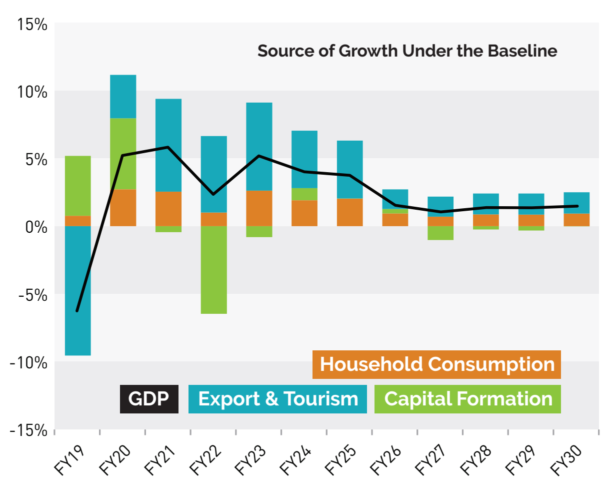


**Figure 56**
Projected GDP in te private and public sector

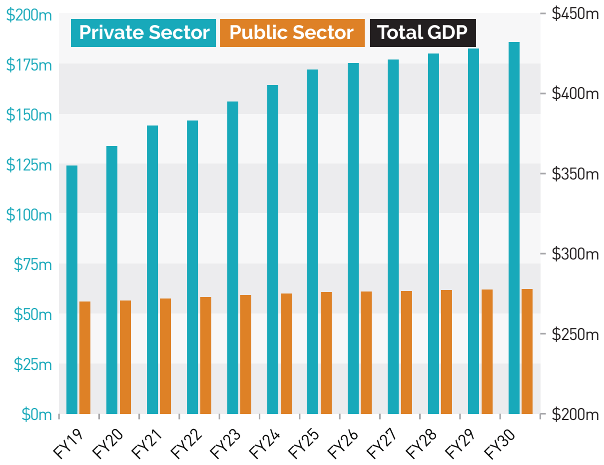
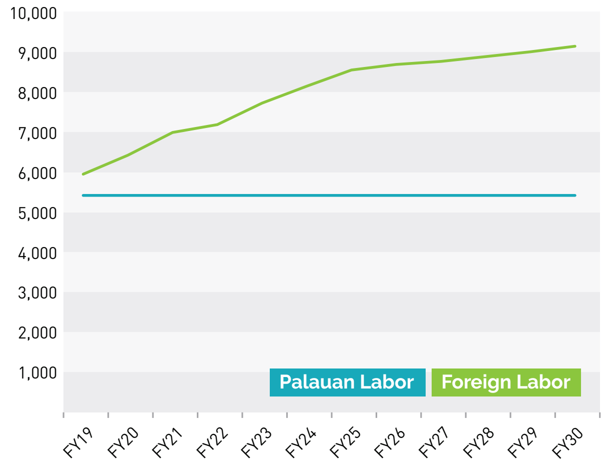



**Figure 57**
Projected employment, Palauan and foreign labor




implicit policy decision executed since FY2000 to maintain the real size of government constant and also the limitations placed on expansionary fiscal policy due to limited human resources, i.e. labor supply. As a result, the contribution of the public sector to economy is projected to decline. This has important implications both to limit the absorption of scarce resource by government thus encouraging private sector development and to ease fiscal pressures.

**Limited labor supply of Palauans results in increased demand for foreign labor as the economy expands:** Finally, in this section Figure 57 provides a projection of demand for labor in the Palauan and alien labor segments of the market. Palauan labor is projected to remain unchanged through the horizon reflecting the impact of migration and a resulting stagnant labor supply. In effect the labor market is fully employed in the Palauan segment. The LTEFF assumes an 0.8 percent annual improvement in private sector productivity, based on past increases. The projected increase in economic growth and demand for additional labor is reflected in the alien market, which grows from 6,400 to 9,100 jobs over the period. This has important consequences for economic and tourism policy, suggesting policy should focus on improving skills in the local market and activities that encourage capital intensity in both investment and human resources, i.e. high value tourism.

## FISCAL PROJECTIONS

**An overview of trends.** Figure 58 indicate the major trends in the fiscal position over the 12-year projection period. The figures for revenues include adjustments for the CRA additional grants received in FY2018 but intended for use in FY2019 and FY2020; the adjusted figures reflect the intended outcome of the CRA, of $18.147 million during this period. In FY2019 adjusted revenues and expenditures (as a percent of GDP) are relatively well balanced, but with the significant improvement in the economy in FY2020 revenue growth outstrips expenditures. From FY2020 onwards through the end of the CRA period, the gap between revenues and expenditures narrows reflecting the decline in fishing revenues received through the PNA. Through the remainder of the projection period revenue growth is more buoyant than expenditures.

**Long-run trends indicate declining revenues and expenditures in proportion to GDP, as financial stability is maintained:** Several important factors are revealed in the exercise. Revenues decline as a share of GDP despite an elastic tax base. This reflects the reliance on grants that are fixed in nominal terms and other revenues such as fishing fess that are planned to fall with implementation of the marine sanctuary. The elastic nature of the tax

**Figure 58**
Revenue and Expenditures % GDP

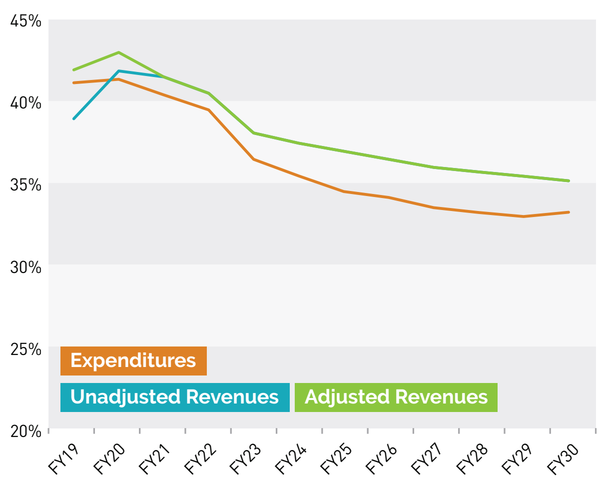
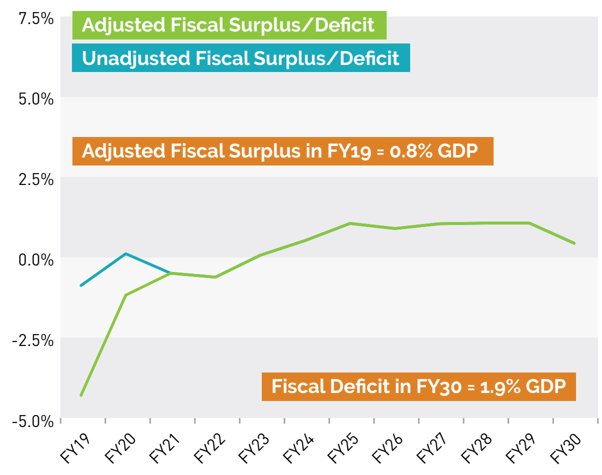



**Figure 59**
Projected adjusted and unadjusted fiscal surplus/ deficit percent GDP




base is insufficient to compensate for the strong downward trend in grants to GDP. Expenditures also decline in relation to GDP reflecting the relatively prudential fiscal position adopted historically by the government and reflected in the base scenario. Employment at the national government is stationary but with allowance for wage growth slightly above inflation. Use of goods and services, grants, and other expense are also assumed to remain constant in real terms. With a growing economy, expenditures also decline as a share of the economy. Figure 59 indicates the emerging fiscal outturn during the period. The fiscal position improves in FY2020 as the economy returns to growth but deteriorates during the next few years with the loss in fishing revenues. In the long run there is a small improvement and fiscal stability is maintained.

**Tax revenues are buoyant despite highly inelastic import duties:** Over the longer-term tax revenue displays a gradual rising trend, growing from 21.3 percent to 22.9 percent of GDP percent of GDP between FY2019 and FY2030. This reflects the base of each major tax and their buoyancy in relation to GDP. Personal taxes (wage-and-salary tax) are projected based on a projection of the total compensation of employees for the economy plus an adjustment for tax buoyancy of 1.17. The GRT projection is based on current-price GDP projections (given the lack of estimates for gross output in the MFFF) for private sector activities plus a buoyancy ratio of 1.08. Similar customs taxes are projected in relation to import demand from the GDP(E) projections with a buoyancy ratio of 0.68. Export taxes are assumed to disappear with the commencement of the marine sanctuary in FY2022. The other major tax is the PPEF, which is projected in relation to visitor arrivals and GDP growth (for nationals). While each of the major taxes is buoyant in relation to GDP the main weakness of the tax regime is the over reliance on customs duty which are highly inelastic.

**Grants decline significantly as a share of GDP:** Grants also as a share of GDP decline significantly over the period by 2.9 percent reflecting a variety of forces. With the implementation of the CRA, nominal grants will remain at $18.147 through FY2021 and then drop to the $15 million drawdown from the COFA Trust. The CRA $20 million of capital projects boosts capital grants temporarily FY2019 through FY2022 but other non-Compact grants are assumed fixed in real terms. Overall grants decline from 11.3 to 8.4 percent of GDP. Other revenues include fees of government departments and fishing royalties derived from the Vessel Day Scheme of the Parties to the Nauru Agreement. With the implementation of the Marine Sanctuary Act, it is assumed that half of fisheries royalties will be lost by FY2024. As a result, government revenues decline steadily over the period from 39 percent to 35 percent of

GDP, indicating the long-run need for tax reform to ensure Palau generates a buoyant form of revenue for government.

