Palau Country Focus:
The Economic Impact of the End of Compact Grant Assistance

DRAFT FOR DISCUSSION
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ADB

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Foreword

The Asian Development Bank (ADB) commissioned a study to benefit its three North Pacific member countries and their development partners. This study provides information and analysis about the Freely Associated States (FAS) as they approach an important milestone in their respective Compact relationships with the US. At the time of conceiving this study, in late 2018, the range of possible outcomes at the end of each specified Compact funding period for the FAS was quite broad, and ADB believed that the affected parties and their development partners would benefit from a professional study that estimated the range of potential fiscal adjustments and then modeled the associated economic outcomes.

US announces intention to negotiate extension of Compact. This study was commissioned in May 2019. Since that time, the US government has officially announced its intention to negotiate an extension of Compact funding with each FAS, including the Republic of Palau (Palau). As of June 2021, the US government and the government of Palau are in a holding period with respect to renewal negotiations in the form of an acceleration of the Compact section 432 review called for after the 30th year (2024). An undisclosed offer of assistance was shared by the US with each FAS, including Palau, in late 2020 as the end of the term of the prior US administration approached.

Both the US and Palau have new Presidents and will re-constitute their respective negotiating teams. The current US administration has maintained technical dialogue with Palau while a full return to negotiations awaits an internal US review process. Palau, too, has had a new administration since January 2021. The President of Palau has designated his Minister of Finance as Chief Negotiator and the support team is being re-constituted as of this writing. ADB decided to continue this study along the initially conceived lines: with two downward adjustment scenarios and one Compact funding extension scenario. Given signals from Washington, the authors note the extreme unlikelihood of the most severe adjustment scenario for each FAS and have extended their analyses for the less severe fiscal adjustment scenario and the Compact extension scenario. The less-severe case is noted as nearly identical to the outcome that would result even from a delay in a fully authorized and funded period of extension with each country. The extension case, optimistically, provides all parties with the welcome challenge of ensuring additional resources have the greatest sustained impact to the benefit of each member country.

COVID-19 pandemic impacts demand a reassessment of the economic outlook for each FAS. Since the findings of the original three-country study were shared in draft form with all affected parties in January 2020, the world suffered from the COVID-19 pandemic with varying degrees of impact on each FAS. This country-focus study serves two purposes: (i) it covers only Palau in a more detailed manner; and (ii) it updates all the underlying model assumptions to take into account the estimated impacts of the COVID-19 pandemic. ADB felt that individual country-focus studies would supplement the original three-country study and prove more beneficial to the interested parties. Given the breadth and depth of the COVID-19 pandemic, the use of updated model assumptions was also deemed both beneficial and necessary.

COVID-19 has had an extreme impact on the Palau economy. The impact of the COVID-19 pandemic on Palau has been more severe compared with the Republic of the Marshall Islands (RMI) and the Federated States of Micronesia (FSM). Tourism is markedly more important in the current economic structure of Palau than in the RMI and FSM. The impact on Palau has been extreme with an estimated 21 percent reduction in economic output during the fiscal years 2020 and 2021 (FY20-21). Hence the need to update the projections and scenarios for the pandemic impact.

Palau embarks on a series of reforms to support fiscal and economic stability post COVID-19. As a result of the economic and fiscal impact of the COVID-19 pandemic, Palau, supported by the Asian Development Bank under a Policy Based Loan (PBL), has embarked on a series of reforms. Key elements of the program include enactment of a fiscal responsibility and debt management law, comprehensive tax reform, national infrastructure investment plan, Social Security reform, a framework for private public partnerships, corporate law reform, corporate registration, and arbitration law. The impact of these programs has been built into the projections made in this study.

