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EconMAP
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U.S. DEPARTMENT OF THE INTERIOR
OFFICE OF INSULAR AFFAIRS

The FY21 Palau Economic Brief

By mid-2021 Palau had fully vaccinated close to 100% of its adult population and reopened its borders to travelers that were both fully vaccinated and tested negative. In the early months of 2020, the onset of the COVID-19 global pandemic ravaged the global economy with unprecedented reductions in economic activity and rapidly rising global unemployment. To reduce the spread of the virus, global travel restrictions were implemented which led to a collapse of international travel and tourism. In response to the pandemic Palau effectively closed its borders at the beginning of April and established a 14-day quarantine period for limited approved arrivals. As a result of these policies Palau has remained COVID-free with no recorded cases either in quarantine or in the community. The restrictive travel policies and the priority placed on health, at a time of highly limited demand for international travel, has served Palau well. By mid-2021 Palau had fully vaccinated close to 100% of its adult population and 50% of the 12-17 age group, likely the highest rate of vaccination in the world. As a result, Palau re-opened its borders to travelers that were both fully vaccinated and tested negative with an approved PCR COVID-19 test.

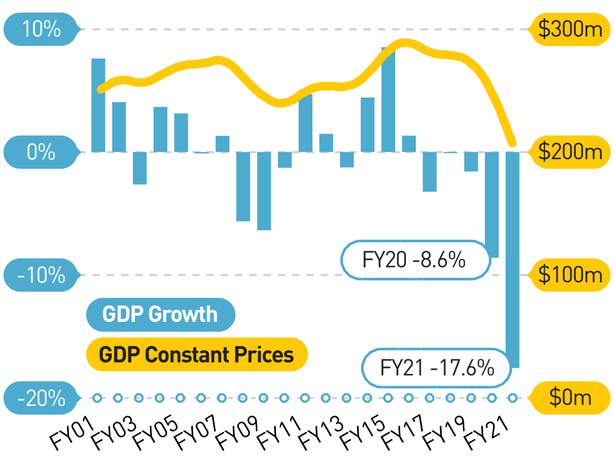
1. Recent Economic Performance

Performance

Palau's economic growth has been modest and has displayed considerable volatility. Palau's economic performance during the pre-COVID period FY00-FY19, has been modest with economic growth averaging 0.6% during the period, see **Figure 1**. This is comparable and about halfway between Palau's sister FAS, the RMI, which grew by an average 1.2% growth, and the FSM, which grew at an annual average of 0.1%. Palau's low average growth during the period reflects high volatility between periods of strong growth in construction and the tourist industry, against periods of substantial contraction. The main drivers of growth have been tourism, and the construction

Figure 1: Palau economy falls by 9 percent in FY20, and further 18 percent in FY21

Palau real GDP annual growth, FY2015 prices, (%)



industry. During the initial part of the 2000s through FY05 the economy grew by an average 3.1% which reflected a combination of the construction of the Compact Road and tourism. This was followed by a period of contraction as these forces came to an end, and because of the impact of the global financial crisis in 2008 and 2009; overall GDP declined by an average 2.5% during FY05-FY10. From this point going forward Palau underwent a tourism expansion phase growing by an annual average of 3.7%. But this in turn came to an end in FY15 and the economy stagnated through FY19 as visitor arrivals contracted to a level only 6% above the FY05 level.

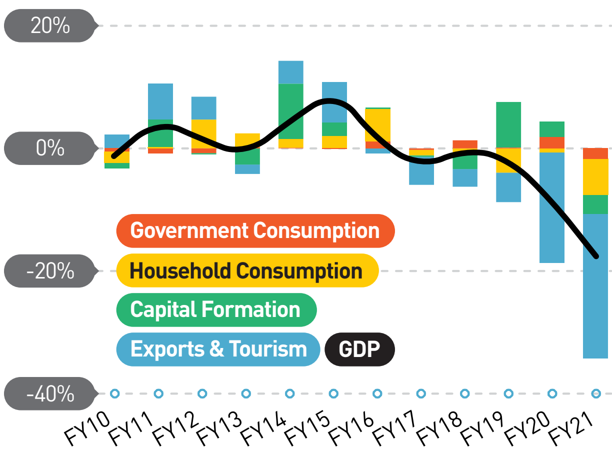
Palau's economy is project to decline by 25% in FY20-FY21 compared with pre-pandemic levels. FY20 was set to be a good year for the Palau economy as construction activity picked up pace, and in February the tourism industry was set to grow by 30 percent for the fiscal year. Then COVID-19 descended on the world and international travel dried up and no further visitors arrived in Palau. GDP is estimated to have contracted by 8.7 percent in FY20 and is projected to fall further by an additional 17.6 percent in FY21 as the full force of the collapse in the tourism economy is felt. The drop in FY21 reflects the disappearance of visitors throughout the entire fiscal year, a reduction in the level of construction activity, see **Figure 2**, but assumes the continuation of the mitigation programs including both the CROSS and CARES Acts provisions (described below).

Private sector experienced most of the the impact of the pandemic and is projected to fall by 38%. **Figure 3** indicates the impact of the COVID-19 pandemic on the private sector. While the public sector is projected to remain unchanged—thanks to donor financing to maintain basic services—the brunt of the COVID-19 pandemic impact has fallen upon the private sector. In FY20, a large reduction of 17 percent was experienced, reflecting the collapse of the tourist economy after the end of March and indirect effects on secondary industries. In FY21, a further reduction of 26 percent is projected, reflecting the full-year impact of the reduction in tourism. Overall, a massive loss in output of 38 percent has been projected for the private sector.

> The economy is projected to fall by 25% in FY21 compared with FY19.

Figure 2: Tourism and investment main drivers of economic growth

GDE, contribution to growth



Gross National Income per Capita

GNI is projected to decline to $13,265 in FY21 reflecting the impact of the COVID-19 pandemic but still remaining within the World Bank's grouping of high-income economies. The population of Palau consists of Palauans and a large number of foreign workers, mostly Filipinos. Since 1986, the Palauan component of the population has grown by 0.2%, after allowing for external migration, reaching 12,890 in FY15. The number of foreign residents has grown from 1,550 to 4,771 over the same period, reflecting the increased need for tourism-industry workers. GDP per capita has risen by 1.1%

Figure 3: Private sector peformance has been volatile and bore the brunt of COVID

Private and public sector GDP, constant prices, FY15

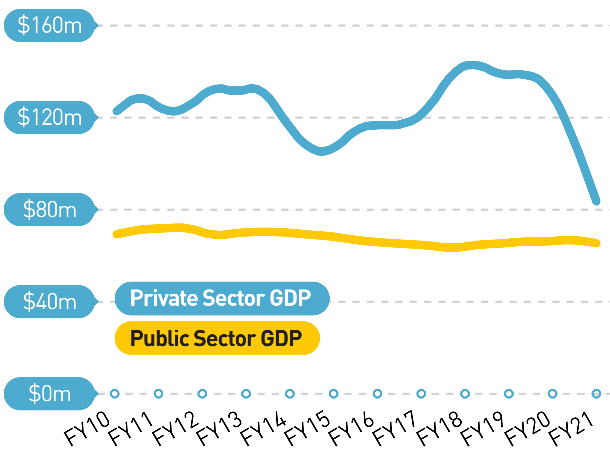
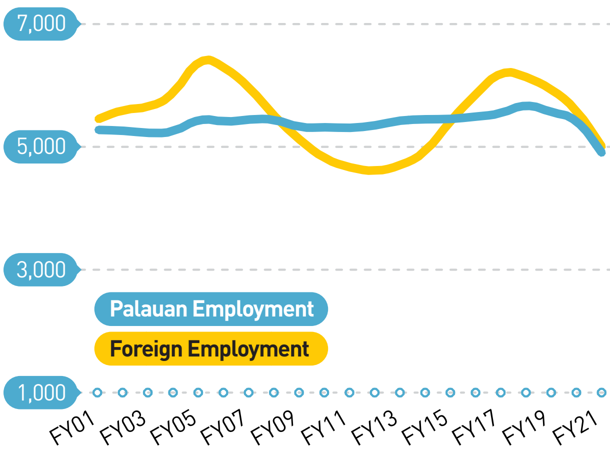


Figure 4: Palauan employment stable until FY20 with collapse in tourism economy

Employment by Palauan and foreign workers



per annum since FY00. Gross national income attained a level of $16,745 in FY19, placing Palau in the World Bank's high-income group by exceeding their $12,696 threshold. In FY21 GNI per capita is projected to fall to $13,265 reflecting the impact of the pandemic but to remain above the World Bank threshold. This has important implications for the eligibility of Palau for assistance from both multilateral and bilateral donors.