**Both payroll and use of goods and services decline as a share of the economy:** On the expense side of the equation, compensation of government employees is projected as an estimate of the change in employment and trend in wage increases. Employment in government is projected to remain unchanged. Wage rates are projected to rise in line with the historic trend. The result is the government's total wage bill is projected to decline from 16.3 percent of GDP to 13.3 percent over the period. Use of goods and services has been projected by component. Most items are forecasted as moving averages, reflecting the static nature of the component. Several items have shown more rapid growth, such as medical supplies and referrals, and these have been projected on trend. Use of goods and services is also projected to decline as a share of GDP from 10.0 to 8.2 percent.

**Subsidies remain minor but potential of OEK action to offset rising fuel prices in electricity production presents a significant risk:** Projections of subsidies to public enterprises include payments to support the provision of water and wastewater services to PPUC in the absence of adoption of full-cost recovery. This maxes out at $2 million in FY2019 through FY2023. The current subsidy to PPUC on account of electricity bills of low-income earners is small and has not been included in the projections. However, the possibility of large subsidies to support rising fuel costs in electricity generation resulting from action by the OEK has the potential to undermine fiscal stability. In the FY2019 budget an allowance of $0.5 million was appropriated for this purpose, but the status is unknown, and it has not included in the projections.

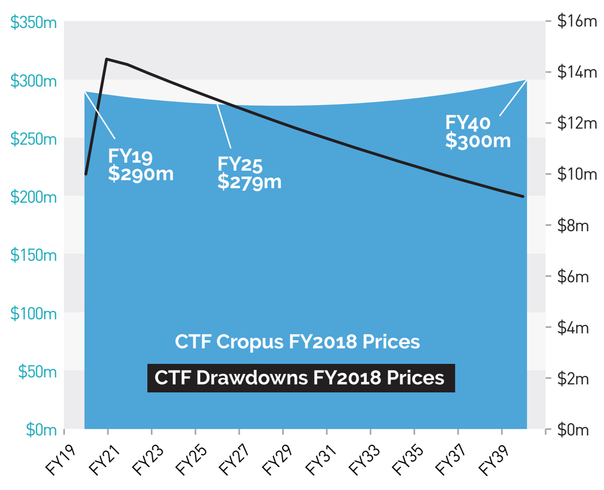
**Grants, and other expense projected to fall in relation to GDP despite large increase in transfers to support collapse of the CSPS:** Transfers to the state governments are projected on trend and according to their share of the PPEF. Support for the new fisheries protection fund is also projected in relation to its share of the PPEF. Transfers to government agencies are projected to be constant in real terms. The major threat to fiscal stability in the baseline is the collapse of the civil service pension scheme projected in FY2030. From a level of $1.1 million in FY2019 this rises to $8 million in the early FY2030. Despite the large increase in transfers to the CSPF, transfers and other expense falls as a share of GDP from 10.4 to 9.0 percent of GDP, reflecting modest growth in other areas.

**Outlays on fixed assets projected to decline as a percent of GDP:** Outlays on nonfinancial assets (gross fixed-capital formation) are set equal to the total level of capital grants. It is assumed the government maintains a constant debt-to-GDP ratio of 10 percent and that new funds are used for infrastructure projects. As a result, investment in infrastructure as a share of GDP falls from 3.8 to 2.4 percent of GDP. This suggest the need to adopt a policy to maintain infrastructure investment levels as a share of GDP as an important objective to support a growing economy.

**Net domestic financing projected to remain stable:** On the financing side, debt repayments are based on scheduled debt repayment of existing loans, and on the assumption that new borrowing maintains a 10 percent external-debt-to-GDP ratio. The government is assumed to set aside 2 percent of domestic revenues as per budgeted allocation to establish a revenue reserve fund to help smooth irregularities in cash flow and unforeseen needs while mitigating cyclical downturns. External borrowing by SOEs is on-lent by government and incurs creation of matching domestic debt and repayments. The model does permit issuance of domestic government debt, and the residual on the fiscal account is assumed to be a drawdown of domestic deposits. An indicator of financial stability is measured through net domestic financing, which in Palau's case includes the general fund reserve, domestic on-lent loans and domestic deposits. This indicator closely tracks the overall fiscal balance and remains stable during the projection period.

**The COFA Trust Fund projected to yield a nominal $15 million through FY2040 but with a non-negligible 4 percent risk of collapse:** Figure 60 provides a projection of the COFA Trust Fund on the assumption of no market risk and that a real market rate of return of 5.0 percent is achieved (7.0 percent inflation

**Figure 60**
Projected value of the CTF in constant prices of FY2019



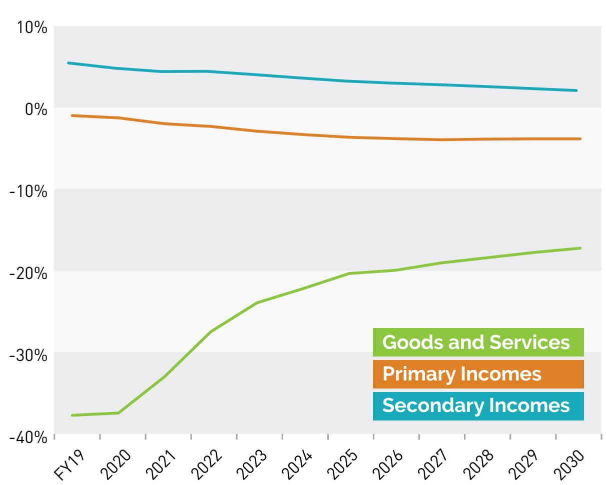

adjusted). The estimate for the trust fund at the end of FY2019 includes the additional fund from the CRA; it is projected to attain a value of $290 million. Based on the assumption that Palau draws $10 million in FY2019, $14.867 million in FY2020, and the agreed $15 million thereafter, the fund is projected to decline in real terms (FY2019 prices) to $279 million in FY2025 at the start of the post CRA period and to rise gradually thereafter attaining a projected value of $300 million by FY2040. While this suggests the fund may support a perpetual fund yielding a fixed nominal drawdown, the analysis in chapter 9 indicates there is a non-negligible 4 percent chance the fund will collapse before FY2044. Further, with re-specification of the benchmarks adopted in the CTF simulation analysis to nominal terms, the overall performance indicator attains 91 percent, but below the target 95 percent. This suggests that a prudent distribution policy would withdraw less than the agreed-upon rate of $15 million per annum so as not to pass on the risk of fund depletion to future generations.

## BALANCE OF PAYMENTS

**Balance of payments included in LTEFF:** The balance of payments has less policy implications in Palau than in economies with their own currency. Using the US dollar insulates the economy from the need to take balance-of-payments protective action. Adopting somebody else's currency removes monetary policy as a tool of adjustment and focuses adjustment strategy squarely on fiscal policy. While the GDP, household and fiscal accounts have been modeled with care and attempt to capture the underlying transactions, the transactions in the BoP are subject to a higher degree of error. That said, the LTEFF has included the balance of payments and monetary accounts not only for completeness, but also because several important variables are estimated in these accounts.

**Significant increase in export to GDP with the projected growth in tourism:** Figure 61 indicates trends in the current-account balances of the balance of payments. The goods-and-services account is projected to improve over both the medium and longer term. The ratio of exports to GDP rises significantly as tourism activity returns to normal through FY2025 but continues to increase through the end of the period at a slower rate reflecting the underlying growth in visitors. The import-to-GDP ratio is projected to remain largely stationary throughout the period. The demand for imports is projected in three major categories: food, fuel and general imports. Food imports are linked to household incomes with a low-income elasticity of 0.9. Fuel imports are more elastic 1.2 and linked to GDP growth. General imports have an income elasticity of 1.25 and are also linked to GDP.

**Figure 61**
Balance on goods and services, primary and secondary incomes, percent GDP



**Both primary and secondary income accounts decline during the period:** The two major items on the primary-income account are foreign-investment dividend outflows and earnings on social security investments. The former increases with the improvement and growth in the tourism industry, while earnings on social security funds are insufficient to outperform the foreign investment outflows. As a result, the primary-income account deteriorates as visitor numbers and the hotel-occupancy rate improve. For secondary incomes the major items are grants, tourist-departure taxes, and foreign-labor remittances. While current grants are inelastic over the long term because most grants are fixed in nominal terms, departure taxes rise with the growth in tourism. Foreign-worker remittances also rise, and the overall result is a declining balance in the secondary-income account.

**Continued FDI and build up in external assets of the commercial bank system dominate the finance account:** The capital account as a percent of GDP declines through the period, reflecting the assumption of constant real grant flows. On the finance account the major items include FDI, portfolio investments of the social security and CSPF funds, external assets of the commercial banks, and net borrowing of the public sector. After a lull in investment in the tourism industry, FDI is projected to rise with the moderate long-run growth in tourism. SS funds continue to grow through the period after the recent reforms and commitment by government to continue financing the recent increase in benefits to pensioners. The CSPF continues to draw on investments until the fund is projected to crash in FY2030, when investments have been exhausted and the system requires subsidy from government. There continues to be significant buildup in external assets of the banks, reflecting the rise in liquidity and weak domestic lending environment. Government borrowing is high in the near term with the large investments in infrastructure projects but slows significantly as government external debt plateaus at 10 percent of GDP. SOE borrowing reflects repayment of existing loans in the near term and the adoption of the long-term ceiling of 20 percent of GDP. After the initial years when the economy recovers from the recent contraction, the finance account settles representing an average of about -12 percent to GDP.