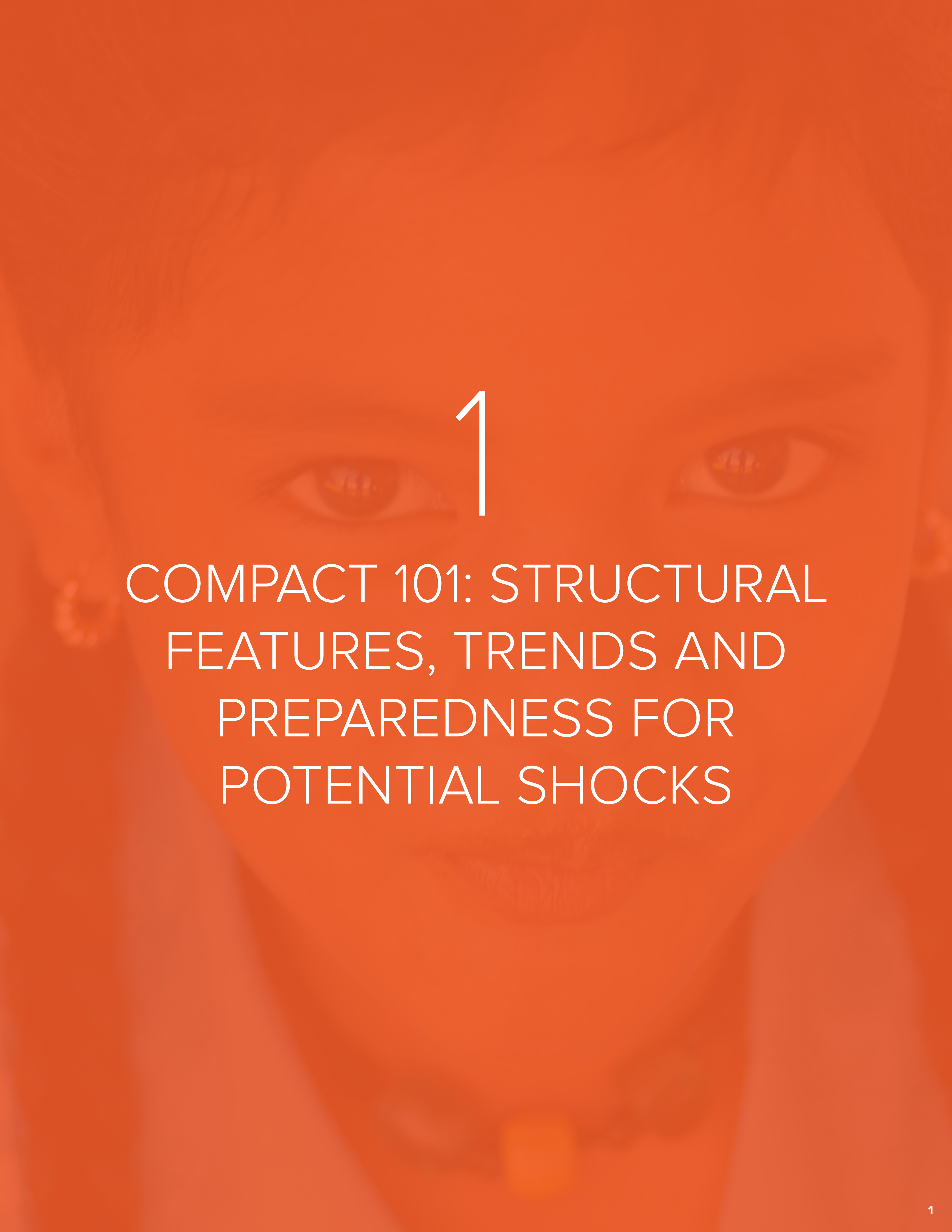
Economic and fiscal situation has significantly changed since onset of the COVID-19 pandemic. In summary, the Palau model results indicate lower economic activity, a significantly impaired fiscal stance, and a greatly increased external debt obligation at the end of the current Compact funding period through fiscal year FY24. There is also a modest increase of the projected Compact Trust Fund value at the end of FY24 reflecting the substantial recovery from the deep decline in asset values at the start of 2020. It should be noted that the updated model estimates are only as good as the data available at the time of writing. While the COVID-19 pandemic has been a significant threat to Palau the participation in Operation Warp Speed and the achievement of a 99 percent vaccination of the adult population as of 5/10/21[1] should enable the economy to rapidly recover once demand for overseas travel re-emerges in Palau's partner nations.