Employment

Early projections of job losses turned out to be over-estimated with a reduction of 1,482 jobs compared with the level in FY19. The labor market in Palau was comprised in FY19 of 5,549 Palauan workers and a larger number, 5,943, of foreign workers. In normal times the Palauan segment is fully employed with excess demand supplied by foreign workers. During the FY00-FY19 period the Palauan segment had grown by an annual average of 0.3 percent with the number of foreign workers fluctuating with the demands of the economy, see **Figure 4**. Initial projections of the impact of the pandemic on employment suggested that a total job loss of up to 3,100 could be anticipated or 27 percent of the labor force.

However, as more recent employment data has become available, it indicated as of mid-FY21 (March 2021) that only 779 jobs or 7 percent of the FY19 labor force had been lost. This unexpected result requires a deeper dive into the data.

The impact of job loss has been mitigated by government temporary job programs and by the private sector retaining workers to support recovery. Firstly, employment in the private sector (average of 1st and 2nd quarters FY21) indicates a loss of 1,315 jobs or a 20 percent decline of the private sector labor force since FY19. However, the Social Security records on which these figures are based do not account for a reduction in working hours or reduced pay rates that tourism operators have used to offset lost revenues during the pandemic. On a full time equivalent basis, the loss of private sector jobs would have been considerably higher than the figures imply. Secondly, the data indicates the creation of 702 jobs by government agencies reflecting

> Job loss is estimated to be 1,500 but not as severe as originally projected.

the temporary jobs program managed by the Palau Visitors Authority. The resulting impact of the COVID-19 pandemic on employment thus turned out to be less dire than anticipated due to employers retaining workers on reduced hours to enable recovery and the impact of mitigation programs to offset the impact.

Inflation and Wages

Inflation in Palau is currently low but can be expected to rise reflecting increasing fuel prices. Inflation in Palau has averaged 2.9 percent since FY00 and generally has been moderate. Inflation rose rapidly in FY08 reflecting the global financial crisis, rising fuel and food prices, see **Figure 5**. However, since FY15 inflation has been low averaging 0.8 percent through FY20. As of the end of June 2021 inflation recorded 1%, but the figure masks a set of factors. While food prices had fallen compared with a year earlier, the impact of increasing fuel prices after the depressed levels at the start of the pandemic is exerting upward price pressure. The transport section of the CPI recorded a 19% rise but was offset by 28% reduction in electricity prices. Electricity prices are based on a highly lagged formula and the lower prices reflecting fuel prices several quarters earlier. As the impact of sharply rising fuel prices works its way through the system, electricity prices and the CPI can be expected to rise significantly. Other supply and demand impacts in the US do not—as of yet—appear to have had an impact on inflation in Palau.

Figure 5: Inflation remains modest droping to 0.7 percent during FY20 with low fuel prices
Consumer price index

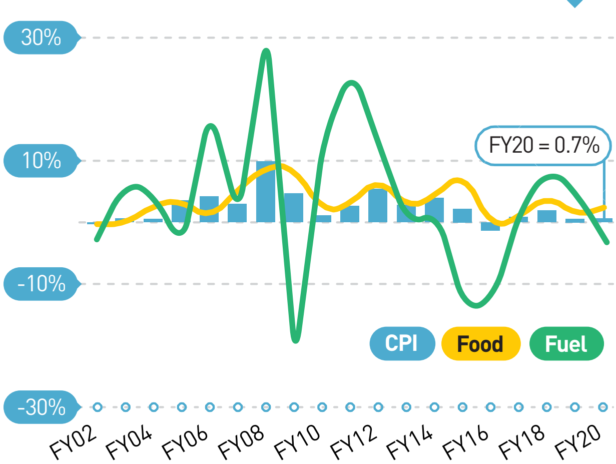
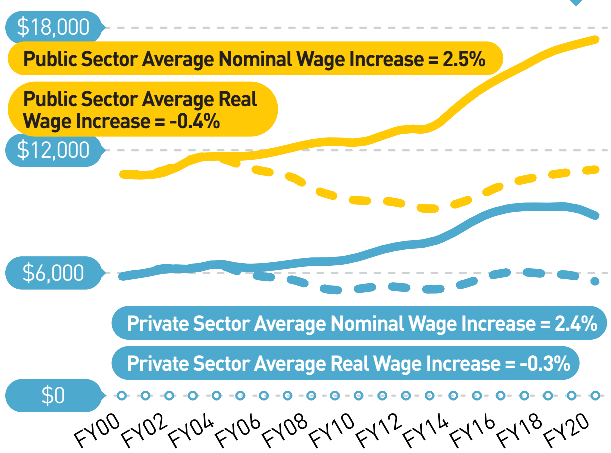


Figure 6: Real Wages improve since the tourism boom and low inflation. Public/private sector wage differential remains large
Nominal and real wages, FY15 prices



Real wages have declined in both private and public sectors with a considerable differential between the two. Nominal wages in the public and private sectors in Palau have grown by 2.4 and 2.5%, respectively, since FY00 with public sector wages being 85% above those in the private sector, see **Figure 6**. Real wages have declined marginally in the public sector, -0.4% per annum and by an average of -0.3% per annum in the private sector. Citizen wages are 55% above non-citizen wages with a majority of Palauan workers in the public sector and a majority of non-Palauans in the private sector.

2. COVID-19 Mitigation Programs and Donor Assistance

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

CROSS Act extended throughout FY21. By the expiration date of the CROSS Act at the end of January 2021, funds used on the program turned out to be considerably less than the $20 million originally projected with actual use of funds estimated to have been $10 million. The program was extended under the new administration through the remainder of FY21 to be financed out of the remaining funds. However, the structure of the program was to be altered with Palauans to fall under the temporary jobs program and the foreign work force to be returned to their former employers. Foreign work force employees were expected to work 20 hours weekly at the minimum wage of $3.50 an hour, with a cost saving from the original $400 per month to $280.

> Mitigation programs have had a large beneficial impact in supporting household incomes.

The US CARES program provided an important lifeline for Palauans made unemployed by the pandemic: In addition to the Palau CROSS Act, the citizens of the Freely Associated States are eligible for certain unemployment benefits under two US-funded facilities: Pandemic Unemployment Assistance (PUA), and the Federal Pandemic Unemployment Compensation (FPUC). Allowances under these two programs for Palauans were originally set at $397 a week for up to 39 weeks through December 31, 2020, under the PUA, and $600 a week for periods beginning on or after 1 April 2020, through 31 July 2020, under the FPUC. The CARES programs were extended for a further two periods through the end of FY21.

ADB provided critical loan-financed funding to support government operations and the cost of the CROSS Act. In addition to its own mitigation effort Palau has been fortunate to have access to concessional donor loan financing. The Asian Development Bank has been the major supporter through a series of loan facilities: the Palau Disaster Resilience Program (DRP) $15 million, the COVID-19 Pandemic Response Option (CPRO) for $20 million and a Policy Based Loan (PBL) of $55 million. The PBL also known as the RISES program (Recovery through Improved Systems and Expenditure Support) involves the commitment of the national government to implement a series of fiscal and economic reforms. The first tranche conditions of the loan, subprogram 1, were fulfilled, and Palau received $25 million for budgetary support anticipated to fund the government through the end of FY21. The second tranche, or subprogram 2 of $30 million will require passage of a further set of deeper and more demanding reforms and will hopefully provide Palau with sufficient resources to fund government operations and mitigation efforts through FY22 and until the recovery of the economy is well underway.

Mitigation programs had large beneficial impacts on household incomes. Without the CROSS and CARES mitigation programs and unemployment benefits, household incomes were projected to have fallen by 11 percent, FY19-FY21, resulting in rising levels of poverty in both the Palauan and foreign sectors of the workforce, see **Figure 7**. With mitigation and based on both the CROSS and CARES Acts provisions, however, average household incomes are projected to have risen by 2 percent compared with FY19. For FY22 the projections assume the CARES Act will terminate and consequently household incomes will fall by 3 percent despite the beginnings of the recovery. Overall, the magnitude of the coordinated government and donor response has been both timely and significant. The government and donor community should both take credit for rapid and apparently effective mitigation efforts.

3. Tourism Developments and Policy

Tourism Developments

The rapid growth in tourism presented special challenges to Palau during the boom period. In FY15, annual visitor arrivals grew by 34% and recorded a level of 168,767 visitors, an increase of 88,000 visitors above the FY10 level, see **Figure 8**. In FY16, through FY19 the numbers dropped in each consecutive year reaching a nadir of 89,726 in FY19. 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 39% in FY10 to 63% in FY15. The majority of the increase originated in middle-to lower-grade establishments with an associated large increase in package-tour visitors predominantly from China.