**LTEFF lacks macro consistency:** Overall the errors and omissions on the balance of payments improves as a percent of goods and services. However, the results can be volatile and indicate the inherent weaknesses in the LTEFF, which does not include internal macro consistency.

### THE BANKING SURVEY

**The deposit base is projected to expand but credit creation remains weak and foreign assets grow strongly:** The projected banking survey (see Figure 62) relies on a few basic assumptions. Deposit growth is projected by institutional sector. For the national and state government deposit growth reflects the respective fiscal position of the entities. For the private sector and households deposit growth has been projected in relation to current GDP and household incomes. As a result and the positive fiscal outturn of the national and Koror states deposit growth is projected to grow during the period. Lending, on the other hand, which is linked to household incomes for consumer credit and to GDP for commercial credit, expands only slowly and reflects the reluctance of the banking sector to lend in Palau with many structural impediments. The result is continuing growth in liquidity, which the banks use as a source of funds for offshore lending. The result is a rising trend in foreign assets largely mirroring the growth in the deposit base.

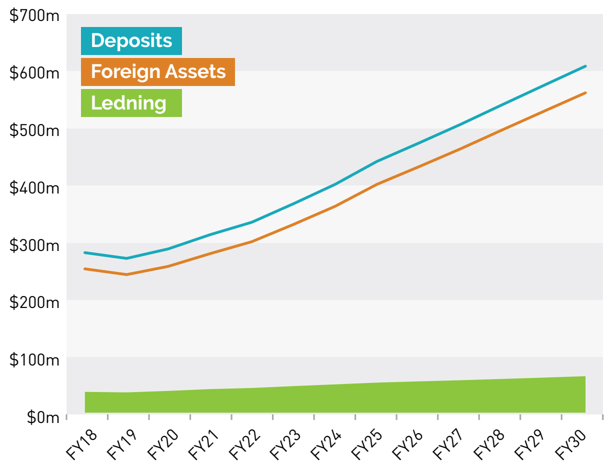
## B. Adoption of a fiscal strategy and resonsibility framework

### ELEMENTS OF THE REFORMS

In this section we present the results and impact of adoption of the recent fiscal strategy and responsibility framework developed under a recent ADB TA[1]. The individual components are itemized in the following list and then discussed in more detail. The impact of adoption of the

1 Asian Development Bank, TA-8581 REG: Strengthening Public Sector Management in the North Pacific, 2018

**Figure 62**
Commercial bank deposits, foreign assets, and lending




fiscal strategy is presented in graphical form contrasting the impact of the results compared with the base line scenario.

- **Tax reform.** Palau implements a comprehensive tax-reform strategy in FY2021.
- **Perpetual COFA Trust Fund.** Drawdowns from the CTF are reduced in FY2021 and in subsequent years sufficient to establish a perpetual fund as specified under the "SAFER" option of Chapter 9.
- **Civil Service Pensions Fund Reform.** Government allocates additional transfers from the PPEF to the CSPF together with an increase in employer and employee contributions.
- **SOE reform:** Government adopts the KASP I project requirement of full cost recovery and further implements KASP II with a Community Service Obligation (CSO) to address impact on vulnerable households.
- **Infrastructure Development.** Commitment is made to maintain national government infrastructure spending as a fixed proportion to GDP.
- **General Fund Reserve:** The GFR is restructured to maintain the reserve at a specified ratio to domestic revenue.

**Tax Reform: The major elements of the tax reform proposal are as follows:**

i. Introduction of a VAT (referred to as the Palau Goods and Service Tax). The rate of tax is such to equate the fiscal outturn of the full reform package to the pre-reform position in FY2021, the first year of introduction of the tax. It has been assumed that in the first year of the implementation there is 20 percent non-compliance, but this falls ratio falls to 10 percent over three years. The tax reform is thus revenue positive over time.

ii. Introduction of a net profits tax at the highest marginal wages tax rate; this is 15 percent.

iii. Reform of the wages tax to exempt low income earners on minimum wage below $8,000. The tax reduction is designed to compensate low income earners from the impact of the PGST on inflation. At present all income earners above $8,000 pay a marginal rate of 12 percent. In the reform two bands are introduced: $8,000—$24,000 with a tax rate of 10 percent and above $24,000 which attracts a rate of 15 percent.

iv. Repeal of the gross receipts tax, removal of the general import tax, and illimitation of other small import duty rates. Previous taxes collected on alcohol and tobacco are converted to excises.

v. A tax threshold for businesses subject to the NPT and PGST of $100,000 of sales is assumed, which includes 96 percent of all business and 30 percent of enterprises. Business below the threshold pay an annual presumptive tax.

The implementation of the tax reforms is assumed to take place in FY2021. The revenue neutral PGST tax rate without implementation of the other reforms of the package is 8 percent. When implemented with the overall package the NPT is set to 20 percent and the revenue neutral PGST rate rises to 12 percent. Overall this is equivalent to a 3 percent of GDP revenue effort, which is born by the household and private sectors.

**Perpetual COFA Trust Fund:** In the case of the COFA trust fund the fiscal strategy proposes that in FY2025 the rate of drawdown is reduced to establish a trust fund according to the "SAFER" rule outlined in Chapter 9. This is estimated to be $9.2 million, which is indexed from that time forward. It is also assumed that the government reduces its drawdowns from the trust fund by 2 percent of GDP (from the time of implementation of the tax reform) to enable the fund to accumulate before the end of the CRA period. The impact on the fiscal relative to the baseline deteriorates through the end of the CRA period, but thereafter improves. This reflects (i) the reduced drawdowns in the early period, and (ii) the indexing built into the SAFER rule. In effect the reduced drawdown in FY2025 reduces the wellbeing of the current generation to establish a perpetual fund that benefits all future generations.

**Civil Service Pension Fund Reform:** The civil service pension fund is in dire need of restructuring, and reforms are being developed to ameliorate the imminent collapse of the fund. In the meantime, this review proposes two reforms: (i) increase the government transfer from the current $12.50 per visitor arrival to $25 (as specified in the original Marine Sanctuary Act), and to increase the rate of contribution of both employees and employers from 6 to 8 percent. These reforms place the fund on firmer footing and the fund corpus is projected to grow from its currently level of $27 million to over $49 million by FY2030. In the near term the impact is negative, but after FY2030 the impact is positive since the projected collapse of the fund has been averted.

**SOE reforms: Koror Airai Sanitation Project:** The fiscal strategy proposes the government implements a tariff schedule for water and wastewater consistent with full cost recovery and thus eliminates the subsidy assumed in the baseline. The reforms also assume that the KASP II project is undertaken to complete the unfinished elements of KASP I and additional capacity need for economic and tourism development. However, it is assumed that government covers part of the cost of the extended project through a community service obligation (CSO) to support low income households. The impact on the fiscal position is positive in the near term with implementation of full cost recovery but negative in the longer-term as the government commits to pay the CSO.

**Infrastructure Development:** The fiscal strategy proposes the government implements a policy to maintain public infrastructure at a fixed ratio of 5 percent to GDP (after allowing for a declining level of grant aid in terms of GDP) to support the growing economy. This requires a rising level of funding from FY2023 onwards after the current pipeline of donor funded grants and CRA $20 million are complete. This objective is the costliest element of the reform package in the longer term.

**General Fund Reserve:** The national government already has legislated to establish a General Fund Reserve (GFR) at 2 percent of domestic revenues. The fiscal strategy proposes to restructure the GFR such that the fund is maintained at three months' worth of domestic revenues. In FY2017, this amounted to $19 million. The fiscal strategy also proposes that a proportion of the cash reserves held on deposit at commercial banks—past savings from fiscal surpluses—is earmarked for this purpose. The impact of the policy is that the additional funds required each year to sustain the reformed GFR are less than under the current 2 percent rule. The revised policy rationalizes the approach to countercyclical policy, but at the cost of sterilizing a portion of current savings for future emergencies—either fiscal downturns or disasters.

## COMBINED IMPACT OF THE REFORMS

Impact on the real economy, GDP and jobs is minor, but impact on household real incomes is significant: The combined impact of adoption of the fiscal strategy is indicated in the set of graphs in Figure 63. The first two graphs indicate the impact on the real economy and indicate there is little impact on the real economy or in terms of employment. The reforms are largely financial in nature and the impact on the economy is likely to be long-term in nature. The second set of graphs on consumer prices and household real incomes indicates the major cost of adoption of the fiscal strategy. As a result of the tax reform and need to generate significant domestic resources, the PGST rises 4 percent above the revenue neutral rate and the net profit tax rises from 15 to 20 percent. As a result, consumer prices rise by about 4 percent above the base line projected rate of inflation. Household real incomes fall from an average $9,103 to $8,612, a 5.4 percent reduction.

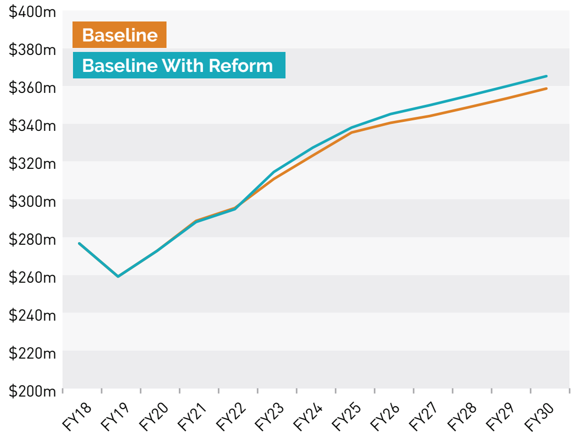
**Expenditures rise to cover the cost of the reforms and matched through implementation of the tax reform:** The next two graphs indicate the impact on government revenues and expenditures. The overall impact on the fiscal balance is not shown as the program has been designed to be revenue neutral. Expenditures are projected to rise to pay for the increased cost of the reforms. Revenues by design and implementation of the tax reform rise to balance the equation; revenue neutrality is achieved in FY2021, but there after the reforms are revenue positive.