ADB trusts that the extension of information and analyses herein will prove beneficial to all interested parties. This study and its series of three-country and individual country-focus studies builds upon the ongoing work of the Economic Monitoring and Analysis Program (EconMAP), administered by the Graduate School USA with funding support from the Department of the Interior's Office of Insular Affairs. ADB trusts that the extension of information and analyses herein will prove beneficial to all interested parties.

Importantly, this study explicitly makes no recommendations to the directly affected parties. ADB looks forward to working with Palau and its development partners to address needs that will surely arise. In the event of unlikely but conceivable severe fiscal outcomes, such work might entail a greater focus on mitigating the effects of painful fiscal adjustments. More optimistically, following a commitment by the US to extend the financial terms of each Compact, ADB could focus more directly on policy reform and in-country economic management needs to support the achievement of enhanced private sector-led economic growth results.

ADB looks forward to a dialogue on this draft country-focus report on Palau and welcomes feedback from all parties.

1. Based on adult population of 75.3 percent of an estimated total population of 18,000.



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COMPACT 101: STRUCTURAL FEATURES, TRENDS AND PREPAREDNESS FOR POTENTIAL SHOCKS

1 COMPACT 101: STRUCTURAL FEATURES, TRENDS AND PREPAREDNESS FOR POTENTIAL SHOCKS

Palau has been an independent nation in Free Association with the United States of America since 1 October 1994. This chapter describes the structure and timing of the initial and subsequent Compact funding periods for Palau, followed by a timeline of key trends during those two distinct Compact periods. It is vital for readers to understand that the Compact of Free Association represented the choice Palau made in order to terminate its status as a territory under the UN Security Council mandate for the Trust Territory of the Pacific Islands. The Compact relationship delivered sovereignty and self-governance to Palau and the nation is governed according to its own Constitutional provisions. Palau has demonstrated an abiding commitment to free and fair democratic elections. The Compact also included economic assistance provisions to support the development of the economy and support the ultimate achievement of self-reliance. While there is greater similarity between the FSM and RMI Compact provisions, the Palau Compact negotiations followed a different track, even though the Palau Compact was passed into US law less than a year after the passage for the FSM and RMI. The Palau Compact came into effect fully 8 fiscal years after the Compacts for the FSM and RMI.

Palau Compact Structural Features

Palau Initial Compact Period (FY95 to FY09)

There was more than an eight-year delay of entry into force of the Palau Compact after its original approval. The Palau Compact of Free Association with the United States came into full force on 1 October 1994, at the outset of FY95. The Compact had been mutually approved on 10 January 1986. After that, each government required additional actions consistent with its respective constitutional processes. In the US the Compact with Palau was approved by Public Law 99-658 on 14 November 1986. In Palau, however, the Compact approval process was delayed for nearly 7 years after the US approval. Following seven referenda wherein the Constitutionally-mandated 75% majority requirement was not achieved, a 1992 amendment to the Constitution reducing the 75% approval requirement to 50% enabled the eighth UN-observed plebiscite to be successful. The Compact was approved on 9 November 1993 by 68% of Palauan voters. The vote was considered a sovereign act of self-determination.

The Compacts of Free Association have a special treatment in US law—they required statutory approval by both houses of the United States Congress. Notably the Compact and its subsidiary agreements were approved by the US as an "Executive Agreement of the United States containing international obligations." The Compact is treated within the US government as a treaty obligation that required not simply approval by resolution of the United States Senate, but rather by passage of a public law by both houses of the United States Congress. Pursuant to section 121 of the Compact, Palau became a self-governing entity, with the right to conduct foreign affairs in its own name, on 1 October 1994.