Figure 7: Household incomes fall by -6% between FY19 and FY22 with mitigation, and without mitigation by 11%
Household impact with and without mitigation

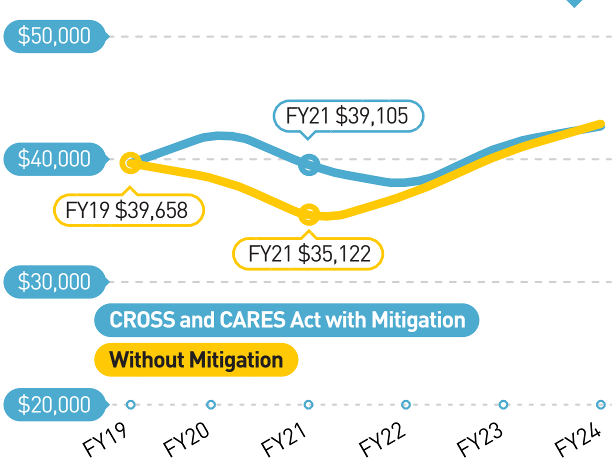
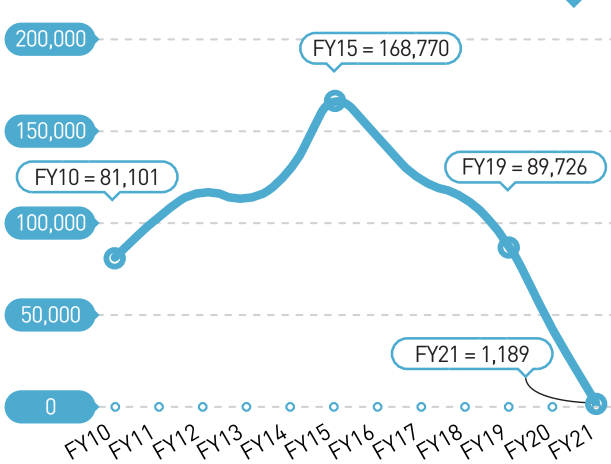


Figure 8: After peaking in FY15 visitor arrivals decline to zero in FY21 with impact of COVID
Visitor arrivals



Boom in the tourism industry encouraged new investment, but numbers dropped, and occupancy rates fell to very low levels. On the downside, FY15-FY19, the drop in arrivals was strongly associated with a contraction in the Chinese segment of the market. However, there was also a significant reduction in the more traditional, higher spending tourists. The large increase in visitors and improvement in occupancy rates in the mid-10s encouraged additional construction in hotel plant just as the industry was undergoing contraction. The drop in arrivals through FY19, coupled with the additional largely unoccupied plant led to a reduction in occupancy rates to 40% in FY18 and 33% in FY19.

Tourism collapsed as COVID hit but attempts to open a sealed corridor fail as Taiwan suffers from outbreak of the Delta variant. FY20 was set to be a better year with 120,000 visitors anticipated, but with the advent of COVID-19 that number dropped to zero by the end of March, even as 42,000 visitors were recorded for the fiscal period that began in October 2019. In April 2021 Palau instigated a "sealed corridor" or "bubble" with Taiwan permitting travel between the countries and the potential of a slow recovery in the tourism industry. Initial uptake was slow with high costs of tours, restrictions on returning travelers in Taiwan, and hesitancy to travel while the COVID threat remained. As these issues were being resolved Taiwan, which had up to that time managed to build one of the world's best defenses to COVID-19, experienced an outbreak mid-May of the Delta variant effectively shutting down the corridor.

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

Tourism Policy

Despite the current demise in the tourism industry there is a need to develop a strategy and master plan on how to implement the high value concept. Palau has adopted a policy to attract high-value tourists but has limited resources and tools to implement the policy. As a result, tourist developments have been virtually unconstrained, and in an unregulated market, the economy has been subject to volatility and large swings in visitors. In 2015 Palau requested support from the ADB to assist with rationalization of the industry. The report endorsed the high-value concept and indicated the need for a comprehensive tourism strategy or master plan. This was further developed under a grant from the US Department of the Interior; however, that effort was limited to producing a Responsible Tourism Policy Framework. While the framework outlined important broad principles, it fell far short of a comprehensive strategy with specified and implementable actions. 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.

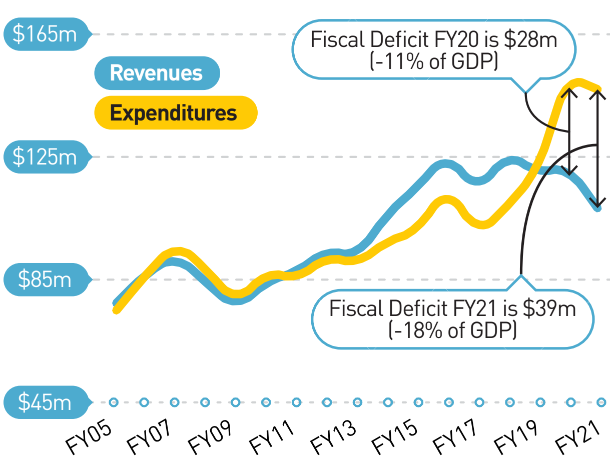
> Palau needs a Tourism Master Plan to guide and regulate development as the industry recovers .

4. Fiscal Performance and Reform

The Fiscal Position

Palau has maintained a prudent fiscal policy while running surpluses during the tourism boom years. Between FY05 and FY13 Palau maintained fiscal balance on average with expenditures matching the revenue envelope, see **Figure 9**. During the global financial crisis in FY07 and FY08 fiscal balance turned negative, but the deteriorating position was largely contained. After the recovery in FY14 and reflecting the tourism boom years through FY18, the government recorded surpluses in each year, averaging 4.6 percent of GDP. By period end FY18, government deposits had risen to $43 million, up from a level of $9 million five years earlier. In FY19 as the number of visitor arrivals fell to a level not seen since FY10, and the fiscal position tightened, the government ran a small deficit of -0.4 of GDP and cash deposits had fallen to $31 million. However, despite the reduction in reserves, fiscal prudence during the boom years had established a significant cushion which would come to serve the nation well during the onslaught of COVID-19.

Figure 9: Palau generates large fiscal surpluses as tourism industry booms, but runs large fiscal deficits during COVID
Government revennues and expenditures



Total financing needs of over a third of GDP—36%—are required to support the fiscal deficit during the COVID-19 crisis. With the impact of COVID-19 the fiscal position deteriorated rapidly. From a balanced position in FY19 this briefing note estimates a deficit of $28 million or 11% of GDP in FY20 rising to $39 million or 18% of GDP in FY21, as the impact of the pandemic is felt during a full fiscal period. Not only did tax revenues decline reflecting the impact of the loss of the visitor industry but also Palau embarked on a series of mitigation programs requiring additional expenditures under the CROSS Act. Given that recovery of the tourism industry is only assumed to return in the second half of FY22, a further deficit of $19 million or 7% of GDP is projected for FY22 before full recovery in FY23. Total financing needs thus amount to $86 million or 36% of GDP to finance Palau through the crisis.

Available financing will be sufficient to keep the government open through the end of FY22 assuming full recovery by FY23. To finance the deficit Palau requested funding from the ADB to support the nation through the crisis. A series of loans were initiated: (i) a $15 million facility under the DRP (Disaster Resilience Program) (ii) $20 million under the CPRO (COVID-19 Pandemic Relief Option,

> Total financing needs arising from COVID-19 will reach 36% of GDP to keep government open and sustain mitigation programs.

and (iii) a further $55 million Policy Based Loan (PBL) comprised of two subprograms amounting to $25 million and $30 million each. The conditions for release of funds under Subprogram 1 have now been met, with anticipation of completion of the second set of conditions in time for release of funds at the start of 2022. Part of the second program funds up to $15 million has been earmarked for Koror state. Availability of funds including Palau's reserves should therefore be sufficient to keep the government open on the assumption of full recovery by FY23.

Fiscal Responsibililty and the RISES program

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

1. Policy and legislative framework for public financial management

a. Fiscal Responsibility Law

2. Public sector initiatives

a. Tax reform
b. Fiscal review of FY21 budget
c. National infrastructure plan
d. External debt management law
e. Social Security reform

3. Private sector reforms

a. Private public partnership framework
b. Arbitration law
c. Corporations law and registry

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

Fiscal Responsibility Framework

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

1. Manage **operating expenditures** over the medium-term within operating revenues and in relation to the rate of growth of the economy;
2. Manage net **capital and financial assets**, to achieve rising real national net worth over time;
3. **Manage debt** prudently;
4. Manage the **revenue regime** to best fit the structure of the economy, to provide for an equitable allocation of tax burdens, and to allow for predictability over time;
5. Manage **reserves and insurance coverage** to offset cyclical volatility, the costs of natural disasters, and the impact of climate change;
6. Manage the non-primary government public sector prudently including ensuring

State Owned Enterprises and Public Financial Institutions are managed to deliver services on an effective and financially sustainable basis; and

7. Manage **fiscal risks** and contingent liabilities prudently.

Tax Reform

Tax reform in Palau has been long overdue with its economy ideally suited to a goods and services tax or VAT. In 2014 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 (PGST), is ideally suited to Palau because a large part of the tax base falls on tourist expenditures. In FY18 the tax base including household and tourist expenditures amounted to 99% of GDP, with tourist expenditures accounting for 40%. 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 Business Profits Tax (BPT) with rates set to ensure equity between wage earners and the business sector.