**Financial impact of the reforms improves significantly the net wealth of the nation:** The final four graphs indicate the impact of the fiscal strategy on public sector financial and not financial assets. Implementation of policies designed to turn the current COFA Trust Fund into a perpetual fund result in an increase in the real value of the fund by 24 percent by FY2030. This results from the additional contributions made by the government to the fund and the reduced drawdown in FY2025. In the following years the FY2025 drawdown is adjusted for inflation and as the fund grows increases in real drawdowns is permitted. The additional contributions to the CSPF stabilize the fund in real terms and avoid the collapse projected in FY2030. Although beyond the horizon considered here reform of the CSPF enables considerable fiscal savings. The impact on the accumulated level of capital investment (fixed assets) through adoption of the 5 percent infrastructure target is shown to be significant (this indicator does not allow for deprecation).

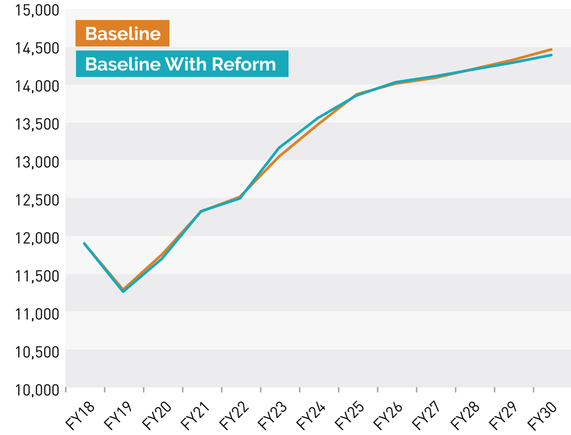
**Improvement in the financial position of the nation is born through a reduction in real incomes:** The impact of adoption of the fiscal strategy on public sector net financial wealth is shown to improve significantly by 27 percent. This indicator does not include accumulation of fixed assets but does include external debt (external debt is not shown and does not change significantly with the reforms). The results of the reforms reveal the financial position is considerably improved: the CTF becomes perpetual, the CSPS is stabilized, the nation's infrastructure is improved, and fiscal policy has been protected against cyclical volatility. The nation has implemented an economical efficient tax regime. The impact on the economy and jobs is projected to be minor. The main cost has been a reduction in household real incomes of 5 percent.

**Figure 63** Impact of the reform strategy and reforms on the Palau economy

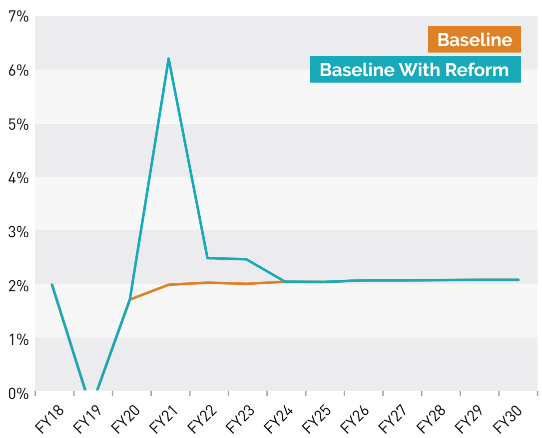
## GDP (constant prices)



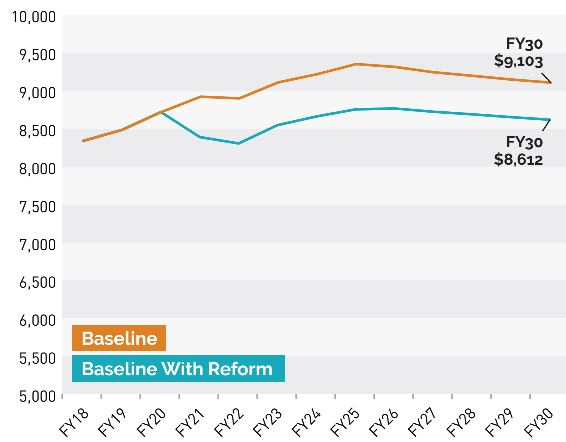

## Employment



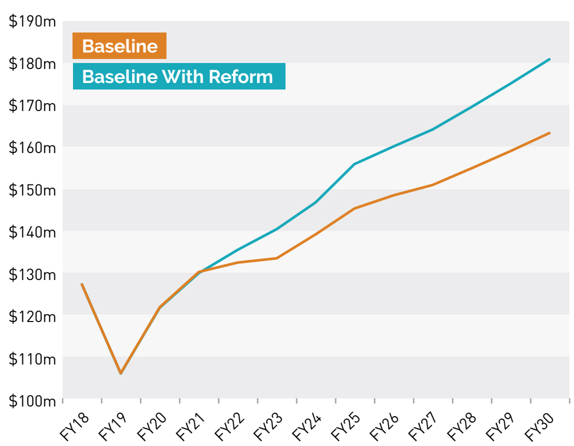

## Consumer Prices



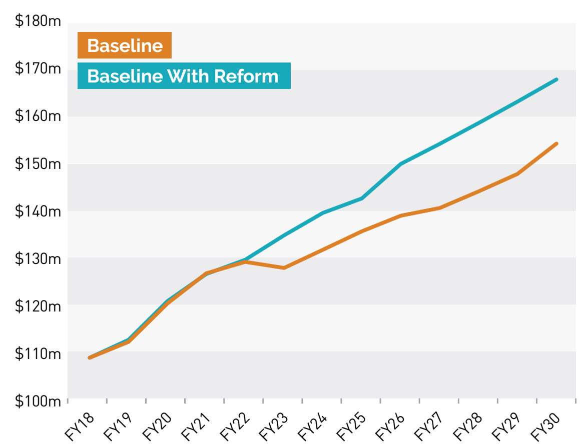

## Household per capita real incomes



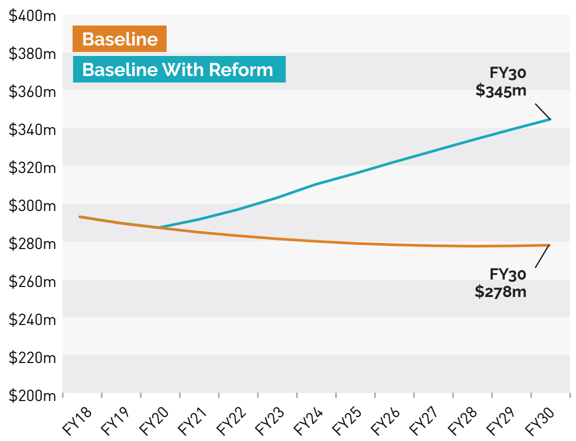

## Revenues



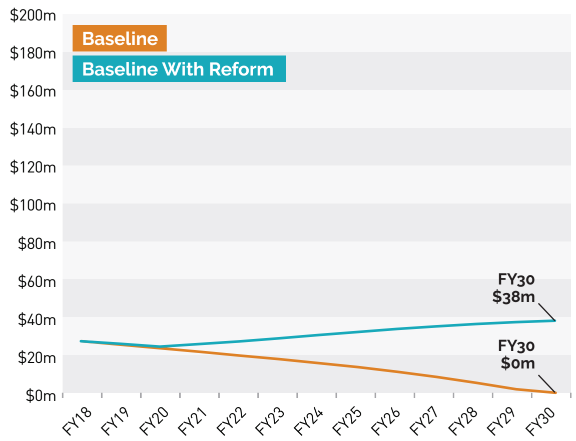

## Expenditures



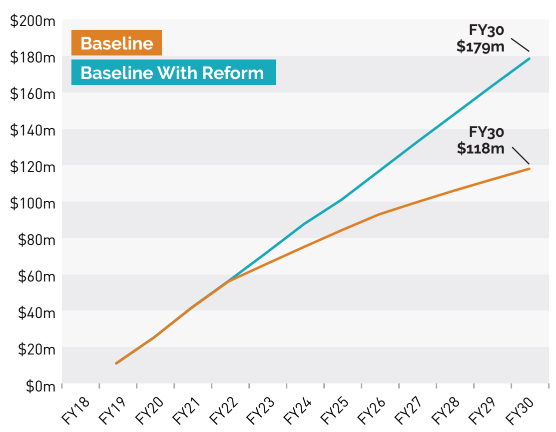
## CTF value (FY2019 prices)



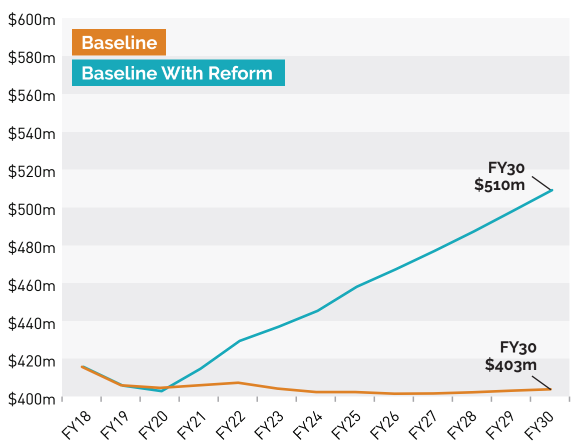

## CSPF investments (FY2019 prices)




## Investment (accumulated FY2019 prices)




## Net financial worth (government, FY2019 prices)



# Appendix 1

## The Policy Scorecard

Table 10 provides a selected summary of various components of Palau's policy and institutional structure comprising a reform agenda and discussed in this review. A brief summary is included in the table with a color-coded indication of the success of the reforms.