Only after Palau completed its sovereign act of self-determination was the United Nations Security Trusteeship dissolved. Palau was the last of the Trust Territory of the Pacific jurisdictions to be under the oversight of the UN Security Council. The Trusteeship was dissolved on 10 November 1994 by the unanimous approval of UN Security Council Resolution 956. On 15 December 1994, UN Resolution 49/63 granted Palau membership in the UN. Palau has, at least until the past few years, typically been within the top three countries in the UN with respect to coincidence of votes with the US. As of July 2019, Palau had diplomatic relations with 89 countries.

Palau delayed taking authorized $5 million annual distributions for the first three years in which they were allowed. Title II of the Palau Compact describes the economic assistance for the 15-year period from FY95 to FY09. During this period, most funding was provided under section 211(a) as unspecified budgetary support. Palau's Compact designated $12 million annually for FY95 to FY98, $6 million annually for FY99 to FY04, and $5 million annually from FY05 to FY09. During the latter two periods Palau was authorized to distribute $5 million annually from the CTF to supplement its budget. Notably Palau chose to forgo the available $5 million CTF distributions for the initial three years from FY99 to FY01, before beginning its annual allowable draw of $5 million from the CTF in FY02. That forbearance has resulted in a substantially larger current CTF value. Estimating the impact of the $15 million left in the CTF during FY99 to FY01 is an end of FY20 value of $39.9 million or 14.5% of the end of FY20 CTF total of $275.6 million.

In addition to categorical funding Palau benefited from a $149 million US-funded completion of the Palau Compact Road. Additional annual US transfers for a total of $2.781 million were provided for categories of expenditure including: communications, marine surveillance, health and medical programs, scholarships, and education/health block grants. Lump sums were provided in FY95 for infrastructure ($36 million); energy ($28 million), military options ($5.5 million), communications ($1.5 million), and $667,000 for surveillance, referrals and scholarships. Importantly, Palau benefited from a US-managed construction project to complete the Palau Compact Road for which the US estimated expenditures of $149 million and which we allocate evenly across the seven years from FY01-FY07.

An inflation factor equal to two-thirds of US inflation was applied to most Compact funding. Most of the specified annual transfer levels provided during the initial Compact funding period were adjusted for inflation by a formula that provided two-thirds of the annual change in the US GNP Implicit Price deflator, with a capped maximum annual adjustment of 7% (which never limited the annual adjustments.) An initial adjustment of 46% was applied to the affected initial year distribution, reflecting two-thirds of the inflation from the mutually agreed Compact negotiated terms at the outset of FY81 until the start of FY95. By the final year of the initial Compact period in FY09, the annual adjustment applied to the affected base grants was 71%.

Figure 1 provides a summary comparison of the features of the initial Compact period described above and the Compact Review Agreement period described below for Palau.

Palau Compact Review Agreement Period: FY10-FY24

The first of three mandated reviews of the Compact was completed on 03 September 2010. The Palau Compact requires a review on the 15th, 30th, and 40th anniversaries of Compact effectiveness. These reviews (titled Section 432 Reviews) assess the operating requirements of the Government of Palau and review the nation's progress toward meeting development objectives. While the Palau Compact provided no mandate to negotiate an extended period of funding, as was specified within the Compacts for the FSM and RMI, Palau made the case through the Review process, that an extension of funding was necessary to avoid a major fiscal shock. More importantly, Palau argued that an extension of funding was necessary to improve the likelihood of continued progress toward achieving the mutual goal of economic self-reliance. Three key outcomes of the negotiations included:

i. The parties agreed that the originally projected 12.5% annual growth rate for Palau's CTF was flawed and warranted redress. As such, the review process established the objective of "topping up" the CTF to achieve—at least—its goal of providing $15 million annually through the fiftieth year (FY44). Midway through the review dialogue, the parties agreed to a new target of 5.5% annual nominal growth, and used the new target for subsequent calculations.

ii. The US insisted on changes to the accountability provisions for transfers during the CRA period. However, the new oversight requirements in Palau were significantly lighter than in the amended Compacts for the FSM and RMI. In the

Figure 1: Comparison of Palau Compact Features (Initial and Amended Compact Periods)