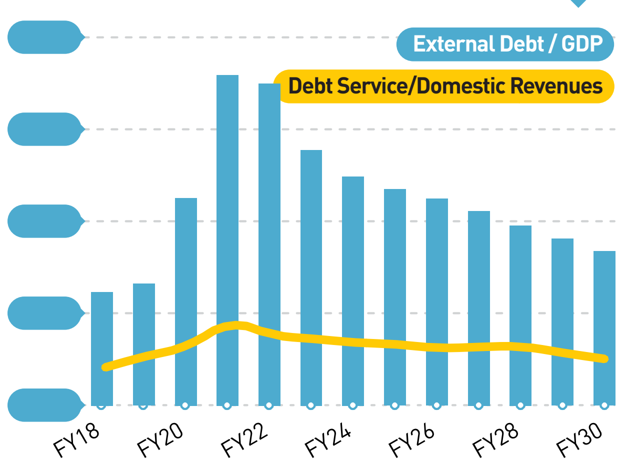
Tax reform has passed 2^{nd} reading in the Senate and when it passes 3^{rd} reading will be debated in the House of Delegates. After a long period and a further attempt at introduction in 2018, Palau decided to place a major focus on tax reform as part of the PBL or RISES program. The former PGST bill was resurrected, a new section on business profits added, and coupled with various revisions for recent developments, the bill was transmitted to the OEK by the President in January of 2021. The bill has now gone through a series of hearings, state level townhall meetings and has been widely debated. An economic symposium was held in May supported by the Chamber of Commerce and the bill has passed 2^{nd} reading in the Senate and when it passes the 3^{rd} reading will be debated in the House of Delegates.

> Palau adopts a fiscal responsibility framework and comprehensive tax reform to maintain fiscal stability in recovery period.

5. External Debt

External debt/GDP ratio is projected to rise rapidly to nearly 90 percent of GDP to finance the impact of the COVID-19 global pandemic. As a result of the COVID-19 global pandemic the need for external borrowing is projected to rise rapidly in the short-term (see **Figure 10**). External debt rose from a level equivalent

Figure 10: External debt rises to alarming heights due to COVID financing
External debt and debt service, % GDP



to 32 percent of GDP in FY19 to 56 percent in FY20, and then is expected to reach 90 percent of GDP by the end of FY21. While the rise in the debt/GDP ratio is projected to attain record levels, much of the increase is due to the decline in the denominator. In FY21, revaluating the ratio based on the average level of nominal GDP in the FY16-FY18 period indicates the structural level of debt/GDP is about 22 percent lower. After peaking in FY21, the ratio is projected to decline rapidly to 62 percent by FY24 after the economy recovers. While much of the rise in external debt, $80 million, is due to COVID-19, Palau has also incurred significant debt for other purposes: the Taiwan HLDP loan of $15 million for housing and subdivision, an additional ADB PBL for PPUC of $10 million, and $15.75 million for the second internet fiber project. In all, recent additional non-COVID borrowing totals $41 million or 14 percent of GDP.

External debt service is projected to rise significantly but should not result in a high risk of debt stress. Debt service follows a similar but less extreme pattern. From representing 10 percent of government domestic revenues before the crisis in FY18, debt service, including SOE payments, rises to 22 percent in FY21 and to decline thereafter as the economy recovers. Removing the SOE component from legacy borrowing, national government debt service is projected to stabilize at around 12 percent of domestic revenues in FY24. After a period where debt service has been a minor component of the national budget, it will end up consuming a significant but manageable proportion. While the level of debt Palau will incur is large by historical standards, it should not, given fixed low interest rates and the concessional nature of the debt, pose a high risk of debt stress. Return of growth in the economy, the tax reform initiative, and careful monitoring of expenditures should enable Palau to maintain fiscal and economic stability in the years ahead without risk of debt stress.

> External debt projected to reach 90% of GDP in FY21 but to fall below 60% by FY25.

6. Public Financial Management

Public Expenditure and Financial Accountability

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

Once the various PFM reform initiatives are complete Palau may well wish to utilize PEFA as a major yardstick to assess reform progress. In March 2013, Palau invited the Pacific Financial Technical Assistance Center

(PFTAC) to assist the nation in the preparation of a Public Expenditure and Financial Accountability (PEFA) self-assessment. The next stage in the PEFA process is for Palau to undergo a formal external assessment: this was planned for 2019, until COVID arrived. With the external assessment complete, Palau would then be eligible to request that PFTAC assist in the preparation of a road map to improve their PEFA score. Once the various reform initiatives currently underway are complete and the fiscal responsibility framework is implemented Palau may well wish to consider re-engaging in the PEFA process as a major component of assessment of its reform progress.

Financial Management Information Systems (FMIS)

New FMIS has been successfully implemented and the first audit on the new system is being conducted. The former FMIS used in Palau has now been replaced by the Tyler-Munis system utilizing funds provided from the Compact Review Agreement. The implementation program was successfully conducted, and the system is now deployed and operational although tidying up of some of the legacy data remains to be completed. The system is utilized in many US governmental agencies and will provide a robust platform to fulfill compliance with US government accounting standards. The system has a broad array of reporting options, which the Palau staff will no doubt take time to fully learn and take advantage of.

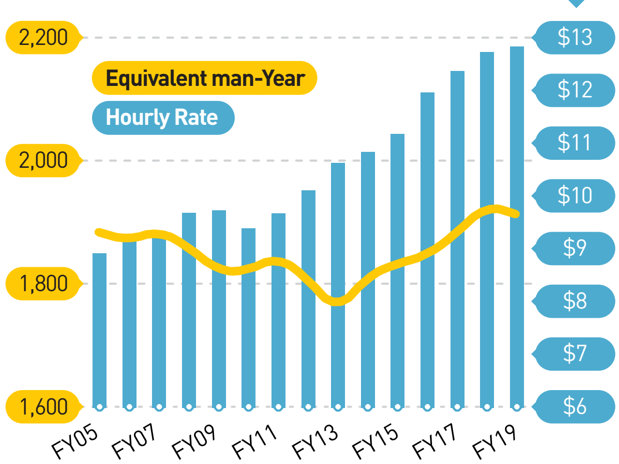
New FMIS does not integrate GFS or performance budgeting management reports. The original intent was that the new system would provide statistics compatible with the IMF standard Government Finance Statistics (GFS) to support management and fiscal policy design. While some chart of accounts improvement was undertaken the new system essentially remains non-compliant with the GFS standard, which is a PEFA component. GFS statistics can be compiled but require a separate data dump, establishment of correspondence tables and development of routines to produce standard GFS tables. In addition to the GFS a similar integration of output/performance budgeting into the new FMIS would have been desirable. In sum the new system has been successfully implemented fulfilling accounting needs but does not provide integration with either fiscal reporting or modern budgeting requirements.

Public Sector Payroll

Government maintains tight control over the size of the civil service and payroll cost. An important component of PFM and fiscal policy is control over payroll cost. Recent trends in government payroll indicate a slight increase in equivalent person-years of 0.1% per annum between FY05 and FY19, see **Figure 11**. Hourly rates of pay (including benefits) have risen from a level of $8.92 per hour to $12.84 an average annual growth rate of 2.8%; 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 0.3% since FY05. The total cost of government's payroll (GFS) has risen by

Figure 11: Government payroll (equivalent man-years) has been tightly controlled

Government payroll: equivalent man-years and hourly wages



an annual average rate of 2.4%, but payroll costs have fallen significantly as a share of total expense and to a lesser extent total expense has fallen relation to GDP. In effect government policy has been to keep tight control over payroll cost and at the same time reduce the size of government in relation to the size of the economy. While these are favorable outcomes, the implicit increase in expense directed to other government entities and SOEs is a source of concern.

7. State Owned Enterprise Reform

The SOE Sector

The SOE sector is small in Palau compared with other Micronesian economies. 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 is being contracted to a public private partnership (PPP) through JICA and a private Japanese corporation.

> SOE sector underperforms and requires framework in law to ensure a commercially viable sector operating on "best practice" principles.

The SOE sector in Palau has underperformed, especially in the power and water sectors. 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 and prices have been set at "affordable" rather than commercial rates, although reforms are under implementation. 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.

Government to consider enactment of the 2014 SOE policy statement into law to guide the operations and monitoring of the sector. In 2014 the President issued an SOE policy with a primary objective that SOEs should operate commercially as successful businesses and recover all their costs, including the costs of capital. A set of policy principles was outlined to support the primary objective: specification of community service obligations (CSOs), appointment of qualified directors excluding political appointees, preparation of annual statements of corporate intent, business plans, performance monitoring and benchmarking, to name a few. Inclusion of the SOE policy statement to be enacted into law as a component of the RISES

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.

program had been considered but was not included in a program already rich in reform. However, it is understood the government is considering enacting the SOE framework in its reform agenda.