### FISCAL POLICY

**Palau has achieved good fiscal performance and favorable control over payroll, but success is yet to be achieved with tax reform:** During the international recession, Palau experienced a period of cyclical downturn and fiscal deficits. This has gradually improved, and Palau recorded an average surplus of 4.8 percent of GDP during the FY2013-FY2016 period This has been maintained although at lower levels as the economy weakened in the last two years. (coded green). National government employment has fallen compared with the levels of FY2000, but nominal wages have increased averaging 2.7 percent, although real public sector wages have stagnated (coded green). Palau initiated tax reforms in the late 1990s and more recently in 2014 with TA support from PFTAC and the IMF. Interest in the initiative was subsequently reactivated: the legislation was reviewed by the IMF, and TA support provided, but there has been no follow through (coded red plus).

**External debt management is favorable, and resources have been devoted to the CTF, but the CSPS is at imminent risk of collapse:** Palau has adopted a favorable external-debt strategy, reflected in a low debt-to-GDP ratio, and external debt poses no significant risk (coded green). Palau has recently developed a long-term fiscal strategy with ADB support to adjust to the reduction in real grant transfers under the Compact, but this has yet to be adopted in the OEK. Further, Palau has recently devoted significant additional resources from the CRA to the COFA Trust Fund, but this has yet to achieve perpetual status. (coded yellow). The Social Security system has been modified to reduce the unfunded liability through legislative change with adjustments to tax rates, thresholds and retirement provisions (coded green). The Civil Service Pension Scheme without legislative change is projected to collapse within 10 years (coded flashing red). Palau with technical assistance from the US has now maintained a comprehensive set of economic statistics suitable for economic monitoring for several years (coded green).

### PUBLIC FINANCIAL MANAGEMENT

**While implementation of the PEFA framework has been slow audit quality is good:** Palau initiated a program to adopt the World Bank and IMF standard Public Expenditure and Financial Accountability (PEFA) framework as a means to improving PFM. However, after an initial internal assessment was made, no further progress has been achieved although a follow up external assessment is planned in the near-term. (coded yellow). In the area of financial accountability and control, audits are no longer qualified, the national-government finance office is adequately staffed, and audits are timely (code green).

**Palau has adopted a medium-term planning, budgeting and fiscal strategy but considerable further work is required for effectively implementation:** As part of a large-scale ADB TA in 2008, Palau prepared a series of medium-term planning documents referred to as the Facility for Economic and Infrastructure Management (FEIM). The FEIM fulfilled the role of both a medium-term fiscal framework and a strategic development plan. With ADB support the fiscal strategy has been updated together with a set of manuals to support performance management and budgeting, although these are yet to be implemented (coded yellow). In terms of the longer-term Strategic Development Plan certain parts of the original FEIM such as preparation of an infrastructure development plan are in need of updating (Coded Yellow). While Palau is thus attempting to put in place a modern system of budget and performance management, this is yet to be achieved (Coded Yellow).

**The FMIS is currently under replacement to introduce a modern system capable of fulfilling Pala's accounting, fiscal and budget needs:** Financial-management information systems provide adequate accounting and audit data but have not provided a basis for measuring output delivery, fiscal statistics or budgeting. An RFP has been issued and identification of a new system to remedy the current weaknesses is under way (coded yellow).

## STATE-OWNED ENTERPRISES

**Subsidies to SOEs have risen with the transfer of water and wastewater to the PPUC; significant reforms have been accomplished in the telecom sector:** The level of SOE subsidy in Palau over the last three

**Table 10** Summary of Palau policy reforms

| | Achievement | Score |
|---|---|---|
| **Fiscal policy** | | |
| Fiscal balance | Fragile, balance achieved since FY2010; large 3% of GDP surplus in FY2016 | |
| Public sector payroll | Size of public service has been reduced since FY2005 -0.5% per annum, wage rates +3.1% pa | |
| Tax Reform | Considered in 2014 not enacted | |
| External debt | Sound external debt position | |
| Long-term fiscal adjustment | Fiscal strategy has been prepared and additonal resources allocated to the Cofa Trust Fund but is yet to attain perpetual status | |
| Social security | Reforms enacted and unfunded liability reduced | |
| Civil service pension fund | CSPS projected to collapse within 10 years without reform | |
| Macroeconomic Monitoring | Full set of Statistics available for economic performance assessment | |
| **Public Financial Management** | | |
| Public Expenditure & Financial Accountability (PEFA) | Assessment completed in 2013 and external assessment planned for the near-term | |
| Financial accountability | Audits currently "unqualified" | |
| Medium-Term Fiscal Framework | Not currently adopted in the RoP | |
| Strategic Development Plan | In FY2008 the RoP completed a strategic development framework: Facility for Economic and Infrastructure Management. A fiscal stragey has been prepared together with a set of budget manuals | |
| Performance management | Weak and no monitoring of outputs or outcomes | |
| Information Systems | Captures financial information only; in the process of replacement | |
| **State Owned Enterprises** | | |
| Subsidies | 1% of GDP | |
| Divestment | Limited public investment in economy outside of utilities and teleocm | |
| Full cost recovery | Utilties operate on cash-flow basis without setting aside funds for depreciation; challenges to achieve operating balance in water/sewer | |
| SOE policy | SOE policy issued by President, but needs enactment into law | |
| **Regulatory Environment** | | |
| FDI | RoP operates a non transparent foreign investment board | |
| Tourism | Tourism Policy Framework prepared, but fails to fulfill need for a comprehensive strategy | |
| Private sector regulatory environment | Recent changes to secure transactions law | |
| Doing business Survey | World Bank survey places RoP 136th out of 190 | |

years has averaged 1 percent of GDP, reflecting subsidy for water operations, and the nation has avoided the financial pitfall experienced in many countries. However, the recent establishment of water and sewer operations at the PPUC will require subsidy for some time until cost recovery even on a cash basis is achieved (coded yellow). The main state-owned enterprises in Palau include the PPUC, the PNCC, the NDBP and more recently the BSCC. Recent reform initiatives sponsored by the World Bank in telecoms include the establishment of an open-access internet provider (BSCC) and liberalization of the market. Legislation to provide the foundation for a deregulated and competitive ICT market and independent regulator was passed by the OEK and signed into law in December 2017 (coded yellow).

**Palau has yet to achieve full-cost recovery in delivery of utility services, although an SOE policy has been issued:** With the recent implementation of new internet services PNCC revenues have grown strongly and the entity operates at health profit levels. However, the transfer of the water and wastewater services to the PPUC reveals the high level of subsidy required to maintain operations. The recent pledge by government to underwrite increases in fuel costs in electricity production will also incur subsidy if prices rise. While telecom operates at full cost-recovery this has yet to be achieve in power, water and wastewater services (coded yellow). The president has issued an SOE policy, but this has yet to be enacted in law (coded yellow).

## PRIVATE SECTOR REGULATORY ENVIRONMENT

**The regulatory environment for the private sector is weak, but Palau has managed to attract significant foreign investment:** Palau operates an old-style foreign-investment board, which operates in a less-than-transparent manner. However, despite this impediment the nation has managed to attract significant foreign investment. Changes to the FDI law were recently enacted, but whether these will effectively resolve the “front”-business matter it was designed to address has yet to be seen (coded yellow minus). A tourism policy framework has been drafted and submitted to the OEK. However, the framework provides a set of guiding principles rather than fulfilling the role of a comprehensive tourism strategic master plan. The critical need for a comprehensive tourism strategy thus remains outstanding (coded yellow). New laws have been enacted to develop a secure-transactions environment, but further efforts are needed to improve the regulatory environment for private sector development, which remains weak (coded yellow). Finally, the World Bank’s Doing Business Survey ranks Palau 133rd out of 190 countries, which is a weak performance—that is, in the bottom third (scored red).

# Appendix 2

# Technical Notes to the CTF Simulations

## MARKET FINANCIAL DATA AND SIMULATIONS

The simulations undertaken in this review are based on statistical estimates derived from historical financial data. The data used were downloaded from the Global Financial Data online database. The following series have been used:

i. S&P 500 Total Return Index (with GFD extension)....................................35%

ii. GFD World x/USA Return Index................25%

iii. GFD Emerging Markets Return Index........5%

iv. USA 10-Year Government Bond Total Return Index ....................................15%

v. Dow Jones Corporate Bond Return Index..........................................................10%

vi. GFD World x/USA USD TR Government Bond Index..........................10%

The data series covers the period 1926–2018 and approximates the portfolio used in the RoP. The weights in the portfolio of the respective series are indicated on the right. It was not considered appropriate to attempt to exactly replicate the current portfolio of the RoP as the investment strategy deployed varies over time. The simulations undertaken are designed to incorporate the risk inherent in the adoption of a trust fund approach to funding Compact distributions relying on international financial markets as the investment vehicle. As indicated in the CTF chapter, there is considerable variation in outturn, and while the intent is to provide the most realistic projections possible, they remain indicative and designed to guide policy rather than to provide any kind of definitive forecast. Comfort is taken from the fact that the results in this study are broadly similar to those in the ADB and GAO studies.[1]

The simulations were programmed using Oracle Crystal Ball software, which is designed to enable Monte Carlo simulations in an Excel spreadsheet environment. The software is easy to use and coupled with Excel provides an excellent environment for the type of exercise conducted here. For each time series, a log-normal distribution has been fitted to derive estimates of the mean, standard deviation and covariances. Estimates of autocorrelations were also made. But, except in the case of the Dow Jones bond index and GFD world bond index, the series were not found to be significantly autocorrelated. Table 11 provides a list of the statistical estimates that were used.