Reform in the water, wastewater and power sector

Water and wastewater services operate at significant loss and well below full cost recovery. 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 water and wastewater services at full cost recovery. Significant price increases have been achieved, although not sufficient to achieve full cost recovery and the water/wastewater section of PPUC continues to record a large operating loss.

Koror-Airai sanitation project is well behind schedule and poses significant fiscal risk to PPUC and the government. A second ADB supported program in the sector, the Koror-Airai Sanitation Project (KASP I $28 million), entails substantial upgrading of infrastructure, and should be completed shortly after many years of delays. A second phase of the project, KASP II, is needed to complete the task ($25 million) but has been deferred due to cost implications and fiscal risks to both PPUC and the national government. The KASP projects would result in significant increase in tariffs—in line with improved services—if full cost recovery is to be achieved. Current projections suggest tariff increases of 34 and 28%, respectively for the two phases accumulating to a total of 63%. In the absence of a firm commitment to raise tariffs, which have already risen, KASP I and possibly KASP II would pose a significant risk to fiscal stability.

PPUC engages with the ADB for a power sector policy-based loan to avoid insolvency. PPUC is also responsible for power generation and distribution in Palau and has operated on a cash flow basis well below cost recovery levels. Management results are weak and maintenance of plant has been deferred due to the weak financial position. In 2020 PPUC is reported to have been insolvent. As a result of the emerging crisis the ADB was requested to support a series of reforms through a policy-based loan Palau Public Utilities Corporation Reform Program. The program contains four key areas: (i) tariff reform and adoption of full cost recovery, (ii) financial management improvements, (iii) corporate governance improvement, and (iv) market access for private sector participation in the development of renewable energy. A full cost recovery tariff has been adopted. However, the lagged structure of the automatic fuel price adjustment clause (AFPAC) has resulted in electricity prices being well below cost as international oil prices have risen rapidly with the recovery in the world economy. A lack of transparency in publicly available information makes it problematic to monitor attainment of the full cost recovery principle.

ICT Reforms

Laying of new fiber optic cable connecting Palau to the internet backbone has significantly improved internet access. Reforms in the Telecom sector have progressed positively with the creation of the Palau Submarine Cable Company, an SOE created to manage a new fiber optic link to the internet backbone and funded through a loan from the ADB. Palau has partnered with the SEA-US cable project linking Indonesia, the Philippines, Palau and Yap to Guam, Honolulu and the US mainland. Laying of the cable was commissioned at the end of 2017 and is now 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.

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

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

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

Palau needs to complete the internet project and investment made in the two fiber projects of $55 million with connectivity to the home/premises of $5 million. As a result of the two fiber projects Palau will now have reliable high-speed access to the internet. However, the fiber connection only provides a trunk to the major telecom hubs in Airai and Koror and is yet to be distributed to the home/premises. After the initial boost to the internet experience in Palau resulting from PC1 back in 2018 there has been little improvement in service or cost. The current infrastructure only supports relatively slow speeds through the antiquated copper system insufficient to support uninterrupted zoom calls now common place in the COVID era. Total cost to remedy this situation of laying fiber from the main hubs to the home/premises is estimated to be about $5 million. When compared with the total connectivity cost of PC1 and PC2 of $55 million the additional cost that will provide a modern high-speed service to the people of Palau is a relatively small investment.

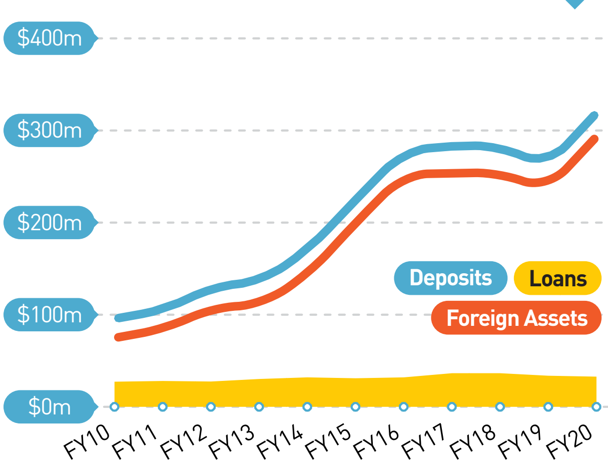
Pricing of internet service requires review to bring down costs to the consumer. The second area of required reform is in the pricing of bandwidth to consumers, which remains high. There are two levels of price setting: (i) retail prices charged by ISPs to the consumer and (ii) wholesale prices charged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

8. The Financial Sector

Banking

Deposits grew rapidly in Palau during the tourism boom years and COVID-19, but lending to the private sector has remained subdued. The deposit base in the Palau banking system ($316 million in FY20) grew very rapidly in the tourism boom period FY11-FY16 reflecting the booming economy, foreign direct investment, and land lease purchases, see **Figure 12**. After the peak in tourism in FY15 the deposit base stabilized and contracted in FY19 with the weak economy. However, in FY20 deposits grew rapidly in all sectors. Government deposits reached high levels reflecting large yet-to-be-spent COVID related borrowing. Both the private and household sectors recorded growth in deposits despite the massive contraction in the tourism industry. Households, reflecting observed trends in other countries with large unemployment benefits accumulated savings and deposits in an uncertain time. While deposit growth has been rapid lending performance to the private sector has been weak and before the pandemic represented only 13% of the deposit base, probably the lowest in the region. In FY20 despite the dire state of private sector tourist operators lending remained subdued reflecting caution both from lenders and borrowers alike. The difference between the large deposit base and low level of credit is invested offshore in commercial bank foreign assets, which in FY20 stood at $290 million.

Figure 12: Commercial bank lending remains very weak; funds invested offshore; deposit growth picked up during COVID
Commerical bank deposits and lending



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

Social Security Sustainability

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

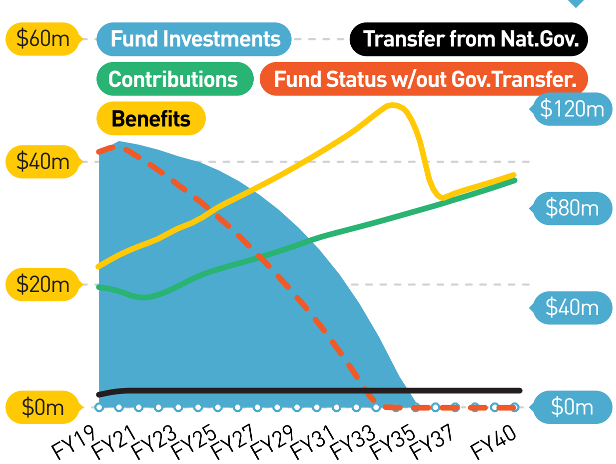
The Social Security system has undergone a series of reforms and adjustments to increase benefits and to maintain sustainability. A set of three supplemental benefits have been awarded of $50 each per month per beneficiary. The first was awarded in October 2014, the second in October 2017, and the third in April 2020. The second award was absorbed into the SS and accompanied with an increase in the contribution rate from 6% to 7%. The other two awards were unfunded and require an annual transfer from the national treasury. In FY19 $2.1 million was transferred and in FY20 this rose to $2.76 million. The FY22 budget proposes a $2.0 million transfer with the second supplemental to be funded from SS reserves. The original cap on wages of $5,000 per quarter subject to SS contributions has now been abolished.

> Recent actuarial evaluation finds Social Security at risk of collapse without reform.

From a position of apparent stability SS has been projected to be at risk of collapse unless suitable reforms are undertaken. Until the recent actuarial assessment the conventional wisdom had been that the SS system was on an even if not fragile keel. The revised assumptions, especially concerning the return on investments coupled with the need to incorporate the two remaining unfunded supplemental benefits into the evaluation turned the outlook from cash flow balance into a rapidly deteriorating financial position. **Figure 13** displays the SS outlook with a projected collapse of the SS in FY35. Fortuitously, the ADB RISES program included the need for evaluation of SS with reform and changes in law as part of the policy matrix. At the current time a working group has been created and is discussing suitable reforms to present to a wider audience at a participatory forum of stakeholders expected to inform the eventual crafting of legislation.

Figure 13: SS including recent unfunded supplemental benefits is now under threat of collapse

Social security fund investments, contributions and benefits



Civil Service Pension Fund

If the financial viability of SS is not bad enough the Civil Service Pension Fund (CSPF) presents an even greater risk to government. In June 2019 an actuarial evaluation and financial assessment of the CSPP was commissioned (Milliman report). The findings of the assessment confirmed those already well known and without reforms or injection of cash the report projected collapse of the fund by the end of FY24. The FY2019 audit indicated that CSPP had an accrued net pension liability of $279 million, and that plan assets of $28.7 million were a mere 10% of liabilities. In the FY20 budget as part of the CROSS Act, the government transferred $3.8 million to the CSPP and $2.6 million has been programmed for FY21. At present there are no plans in the FY22 budget submitted to the OEK. **Figure 14** provides a projection of the plan based on the Milliman report with and without government transfers, which in the latter case are presumed to continue at the level of the FY20 budget.

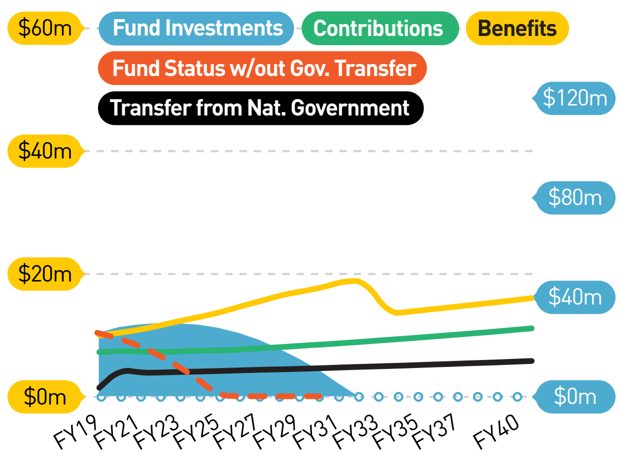
Millian report proposes series of options that failed to provide a solution to inevitable fund collapse. The Milliman report proposed a series of reforms with three basic options:

- For those under 55 years of age extend the retirement age to 65, reduce the future service accrual rate from the current 2% to 1%, but inclusive of a reduction in reduced employee and employer contribution rates to 3%.
- Inclusion of the private sector into a separate defined contribution scheme with 6% contributions from both employees and employers.
- A government transfer equivalent to either $2million or $5 million annually.

However, to all intents and purposes the various options made little practical difference and even under the best-case scenario the CSPP would only survive until FY30. In effect the Milliman report failed to solve the CSPP problem, admittedly largely intractable, and no action was taken with the can effectively kicked further down the road and closer to a looming cliff.

Figure 14: CSPP will collapse in the near term without reform

Civil service pennsion plan fund investments, contributions and benefits



TA designed to craft reforms for SS also tasked to prepare options for the CSPP. At the time of the design of the ADB RISES program the issue of the CSPP was discussed but felt to be overly complex for inclusion in the program. However, in the design of the ADB TA tasked to come up with options for SS, a similar evaluation and list of reform options for the CSPP was specified. While SS reforms were to receive priority, once complete, they would be followed by a similar exercise with the CSPP.

9. Private Sector Development

The World Bank's Doing Business Survey

The World Bank's "doing business survey" would provide a useful monitoring indicator to assess Palau's performance. The World Bank's ease-of-doing-business survey indicates that Palau ranks 145th 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 158th and 153rd, 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, dealing with construction permits, getting electricity, protecting investors, trading across borders, and resolving bankruptcy. While the World Bank's doing business survey is far from a comprehensive assessment of the environment for private sector development, it provides a useful metric against which performance can be assessed. Palau could do well to use the DBS as the basis of a "road map" to guide private sector reform.

> World Bank "Doing Business Survey" places Palau in the lowest 25%, but provides a roadmap for future improvements.

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

Reformed Companies Act and creation of an electronic Corporations Registry is under consideration by the OEK. Palau's regulatory environment is based on its constitution, customary law and common law as applied in the United States and has no Uniform Commercial Code (UCC) or equivalent. An ADB Private Sector Assessment 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. As part of the ADB RISES program Palau has prepared draft legislation for a new reformed Companies Bill, which creates a modern electronic framework, and is now under consideration by the OEK.

Creation of a centralized "one stop shop" will assist in streamlining private sector applications to operate businesses. A large number of requirements, permits, and licenses are required for a business to be allowed to operate in Palau. Many of these problems will be reduced through centralizing the system into a "one stop shop" 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

Regulation of "front" businesses is a special issue in Palau's foreign investment regime which has minimally effective controls. 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.

Private Public Partnerships (PPP)

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

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

A new PPP unit will be created in the Ministry of Finance to identify and develop PPP projects. Once the policy statement has been adopted and approved for consultation a new PPP unit will be created in the Ministry of Finance to assist in the development of a PPP framework that will guide the development of PPP projects and procurement. The PPP unit will be established alongside a debt management unit that forms a key part of the monitoring and loan appraisal process required in the Fiscal Responsibility Framework. The PPP unit will identify candidates for possible PPP financing for consideration by a PPP project Ministerial committee. Once the inception stage Is complete, projects will be assessed for feasibility, and then approved by the President and ultimately by the OEK. After contracting and procurement, projects will be subject to monitoring by the PPP unit for fulfillment and delivery of outputs specified in the agreements.

10. Compact Issues

Compact Renewal

Near the end of FY10 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 FY09 through discretionary annual continuing appropriations. At the start of 2018, the U.S. Congress authorized and appropriated funds to finance the CRA, based on the total funds agreed to in the CRA less those expended on continuing appropriations during the intervening years. The funds, $123.8 million, were provided as a lump sum to be allocated as determined by the original parties.

The terms originally specified in the CRA were for continuing current grant assistance, although at a declining level. Additional resources were provided to support the Compact Trust Fund, infrastructure maintenance and capital projects. By way of a mutual agreement between the 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 FY99 to FY09 and then $15 million annually for government operations through the Compact's 50th year in FY44; this approach differs from the Trust Funds created later for the amended Compacts with the FSM and RMI. Those sister Freely Associated State Trust Funds were designed to provide a perpetual source of fully inflation-adjusted distributions. Moreover, original projections were based on the CTF achieving an unlikely annual return of 12.5%. As it turned out, the CTF achieved a 7.47% return through FY09. This result was slightly better than

> The Compact Review Agreement provides additional funds to shore up the COFA Trust Fund, but is inadequate to establish a perpetual fund.

the blended asset-allocation benchmark market rate of return of 7.32% over the same period; however, based on projections made at the end of FY09 the CTF would have failed by FY22, long before fulfilling the Compact objective of providing level funding through all 50 years (FY44).

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

Post Compact Review Period Uncertainties

The term of the CRA will expire at the end of FY24 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 FY24 from the creation of a perpetual Compact Trust Fund is estimated at the time of this writing to be $5.0 million, the range of possible loss of Federal programs may, in the worst case, add a further $17 million or more to the size of potential fiscal adjustment. In the remaining years of the amended Compact through FY24, clarity is required on the status of these programs so that Palau can effectively plan for the post-FY24 Compact period.

11. Economic Development Issues

The optimal size of the tourism industry

A strong relationship exists between tourism growth and government revenues. A key issue facing Palau is the relationship between economic growth, the provision of public services, infrastructure, and an optimal size of the tourism industry. In FY15 at the height of the tourism boom, government revenues expanded rapidly, and the nation ran a large fiscal surplus, $14 million or 5% of GDP. Over the boom period FY14-FY18 an accumulated fiscal surplus of $65.5 million was generated, equivalent to 23 percent of GDP. It was out of these funds that the nation built up its general fund reserve and was able to support the nation at the outset of COVID-19 before other financing options became available. However, over the period visitor arrivals rose from 126,000 in FY14, maxing out at 168,000 in FY15 and declining through FY18 to 116,000. By FY19 arrivals had declined to 90,000 and the fiscal surplus had vanished.

However, there was considerable concern in Palau during the period that the nation was being swamped by a large influx of low-end, package tour visitors. The government set a policy to limit the number of charter flights, but by the time this became effective visitor numbers had already dropped due to the Chinese policy to limit package tours to Palau. This raised two policy issues, (i) the limited ability of Palau to set or control the number of visitors and (ii) perhaps more importantly the issue of an optimal size for the tourism industry.

Limited ability of government to control the volume of visitors to Palau. Coinciding with the boom in visitors to Palau there was an induced boom in hotel construction and a further 325 rooms became available, an increase of 19%. In FY15 the industry had attained a 63% occupancy rate, which fell to a mere 33% in FY19 reflecting both the drop in visitors and additional hotel plant. The projections in this briefing note indicate that Palau could accommodate 189,000 visitors with the existing level of plant, i.e. no further hotel construction, and with the same level of occupancy attained in FY15. Public opinion may well consider this to be too large a number of visitors. However, the tourism industry is run by the private sector, seeking to make a return on its investment, and without suitable guiding polices there are no restrictions on the number of arrivals.