## SPECIFICATION OF THE SAFER RULE

### INITIAL CONDITIONS

The original Compact agreement of October 1994, the trust fund subsidiary agreement, and the Compact Review Agreement (CRA) of September 2010 (now authorized and appropriated by the US Congress) specify the nature and conditions of the COFA Trust Fund and drawdowns. The original Compact (FY1995–FY2009) included provision for a COFA trust fund with a contribution of $66 million in FY1995 and a further $4 million in the subsequent year of FY1996, thus totaling $70 million. Five years into the Compact, Palau was entitled to draw down $5 million over the period FY2000–FY2009 and thereafter a further $15 million during the remainder of the 50-year Compact period through FY2044.

While the CRA was agreed in 2010 it was not passed into law until 2018. During this

1 See US Government Accounting Office, Trust Funds for the Micronesian and the Marshall Islands May Not Provide Sustainable Income, GAO-07–513, June 2007, Washington, DC; Government Accounting Office, Actions Needed to Prepare for the Transition of Micronesia and the Marshall Islands to Trust Fund Income, GAO-18-415, May 2018, Washington, DC; Asian Development Bank, Trust Funds and Fiscal Risks in the Federated States of Micronesia and the Marshall Islands: Analysis of Trust Fund Rules and Sustainability in an Evolving Aid Relationship, 2015, Manila.

**Table 11** Financial data: statistical estimates of means, standard deviations, and correlations

| | S&P 500 Total Return Index (w/GFD extension) | GFD World x/USA Return Index | GFD Emerging Markets Return Index | USA 10-year Government Bond Total Return Index | Dow Jones Corporate Bond Return Index | GFD World x/USA USD TR Government Bond Index |
|---|---|---|---|---|---|---|
| Mean | 1.089 | 1.071 | 1.087 | 1.028 | 1.042 | 1.026 |
| Standard deviation | 0.196 | 0.213 | 0.237 | 0.088 | 0.086 | 0.114 |
| Correlations matrix | | | | | | |
| S&P 500 Total Return Index (w/GFD extension) | 1 | | | | | |
| S&P 400 Midcap Total Return Index | 0.872 | | | | | |
| S&P 600 Small Cap Total Return Index | 0.733 | | | | | |
| GFD World x/USA Return Index | 0.481 | 1 | | | | |
| GFD Emerging Markets Return Index | 0.328 | 0.608 | 1 | | | |
| USA 10-year Government Bond Total Return Index | 0.079 | -0.074 | -0.068 | 1 | | |
| Dow Jones Corporate Bond Return Index | 0.352 | 0.188 | 0.235 | 0.752 | 1 | |
| GFD World x/USA USD TR Government Bond Index | 0.189 | 0.373 | 0.227 | 0.529 | 0.641 | 1 |

period Palau continued to draw the $5 million permitted under the original phase. With the signing into law of the CRA and agreement between the parties a further $65.25 million was deposited into the COFA Trust Fund by the US and Palau agreed to drawdown $10 million in FY2019, $14.867 in FY2020 and from then onwards at the original greed amount of $15 million. At the end of February 2019, the CTF held a corpus value of $286.612 million.

## DEFINITIONS

| | | |
|---|---|---|
| Actual CTF value in period t | CTF(t) | |
| Primary-target fund estimate | PT(t) | |
| Target distribution in period t | TarD(t) | |
| Distribution in period t | D(t) | |
| Long-run historical real geometric yield on portfolio | i | |
| US GDP deflator in period t (percentage of prior year) | P(t) | |
| SAFER adjustor | s | sim value |
| 0.67 | | |
| SAFER primary target | PTs(t) | |
| The SAFER Distribution target in period t | TarDs(t) | |

The target distribution is defined as follows[1]:

TarD(FY25) = 15 (1)

TarD(t) = TarD(t−1) * P(t−1) (2)

The primary target is defined as follows:

PT(t) = TarD(t) / i (3)

1 In the simulations the target distribution is taken as the inflation adjusted equivalent of the $15 million agreed in the COFA subsidiary agreement. This departure from the COFA agreement, which was defined in nominal terms, is to enable evaluation of the simulations in comparison with the target of establishing a perpetual indexed fund.

## THE SAFER RULE

The SAFER primary target and distributions are given by:
Drawdown in FY2025:

| | | | |
|---|---|---|---|
| PTs(FY24) | = | CTF(FY24) * 1/(1+s) | (4) |
| TarDs(FY25) | = | PTs(FY24) * i | (5) |
| D(FY25) | = | TarDs(FY25) | (6) |

Drawdown after FY2025:

| | | | |
|---|---|---|---|
| TarDs(t) | = | TarDs(t−1) * (1 + P(t)) | (7) |
| D(t) | = | min(CTF(t−1), TarDs(t)) | (8) |
| PTs(t) | = | TarDs(t) / i | (9) |

## TAIL RISK

### DEFINITIONS

| | | |
|---|---|---|
| CTF moving average | CTF_MA(t) | 3-year MA[1] |
| Ratio of CTF_MA(t) to PTs(t) | RC(t) | |
| Ratio of D(t) to TarDs(t) | RD(t) | |
| Venting increment | Vent | sim value 0.05 |
| Venting threshold | VentT | sim value 1.0 |
| Annual decrement | dec | sim value 0.05 |
| Annual increment | inc | sim value 0.02 |

## UPSIDE ADJUSTMENT

The upside adjustment is activated after FY2025 when the venting threshold is breached that is RC(t) > (1+VentT):

| | | | |
|---|---|---|---|
| D(t) | = | TarDs(t-1) * (1 + P(t)) * (1 + Vent)) | (10) |

## DOWNSIDE ADJUSTMENT

The moving adjustment downside adjustment is activated after FY2025 when RC(t) < 1 and is given by the following:

When RC(t) < RD(t−1),
D(t) = min(CTF(t−1), TarDs(t) * RD(t−1) * (1-dec)). (11)

When RC(t) = RD(t−1),
D(t) = min(CTF(t−1), TarDs(t) * RD(t−1)). (12)

When RC(t) > RD(t−1) and provided RD(t−1) * (1+inc) < 1,
D(t) = min(CTF(t−1), TarDs(t) * RD(t−1) * (1+inc)). (13)

When RC(t) > RD(t−1) and RD(t−1) * (1+inc) >= 1,
D(t) = min(CTF(t−1), TarDs(t)). (14)

1 In the initial years between FY2024 and FY2026, a moving average is taken over the period FY24-t.

# Appendix 3

## The Long-Term Economic and Fiscal Forecasting Framework: Projection Methodology

The following discussion provides a description of the projection methodology of the LTEFF[1]. The LTEFF comes under the class of models known as financial programming developed by the International Monetary Fund. The model is based on the four macroeconomic accounts of a nation: the national accounts, statement of government operations, balance of payments and monetary survey. The four accounts are related to each other and rely on simple projection techniques that can be modeled in spreadsheets. The following notes provide a description of each of the major components of the LTEFF framework. While it would be possible to specify the model algebraically, the approach adopted is to describe the important elements of the system and refer the reader to the spreadsheet model. Four main methods of forecasting have been deployed. These include the following:

- Trend, whether linear, exponential or growth factor
- Constant or moving average
- Exogenous, based on policy variables or known factors such as project implementation or investment intentions
- Endogenous, linked to other economic variables in the system

The model uses certain parameters and constants. These are specified in sheet "Param" of the LTEFF Excel workbook.

### PRODUCTION AND GDP

Production and GDP have for the most part been projected in constant prices (sheet "GDP_kp") with the current-price ("GDP_cp") series estimated through inflation by appropriate price indices. The economy can be divided functionally into sets of industries that behave in a similar manner. The methodology for projecting the majority of GDP is covered below, but for those not covered, the spreadsheet model contains further details.

i. **Production for home consumption:** Subsistence, or household nonmarketed production including ownership of dwellings is projected in relation to the level of population, which has been declining in recent years. Household production (agriculture and fishing) for the market (mixed income) is also projected based on population change of the Palauan segment.

ii. **Nontraded production for the home market:** Much of private sector production is driven by the level of aggregate demand and assumes no capacity limitations. Most industries are projected with an estimate of income elasticities. The group includes commercial agriculture, manufacturing, wholesaling and retailing, general transport, IT, financial intermediation, commercial real estate, administrative support services and other private services.

iii. **Tourism:** Tourism services are estimated on a submodel (sheet "Trsm") related to the plant installed, different market segments and an average occupancy rate. Total hotel rooms are projected based on the current stock plus known construction projects in the pipeline and estimated long-run growth. Current hotel plant under active consideration and construction is close to 300 rooms to be completed over the next two years. Room occupancy rates are projected to rise from the current low 28 percent in FY2018 to 50 percent by FY2025; this is

1 The LTEFF spreadsheet model can be downloaded from the Graduate School website at www.EconMap.org.

conservative relative to the 57 percent during the tourism boom period, FY2013_fY2015. Long-run growth in tourism is projected to rise by 2.5 percent, which is below the long-run actual growth of 4.1 percent since FY2000.