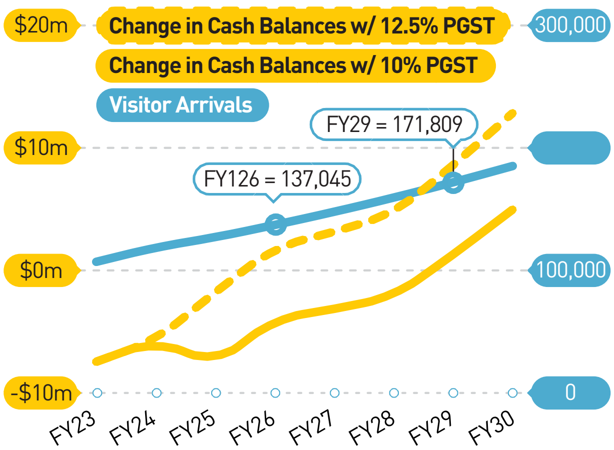
Fiscal balance under current policy is only restored after visitor arrivals attain a level of 172,000. As indicated in the previous sections the impact of COVID-19 has required Palau to incur a significant level of debt to fund government and provide support to affected business and households. This increase in external debt to as much as 90% of GDP will limit the nation's borrowing capacity and constrain expenditure in future years as the nation needs to set aside funds for debt service. Both the provision of government services and the nation's ability to fund infrastructure will be restricted. **Figure 15** indicates the relationship between visitor arrivals and fiscal policy. The figure indicates that with a policy to maintain the real size of government constant and no change in tax effort, it is not until FY29, when visitors attain a value of 172,000, that the nation will return to fiscal balance. The use of the economic model illustrates the important tradeoff between economic growth, tourism, fiscal balance and the ability to increase living standards, public services and infrastructure.

Tradeoff between tourism policy and tax effort indicates fundamental issue facing Palau. Figure 15 also allows simulation of an increase in tax effort through an increase of 2.5% in the proposed PGST. Under this scenario fiscal balance is restored in FY26 when visitor arrivals attain the far lower level

> Palau faces dilemma between tourism development, economic growth and tax effort to fund future government operations and infrastructure.

Figure 15: Fiscal balance not restored unitl visitors achieve 172,000 or 137,000 with additional revenue effort

Visitor arrivals and fiscal balance with and without 2.5% PGST



of 137,000. The choice confronting Palau, made more acute after COVID-19, is precisely this, the tradeoff between tourism expansion and greater revenue mobilization. Parallel to this is the issue of tourism policy: the need to develop a means to control the size of the industry, a mechanism to ensure maximum yield from a given volume of visitors, and regional policy of location and development of tourism on the big island of Babeldaob. As raised earlier these questions beg for a tourism Master Plan to establish guiding principles for the development of tourism in Palau.

12. Other Issues

Statistical

Palau's administrative statistical systems provide a sound base for fiscal and economic monitoring. 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 of the following fiscal year and final estimates are available after completion of the annual audits at the end of June. Current weaknesses exist in the lack of a comprehensive business survey to estimate private sector value added, and provision of producer prices to estimate the constant price series. Efforts to integrate the statistical system through data base management to improve integrity and consistency are now 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.

Palau summary economic indicators, FY2010-FY2020

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20
Per Capita Income measures											
GDP current prices, $ million	189.738	201.459	217.912	227.189	248.705	295.523	305.712	291.302	287.797	275.017	249.141
Population	18,288	17,946	17,611	17,409	17,359	17,661	17,879	17,900	17,535	17,490	17,429
GDP per capita $	10,375	11,226	12,374	13,050	14,327	16,733	17,099	16,274	16,412	15,724	14,295
GNI per capita $	11,234	12,134	13,404	14,165	15,385	17,969	18,531	17,297	17,626	16,745	0
GNDI per capita $	13,170	14,100	15,426	16,243	17,599	19,871	20,325	18,948	20,243	18,084	0
National accounts											
GDP, at constant FY2015 prices, $ million (ave. GDP(P) and GDP(E)	235.2	248.3	250.5	244.0	257.5	283.4	282.8	273.1	275.8	271.7	239.3
GDP, % growth	-0.2%	5.6%	0.9%	-2.6%	5.5%	10.1%	-0.2%	-3.4%	1.0%	-1.5%	-11.9%
Prices (annual percent change)											
Consumer price index	1.1%	2.6%	5.4%	2.8%	4.0%	2.2%	-1.3%	0.9%	2.0%	0.6%	0.7%
Employment and Wages											
Number of employees	**10,104**	**9,951**	**9,970**	**10,115**	**10,333**	**10,882**	**11,340**	**11,739**	**11,802**	**11,492**	**11,093**
% change	-2.9%	-1.5%	0.2%	1.5%	2.2%	5.3%	4.2%	3.5%	0.5%	-2.6%	-3.5%
Private sector	5,248	5,254	5,415	5,594	5,770	6,193	6,626	6,879	6,948	6,670	6,232
% change	-5.2%	0.1%	3.1%	3.3%	3.2%	7.3%	7.0%	3.8%	1.0%	-4.0%	-6.6%
Public sector	3,756	3,666	3,625	3,679	3,709	3,672	3,767	3,875	3,898	3,891	3,957
% change	0.7%	-2.4%	-1.1%	1.5%	0.8%	-1.0%	2.6%	2.9%	0.6%	-0.2%	1.7%
Other	1,099	1,031	930	842	854	1,016	946	985	956	932	904
Palau citizens	5,317	5,297	5,339	5,428	5,444	5,445	5,489	5,526	5,664	5,549	5,479
Foreign workers	4,787	4,654	4,630	4,687	4,889	5,437	5,851	6,213	6,137	5,943	5,614
Average annual wage	**8,486**	**8,859**	**9,175**	**9,249**	**9,986**	**10,391**	**10,930**	**11,198**	**11,447**	**11,669**	**11,673**
% change	1.7%	4.4%	3.6%	0.8%	8.0%	4.1%	5.2%	2.4%	2.2%	1.9%	0.0%
Private sector	6,803	7,193	7,426	7,478	7,976	8,707	9,144	9,279	9,247	9,303	8,816
% change	3.3%	5.7%	3.2%	0.7%	6.7%	9.2%	5.0%	1.5%	-0.3%	0.6%	-5.2%
Public sector	12,317	12,735	13,127	13,078	14,405	14,912	15,588	16,153	16,804	17,143	17,429
% change	-1.2%	3.4%	3.1%	-0.4%	10.1%	3.5%	4.5%	3.6%	4.0%	2.0%	1.7%
Palau citizens	10,714	11,056	11,308	11,213	12,112	12,601	13,315	13,921	14,068	14,278	14,485
Foreign workers	6,012	6,358	6,715	6,975	7,619	8,179	8,693	8,775	9,028	9,233	8,928
Average annual real wage (less inflation)	**10,247**	**10,423**	**10,238**	**10,035**	**10,422**	**10,611**	**11,311**	**11,486**	**11,517**	**11,669**	**11,594**
% change	0.6%	1.7%	-1.8%	-2.0%	3.8%	1.8%	6.6%	1.5%	0.3%	1.3%	-0.6%
Government Finance Statistics, ($ million)											
Revenue	85.7	87.2	95.0	92.0	106.6	114.9	124.7	115.0	126.7	119.4	122.2
Tax revenue	31.2	34.7	39.0	41.4	47.0	56.6	59.1	56.9	60.5	51.8	48.8
Grants	49.6	46.0	48.2	41.9	47.1	43.7	49.3	37.3	49.4	50.3	60.3
Other revenue	4.8	6.6	7.9	8.6	12.5	14.6	16.3	20.7	16.9	17.3	13.0
Expense	-68.0	-70.2	-75.5	-81.1	-86.8	-87.0	-97.2	-92.8	-102.3	-103.6	-134.7
Compensation of employees	-33.4	-34.3	-34.8	-35.9	-36.1	-37.6	-41.0	-42.9	-44.6	-45.5	-47.1
Use of goods and services	-19.0	-20.2	-21.9	-22.6	-24.6	-24.4	-25.9	-25.1	-26.6	-27.1	-28.2
Other expense	-15.5	-15.7	-18.8	-22.6	-26.0	-24.9	-30.4	-24.8	-31.1	-30.9	-59.4
Net Worth and its Changes	-17.7	-17.0	-19.6	-11.0	-19.8	-27.9	-27.5	-22.2	-24.4	-15.8	12.5
Nonfinancial assets	-20.1	-14.5	-17.4	-9.7	-11.0	-13.5	-16.8	-8.4	-6.6	-16.9	-15.7
Financial assets	-6.5	3.8	-13.6	6.6	-9.7	-9.4	-27.8	-18.4	-29.3	-3.3	-19.6
Financial liabilities	8.9	-6.3	11.5	-7.8	0.9	-5.0	17.2	4.6	11.4	4.4	47.8
Overall fiscal balance (In percent of GDP)	**-2.3**	**2.5**	**2.1**	**1.2**	**8.8**	**14.4**	**10.7**	**13.8**	**17.8**	**-1.0**	**-28.2**
Revenue	45.2%	43.3%	43.6%	40.5%	42.9%	38.9%	40.8%	39.5%	44.0%	43.4%	49.0%
Taxes	16.5%	17.2%	17.9%	18.2%	18.9%	19.1%	19.3%	19.5%	21.0%	18.8%	19.6%
Domestic revenues	26.2%	22.8%	22.1%	18.5%	18.9%	14.8%	16.1%	12.8%	17.2%	18.3%	24.2%
Grants	2.6%	3.3%	3.6%	3.8%	5.0%	4.9%	5.3%	7.1%	5.9%	6.3%	5.2%
Expense	-35.8%	-34.8%	-34.6%	-35.7%	-34.9%	-29.4%	-31.8%	-31.8%	-35.5%	-37.7%	-54.0%
Compensation of employees	-17.6%	-17.0%	-16.0%	-15.8%	-14.5%	-12.7%	-13.4%	-14.7%	-15.5%	-16.6%	-18.9%
Use of goods and services	-10.0%	-10.0%	-10.1%	-9.9%	-9.9%	-8.3%	-8.5%	-8.6%	-9.2%	-9.9%	-11.3%
Non Financial Assets	-10.6%	-7.2%	-8.0%	-4.3%	-4.4%	-4.6%	-5.5%	-2.9%	-2.3%	-6.1%	-6.3%
Overall fiscal balance	**-1.2%**	**1.2%**	**1.0%**	**0.5%**	**3.5%**	**4.9%**	**3.5%**	**4.7%**	**6.2%**	**-0.4%**	**-11.3%**