In the GDP projections, tourism is composed of the hotel-and-restaurant sector, diving and water-based tours, airport operations, travel agents, airline operations, and the Rock Islands state park. Based on the visitor-arrival projections and average spending patterns derived from a recent tourism exit survey, projections are made for the various subsectors of the tourism industry. This allows for the impact of changes in the mix of origin countries to flow though into the projections.

iv. **Construction:** Current-price forecasts are made for government projects (linked to the Government Finance Statistics projections), hotel projects (linked to the tourism submodel), the ADB Koror-Airai Sanitation Project including phase II, the Japan-financed landfill relocation project, renewed Compact infrastructure grants, the airport-renewal PPP project, and other large projects. These are deflated by an index of construction costs. Residual private sector construction is estimated through a three-year-lagged-accelerator principle.

v. **Government services:** Government nonmarketed production is considered a policy variable and projected exogenously. While the trend has been for a reduction in payroll numbers, the projections have been based on a policy to maintain the real level of government services. There is thus an in-built assumption for government expenditures to decline as a proportion of GDP. Current-price projections for government services utilize the wage projections in the LTEFF (see below).

vi. **NPISH:** Nonprofit institutions serving households, and various other minor activities, have been projected as a moving average.

vii. **Taxes less subsidies on imports and products:** Taxes on products have been projected in relation to the tax base: import taxes are estimated in relation to aggregate demand, gross-receipts taxes (GRT) in relation to private sector GDP value-added projections, and other taxes on products in relation to the constant-price value of the "cash" components of the economy (i.e., excluding items produced for home consumption). Palau's state-owned enterprises (SOEs) have received only minor subsidies, which have been projected in relation to the growth in the utilities sector.

## PRICE AND WAGE PROJECTIONS

**Prices:** Model prices (sheet "Prices") are projected exogenously on the basis of the small-country assumption. While this is a simplifying assumption, and nontraded-goods prices are domestically determined, it is not realistic to endogenize prices given the very small size of Palau. The CBO (Congressional Budget Office) provides useful long-term forecasts of the US consumer price index (CPI) and US GDP deflator. In the case of commodity prices, the World Bank provides a very handy set of projections for the major commodities affecting Palau: food and fuel. The Palau CPI is projected as a composite index composed of the World Bank projections of food prices and fuel prices with other prices related to the CBO's US CPI projection. Fish prices are derived from Forum Fisheries Agency data on long-line sashimi-grade fish. Projections are made based on long-term trends, which have been rising over the last 10 years.

**Wages:** In the case of wages (sheet "GoI"), the model assumes past trends are likely to continue into the future. Wage rates are projected on trend by institutional sector. For government wages, an "add factor" is included as a policy variable depending on whether government issues discretionary increases such as COLAs. In a more comprehensive model, wage rates would reflect labor-market conditions, but in the simplified world of the LTEFF, wage rates are projected exogenously, with a policy adjustment for the public sector to indicate likely trends.

## GDP AT CURRENT PRICES AND THE GENERATION-OF-INCOME ACCOUNT

**GDP at current prices:** The projection of GDP at current prices (sheet "GDP_cp") is a relatively straightforward affair, with the change in GDP at constant prices being indexed to the respective price or wage indicator. In general, the constant-price traded-goods industries of the economy are inflated by the appropriate world price. For private sector nontraded goods, the US CPI is used. In the case of general government, the constant-price series are multiplied by the projected wage-rate change. The sum of all industry current-price estimates provides the estimate of current GDP at basic prices. To this the value of taxes less subsidies on products must be added. These are projected in relation to the corresponding estimates in the fiscal account. The total of all industrial production and taxes less subsidies on imports and products provides the estimate of GDP at purchasers' values.

**Generation of income account:** The generation-of-income account (sheet "GoI") is the allocation of value added between compensation of employees, operating surplus, and taxes less subsidies on imports and products. An estimate of compensation of employees is made at the industry level through multiplying the prior-period compensation estimate by the increase in industry constant-price GDP and the respective wage index. An economy-wide estimate of productivity is applied equally to all compensation of employees and employment projections for the private sector activities. The model thus implicitly assumes capital-labor factor substitution. Estimates of operating surplus are derived residually through subtraction of compensation from value added. Other taxes and subsidies on production are minor, not known with any degree of accuracy, and may be ignored for practical modeling purposes.

## THE HOUSEHOLD-SECTOR ACCOUNT

**Household generation of incomes:** We are now in a position to bring together the various components of the household-sector account (sheet "Hsl_Acnt") and move toward estimating household disposable income. Household income is generated from a series of value-added components: compensation of employees from domestic production, mixed income from production, withdrawals from quasi-corporate income, and a small amount of compensation accruing to workers at foreign missions. Compensation of employees and mixed income from production are taken directly from the GDP estimates. Compensation of workers at foreign missions is projected in line with current-price GDP. Withdrawals from quasi-corporate enterprises is estimated from the operating surplus derived in the generation-of-income account. A deduction is made for depreciation and the returns arising from foreign ownership by industry.

**Household primary and secondary incomes:** Turning to primary incomes, households receive interest on savings and time deposits and make payments on loans. They also receive rent from foreign owners of capital in proportion to ownership. Rent payments are also made to Koror State. On the secondary distribution-of-income account, there are major receipts and payments to the Social Security Administration and the Civil Service Pension Scheme; these are outlined in the spreadsheet sheet "Fin"). Households pay fees, fines and wages taxes, and receive certain social benefits from government. These are linked to the fiscal account. A significant amount of grants is received from Pell grants and is projected as a moving average. Households receive certain remittances from the rest of the world that are derived from the balance of payments (BoP). Significant outward remittances are transferred by foreign labor working in the economy, again estimated in the BoP.

**Household disposable income:** Adding up all the transactions enables an estimate of total household disposable income, which is either saved in fixed proportion to income (based on historical behavior) or consumed. From deflating nominal household disposable income by the CPI, an estimate of real disposable incomes is derived.

## GROSS DOMESTIC EXPENDITURE AND DEMAND

**Government final consumption expenditure:** The GDE account (sheet "GDE") is built from a mixture of current and constant prices and then either deflated or inflated to derive the corresponding series. Government final-consumption expenditure is derived from the fiscal accounts and is the sum of compensation of employees and use of goods and services, less sales. Each item has a direct counterpart in the fiscal account. Compensation is deflated by government wage increases and use of goods and services by a cost index of the CPI plus the World Bank's manufacturing unit-value index. Sales are deflated by the CPI. General government comprises the national government, state governments and agencies. The fiscal account relates to the national government alone and is used as the driver for the GDE estimates. While the national government is responsible for 67 percent of general-government final-consumption expenditures, the simplification in the LTEFF could be improved through including an account for Koror State, which is becoming increasingly important with growth in the tourism industry.

**Household final-consumption expenditure is composed of three elements:** household acquisitions (or cash expenditures), ownership of dwellings, and production for own consumption (subsistence). Household acquisitions are indexed to the change in real household disposable income from the household account. Estimates for ownership of dwellings and other items produced for own consumption are indexed to population growth. The current-price series are derived through inflation by the respective elements of the CPI. The estimation of consumption of nonprofit institutions serving households (NPISH) is driven by the growth in the NPISH sector's GDP growth in current and constant prices.

**Gross fixed-capital formation** is decomposed into construction and other (mainly plant and equipment). The construction component is indexed to the GDP current- and constant-price series. The constant-price equipment series is also driven by the growth in construction activity, while the current-price series is inflated by a cost index. The assumed constant ratio between construction and equipment is clearly open to question, but has been adopted in the absence of any better assumption. Changes in inventories are not projected.

**Exports less imports:** Current-price estimates of imports and exports are linked to the BoP estimates (see below) and grouped into major categories. Exports are grouped into re-exports (mainly fuel), goods, services, tourism and foreign missions. Imports are grouped into food, fuel, other manufactures and services. The constant-price series are derived through deflation of the appropriate price index.

**Gross Domestic Expenditure:** The estimates of GDP(E) are now possible through adding up all the components of the account. Aggregate demand is considered to be the sum of final consumption, gross capital formation and exports.

## THE FISCAL ACCOUNT AND EXTERNAL DEBT

**Taxes:** The fiscal projections (sheet "Fisc") are based on two different sets of assumptions: (i) revenues are driven by developments in the economy plus known levels of Compact receipts, and (ii) expenditures are projected on the basis of the current policy position. Taxes are projected based on rates of growth of the respective tax base plus estimates of the buoyancy of each tax. Income taxes (wages taxes) are projected in line with the total change in compensation of employees and a tax-buoyancy ratio of 1.17 percent. The gross-receipts tax is projected in line with selected elements of GDE on which the GRT is levied and a buoyancy ratio of 1.09 percent. The LTEFF does not model the gross output of industries directly, so a proxy is used to project the tax base. Import taxes are indexed to the cash components of GDP and a buoyancy ratio of 0.68. The hotel-occupancy tax is related to the growth in current-price GDP estimates of hotels. Fish-export taxes are related to the projected activity of the fish support-service industry; the tax is collected on a quantity basis. Other taxes (e.g., airport-departure taxes) are pegged to the projected number of visitor arrivals.

**Tax reform simulations:** The LTEFF allows for the implementation of the tax-reform proposal that is currently under consideration by government and the OEK. The proposal allows for the introduction of the PGST and a net-profits tax, and removal of the GRT on large businesses and the import tax on general merchandise. The reforms also allow for an offset to the regressive nature of the PGST with a reduction in the wages tax for low-income households.