Palau summary economic indicators, FY2010-FY2020 cont'd

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20
Depositiory Coporations Survey ($ million)											
Net foreign assets	75.4	84.7	108.1	110.2	143.9	200.3	249.1	253.3	254.2	238.5	290.5
Domestic claims	18.0	19.7	13.8	21.0	16.9	8.7	-3.8	-6.9	-6.4	2.7	-27.9
Net claims on national government	-8.9	-8.2	-13.3	-9.1	-15.2	-22.3	-35.6	-43.2	-42.9	-31.0	-60.7
Claims on other sectors	26.9	27.9	27.1	30.1	32.0	31.0	31.8	36.3	36.5	33.7	32.8
Private non-financial corporations	4.0	7.8	2.9	2.7	2.8	1.2	1.2	6.5	8.4	5.4	5.2
Individuals	22.9	20.0	24.2	27.4	29.2	29.8	30.6	29.8	28.1	28.2	27.6
Broad money liabilities	84.8	95.0	115.5	124.8	153.8	201.4	236.4	237.1	237.9	230.3	254.1
Demand deposits	31.1	37.1	54.7	63.0	69.6	88.9	106.1	96.8	91.0	99.4	115.4
Other deposits	53.6	57.8	60.8	61.9	84.2	112.5	130.3	140.4	146.9	130.9	138.7
Capital and other accounts	8.7	7.3	6.3	4.9	5.3	6.0	8.8	9.6	11.2	10.7	6.3
Loans to deposit ratio, %	31.7%	29.4%	23.5%	24.1%	20.8%	15.4%	13.4%	15.3%	15.4%	14.6%	12.9%
Memo: item: National Development Bank of Palau lending	26.4	24.4	21.5	21.4	19.4	18.3	18.2	19.3	n.a.	n.a.	n.a.
Balance of Payments $ million											
Trade balance	-18.0	-30.7	-32.4	-33.8	-38.5	-20.7	-15.9	-15.6	-21.7	-23.9	-19.4
Service balance	52.6	67.0	83.0	84.6	101.2	117.1	110.5	90.0	82.3	65.4	50.9
Primary Income balance	-1.2	-1.1	-1.5	-1.5	-1.2	-0.9	-1.1	-1.7	-1.7	-1.3	-0.4
Secondary Income balance	-42.5	-44.9	-55.2	-53.7	-54.6	-61.7	-66.5	-69.0	-66.2	-71.6	-63.4
Current Account, balance	-17.0	-25.5	-33.6	-32.9	-46.8	-25.7	-40.1	-55.3	-44.4	-86.4	-149.1
Capital Account, balance	26.1	16.8	22.9	19.5	32.6	17.6	24.4	20.6	82.6	20.5	0.0
Financial account balance	16.5	20.9	14.3	22.3	23.3	1.0	25.4	44.8	-13.6	60.9	54.6
International Investment Position (IIP), $ million											
Total stocks, net	-89.9	-123.9	-99.4	-98.4	-98.0	-110.7	-103.6	-109.9	-60.6	-134.6	0.0
Direct investment, net	337.6	335.7	399.1	428.9	471.4	514.3	584.3	624.7	711.1	682.4	0.0
Portfolio investment, net	427.6	459.5	498.5	527.3	569.4	625.0	688.0	734.6	771.6	817.0	0.0
Other investment, net	260.7	284.1	303.9	324.0	347.1	387.6	421.3	460.8	492.6	534.5	0.0
memo: COFA Trust Fund	151.1	146.5	171.8	189.6	199.2	183.9	196.8	219.5	297.5	281.9	275.6
External Debt, $ million											
Gross External Debt, total	66.5	62.7	69.1	65.0	70.6	64.4	75.0	81.1	87.6	87.2	140.8
National Government	21.1	19.5	27.7	26.1	30.4	28.2	43.6	53.4	62.4	64.5	120.8
Public Enterprises	45.4	43.2	41.4	38.9	40.2	36.2	31.5	27.7	25.2	22.7	20.0
Gross External debt as % of GDP	35.0%	31.1%	31.7%	28.6%	28.4%	21.8%	24.5%	27.8%	30.4%	31.7%	56.5%
Debt Service	6.4	6.2	6.5	6.4	7.3	7.6	9.2	7.4	8.0	9.4	9.8
Debt service as % of national government revenues	7.5%	7.1%	6.9%	7.0%	6.8%	6.6%	7.4%	6.5%	6.3%	7.9%	8.0%
Tourism											
Total Tourism receipts, $ million	**69.1**	**86.3**	**101.4**	**108.2**	**122.5**	**144.1**	**136.0**	**119.1**	**114.1**	**95.2**	**52.4**
Tourist nights	**383,487**	**482,973**	**547,050**	**520,029**	**603,658**	**767,022**	**688,150**	**593,231**	**568,244**	**463,589**	**231,622**
Receipts per visitor, $	852	831	853	977	974	854	927	976	984	1,061	1,257
Receipts per visitor night, $	180	179	185	208	203	188	198	201	201	205	226
Direct value added per visitor night, $ million	89.6	87.0	92.0	108.0	104.8	100.8	108.2	106.9	101.6	107.5	0.0
Average length of stay, nights	**4.7**	**4.6**	**4.6**	**4.7**	**4.8**	**4.5**	**4.7**	**4.9**	**4.9**	**5.2**	**5.6**
Tourism arrivals	**81,101**	**103,903**	**118,928**	**110,823**	**125,674**	**168,770**	**146,650**	**122,103**	**115,997**	**89,726**	**41,674**
Japan	28,046	37,759	38,428	36,474	38,200	31,786	30,585	25,829	24,437	19,637	10,647
South Korea	14,104	14,826	18,675	18,501	15,834	12,453	12,529	13,472	12,872	11,569	6,227
Taiwan	22,209	32,682	40,645	28,171	31,175	15,258	15,501	9,493	11,354	14,065	6,269
China	956	1,656	3,715	9,357	21,706	91,174	70,741	55,491	50,211	28,504	9,761
USA	7,560	8,439	8,308	8,432	8,630	8,856	8,499	8,532	8,426	7,832	4,011
Europe	3,819	4,297	5,092	5,507	5,390	4,653	4,293	5,005	4,486	3,786	2,541
Other	4,407	4,244	4,065	4,381	4,739	4,589	4,502	4,281	4,211	4,333	2,218
Hotel occupancy rate	40.7%	51.3%	57.4%	51.1%	55.4%	64.5%	54.5%	43.4%	40.3%	33.8%	32.1%
Number of Hotel rooms, yearly average	**1,291**	**1,331**	**1,349**	**1,410**	**1,534**	**1,674**	**1,786**	**1,911**	**1,961**	**1,876**	**945**
Tourism Direct Value Added, $ million	34.4	42.0	50.3	56.2	63.3	77.3	74.5	63.4	57.7	49.9	0.0
% change											
Tourism receipts	7.8%	24.9%	17.5%	6.7%	13.2%	17.7%	-5.7%	-12.4%	-4.2%	-16.6%	-45.0%
Tourism arrivals	10.8%	28.1%	14.5%	-6.8%	13.4%	34.3%	-13.1%	-16.7%	-5.0%	-22.6%	-53.6%
Tourism nights	11.7%	25.9%	13.3%	-4.9%	16.1%	27.1%	-10.3%	-13.8%	-4.2%	-18.4%	-50.0%
Tourism receipts per visitor	-2.7%	-2.5%	2.6%	14.5%	-0.2%	-12.4%	8.6%	5.2%	0.9%	7.8%	18.5%
Tourism receipts per visitor night	-3.5%	-0.8%	3.7%	12.3%	-2.5%	-7.4%	5.2%	1.6%	0.0%	2.2%	10.1%

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ECONOMIC BRIEF

PALAU FY 2021

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

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