**Grants:** After a delay of nearly eight years, in March 2018 the U.S. Congress finally authorized and appropriated funds to resource the Compact Review Agreement (CRA). The funds received by Palau since FY2010 were deducted from the original agreement and the Congress appropriated $123.824 million. With agreement between the parties of this amount $65.25 million was allocated to the COFA Trust Fund. A further $24.574 million was allocated during FY2018 that after drawdowns from the CTF would enable Palau to maintain a revenue stream of $18.147 million during the FY2019-FY2020 period—that is equivalent to the amount received during FY2010-FY2018 before the CRA was finalized. This implied drawdowns from the CTF of $10 million in FY2019, $14.867 million in FY2020. Thereafter drawdowns from the CTF were to revert to the original Compact agreed amount of $15 million. Finally, the original capital contribution of $40 million for infrastructure was reduced to $20 million. These provisions have been programmed into the LTEFF. Federal programs and other country grants not subject to the CRA are projected as moving averages with special allowance for the Japanese-funded Koror-Airai Water Supply System Improvements project.

**Nontax revenues** comprise fishing royalties, airport landing fees, administrative fees and various minor items. Palau is expected to continue to benefit from the Parties to the Nauru Agreement despite the implementation of the marine sanctuary. However, the model assumes that fishing royalties will decline to half their current levels over a seven-year period but will increase with inflation. Airport landing fees are projected in line with visitor arrivals. Administrative fees are indexed to inflation, and other minor revenues are projected as moving averages.

**Payroll and use of goods and services:** On the expenditure side, under the baseline scenario it is assumed that payroll numbers for public administration, education and health remain unchanged. Wage rates are forecast to grow on trend, at approximately 3.0 percent for the national government. For goods and services, fiscal discipline has been assumed to be maintained, with the majority of components projected as constant in real terms but with an allowance for inflation in current prices. In certain cases, where there have been more rapid increases—medical supplies, communications and contractual services—items have been projected on trend.

**Interest, subsidies and transfers:** Interest payments are derived from the external-debt module. Subsidies to the SOE sector are projected according to differing assumptions relating to recent corporatization of water and sewer operations previously operated by government. It can be assumed that the new venture will operate according to full cost recovery or will be subsidized by government. Transfers to extrabudgetary units are projected as a five-year moving average, while transfers to state governments are projected on trend. Other expense includes transfers to NGOs, households and students, as well as miscellaneous expense. Transfers to the NGOs and students are projected on trend, while other transfers and expense are adjusted for inflation.

**Capital expenditures** are linked to capital-grant disbursements plus new projects funded through external borrowing. On the financing account, the major item is debt transactions, which are derived from the debt module. Domestic other accounts payable has been treated as the residual on the fiscal account.

**Financing:** Existing external-debt service has been projected based on loan-repayment schedules (sheet "Fin"). To fund new projects, the national government is assumed to maintain a fixed external-debt-to-GDP ratio set at the historical average of 10 percent. After repaying existing debt obligations, the national government is assumed to contract new borrowing to maintain the ratio. While there is no indicator of government future needs for project financing, the historical rate provides an anchor for future commitments. All new loans such as those with the ADB are assumed to be contracted on concessionary terms. Unlike in the IMF's external-debt sustainability analysis, it is assumed Palau has no recourse to international financial markets and cannot fund a deficit through borrowing. Budgetary shortfalls must be adjusted through fiscal realignment.

## EXTERNAL DEBT, SOES, NATIONAL INSUANCE, THE COFA TRUST FUND AND OTHER ACCOUNTS

**External debt:** The LTEFF contains a special spreadsheet "Fin" where transactions largely of a financial nature are estimated. The sheet firstly makes estimates of external debt; this is divided into two parts: national government and the SOE sector. Estimates firstly capture of the schedules of existing debt. To this is added known new projects in the pipeline. In addition, the LTEFF is based on the premise that the government targets an external debt to GDP ratio of 10 percent for the national government and 20 percent for the SOEs. This is reflective of historical performance. As debt is drawn on new debt is incurred which is used to finance public infrastructure. In so doing the LTEFF departs from the IMF/World Bank Debt Sustainability Analysis which assumes that all government fiscal deficits/surplus are financed through debt. In Palau's case this is unrealistic as at the current time Palau has no access to international finance markets.

**State Owned Enterprises:** a special account has been set up to project the accounts of the SOEs with a view to estimating their likely requirement of subsidies. Two accounts have been forecast: the provision of water and wastewater of the PPUC and the new BSCC. The recent ADB financed KASP I project will require increases in tariffs if it is to achieve full cost recovery. In the case the government does not raise tariffs subsidies are required. In the case of the BSCC demand has already grown significantly and no requirement of subsidy has been projected.

**National insurance:** projections are made of both the Social Security system and the Civil Service Pension Scheme. Social security contributions are projected to grow in line with the growth in compensation of employees. Social security benefits are based on the actuarial report provided to the Social Security Administration. Similarly, contributions to the Civil Service Pension Scheme are based on growth in public sector compensation of employees, while benefits are projected on the trend growth. While the SS is projected to remain solvent during the projection period, the CSPS is projected to collapse. In the event a large transfer is required from government to maintain the pension rights of existing members.

**The COFA Trust Fund:** Chapter 9 and Appendix 2 outline the basis of the CTF projections. The LTEFF is not a stochastic model and the CTF projections are made based on the estimates of the median simulation. Allowance is made for additional contributions and implementation of the SAFER rule (venting is permitted but not the downside moving adjustment correction mechanism). A few further estimates are made in the "fin" sheet. These include the Koror State park, VDS projections, JICA and the airport PPP implementation schedule, and estimates of the national government financial wealth.

## THE BALANCE OF PAYMENTS

**The trade account:** The balance of payments is specified in sheet "BoP." Palau has a very limited range of exports of goods, with fuel re-exports to airplanes being the major item. This is linked to the growth in visitor arrivals and price of fuel. Other exports are small and projected as moving averages. In the case of imports, there are three major categories: food, fuel and other manufactures. Food imports are projected in relation to household real incomes times a world-price index of food, with allowance for a low income elasticity of 09. Fuel imports are projected in relation to real expenditures times the projected fuel price with an income elasticity of 1.2. Other imports are similarly projected with an income elasticity of 1.3. In the case of exports of services, tourism is the major item and is projected based on the tourism module and the CPI. All other service exports are projected as moving averages. Imports of services are projected on a variety of bases depending on the item. Personal travel and passenger services are the two major components and are projected in relation to the cash component of real GDP plus an allowance for inflation.

**Primary incomes:** In the case of primary-income flows, most inflows are minor with the exception of fishing royalties, which are based on the current Vessel Day Scheme price plus allowance in the longer term for inflation. Interest receipts of the Social Security and Civil Service Pensions Funds are derived from projections of the respective funds. In the case of primary-income payments, the major item is dividend outflows, which is related to the operating surplus of foreign companies estimated in the generation-of-income account.

**Secondary-income** flows are dominated by grants and are consistent with the fiscal account. Drawdowns from the COFA Trust Fund are treated as part of secondary income because the fund is treated as a nonresident international unit. Revenues from the $100 Pristine Palau Environmental Fee are included as part of secondary incomes in the BoP and linked to the projection of visitor arrivals. Household and NPISH receipts are minor, but household remittances outward are significant and reflect the large number of foreign workers in Palau. This is linked to household disposable income but would preferably be derived from a labor-market projection.

**Capital-account and financing:** Capital-account inflows are dominated by grants and linked to the fiscal account. Japanese grants in kind include the landfill relocation project, but in other years are projected as a moving average. Turning to the finance account, foreign direct investment is dominated by investment in the tourism industry and linked to new hotel construction.

Net acquisitions of financial assets is composed of changes in funds held by the Social Security Administration and the Civil Servant Pension Scheme. The annual flows are derived from the finance submodule. Changes in commercial banks' foreign assets are consistent with the banking-survey forecasts, and drawdowns and repayments of the external debt are consistent with the external-debt projections.

## THE BANKING SURVEY

**The Banking Survey** is specified in sheet "M&B." Starting with the liability side, bank deposits by category (demand, savings and time) have been subdivided by institutional category. The major categories of demand deposits are nonfinancial corporations and individuals. Both of these are projected in relation to nominal GDP. In the case of savings accounts, the same two sectors together with government are the major depositors. Again, private sector accounts are projected in relation to nominal GDP while government savings deposits reflect the fiscal account balance. Time deposits are a minor category in the banking survey in Palau, but are again projected in relation to nominal GDP. The capital account has been projected as a constant ratio to demand deposits. On the asset side, consumer lending, the major category, is assumed to grow in line with increases in compensation of government employees, while commercial credit (one of the lowest in the world) is projected in line with nominal GDP. Foreign assets are treated as a residual.

FULL REPORT

July, 2019

# ECONOMIC REVIEW

## PALAU FY 2018

This review has been prepared to assist the government of the Republic of Palau and the U.S. Department of the Interior's Office of Insular Affairs to fulfill their respective reporting obligations under the FSM Compact of Free Association with the United States. Palau is required, under Title One, Section 215, to report to the U.S. president on the use of sector grant assistance and on progress in meeting mutually agreed programmatic and economic goals. Under Title One, Section 104.h, the president is required to submit a similar report to Congress concerning developments in Palau.

This review has been prepared by the Economic Monitoring and Analysis Program (EconMAP) of the Graduate School USA, with funding assistance from the United States Department of the Interior's Office of Insular Affairs. It is not intended to directly fulfill the reporting requirements of the Republic of Palau and U.S. governments, but rather to provide an independent assessment of Palau's economic performance and policy environment, as well as independently verified economic statistics. While the reporting requirements of the two governments differ, much of the material herein will be directly relevant to the two reports.

Additional information on the EconMAP program, as well as a digital copy of this report, is available online at http://www.econmap.org