	INITIAL COMPACT PERIOD FY95-FY09	COMPACT REVIEW AGREEMENT PERIOD: CRA Stopgap Funding FY10-FY17	COMPACT REVIEW AGREEMENT PERIOD: CRA Fully Authorized FY18-FY24
RECURRENT FUNDING	• Annual Budgetary Support: » $12m FY95 to FY98 » $7m FY99 to FY04 » $6m FY05 to FY09 » $2m for scholarships » $631k for surveillance and referrals » $150k for communications • Audit costs funded through OIA Federal Services Account.	Annual Stopgap Funding: • $13m annual special appropriation • Audit costs funded through OIA Federal Services Account.	• Annual Budgetary Support: $24.574m transferred in FY18 for use as follows: » $13.1m in FY18 » $8.1m in FY19 » $3.3m in FY20 • Infrastructure Maintenance Fund: $2m annually FY18-FY24. • Audit costs funded through OIA Federal Services Account.
INFLATION ADJUSTMENT	• Two-thirds of the change in the U.S. GNP deflator, not to exceed seven percent; using FY81 as the base.	• None of the amounts specified in the CRA are adjusted for inflation.	• None of the amounts specified in the CRA are adjusted for inflation.
ONE-TIME FUNDING	• $149m for Compact Road (FY01-FY07) • $36m in FY95 for infrastructure • $28m in FY95 for energy grant • $5.5m in FY95 for military options • $1.5m in FY95 for communications • $667K in FY95 for surveillance, referrals and scholarships		• $20m in FY18 for infrastructure projects
TRUST FUND	• $66m contribution in FY95 • $4m contribution in FY97		• $65m contribution in FY18
TRUST FUND DISTRIBUTIONS	• $5m annually from FY99 to FY09 allowed.[1]	• $5m annually from FY10 to FY17	• $5m in FY18 • $10m in FY19 • $14.8m in FY20 • $15m in FY21 • $15m in FY22 • $15m in FY23 • $15m in FY24
ACCOUNTABILITY PROVISIONS	• Section 231(a) requires an official National Development Plan (NDP) • Section 231(b) requires an Annual Report to the president of the US on implementation of the plan and use of Compact funds. • Section 432 Compact Review after 15th, 30th, and 40th years.		• CRA Section 4(e) created Economic Advisory Group (EAG) • CRA Section 5 and Appendix C created procedures to administer infrastructure grant.
FEDERAL PROGRAMS & SERVICES	• Eligibility for a wide range of federal programs and services.	• No change.	• No change.

1. Palau chose not to take CTF distributions from FY99 to FY01.

end, mutual agreement was achieved on the creation of an “Economic Advisory Group” (EAG) to monitor Palau’s economic progress and put forth recommendations that would, presumably, set the agenda of annual economic consultations. As of April 2021 the EAG had not met. If the EAG does meet, analytical review called for will likely produce an initial set of findings that shows considerable progress by Palau toward the originally specified fiscal and economic policy objectives.

iii. In addition to funding to directly increase the value of the CTF, a simplified schedule of funding was agreed as described below, to be provided in declining amounts through FY24.

The funding structure for the CRA period is relatively simple. It contains three funding streams for Palau and a fourth that accumulates in the Palau Compact Trust Fund:

i. **Budgetary support.** A total of $22.11 million was provided to support spending similar to that negotiated in the original CRA as a supplement to agreed upon annual distribtions of specified amounts from the CTF for the years FY18 to FY20 (after which, Trust Fund distributions of $15 million are the only source of budgetary support). For FY18 Palau had already received $2.47million provided through an FY18 stop-gap appropriation.

ii. **Infrastructure.** A total of $20 million in infrastructure funds is immediately available to fund mutually agreed infrastructure projects after funding is made available at the end of FY18 and which we allocate evenly across the three years from FY19-FY21.

iii. **Infrastructure Maintenance.** $2 million is provided annually from FY18 to FY24, subject to Palau matching contributions of $600,000 annually from FY19 to FY24.

iv. **Compact Trust Fund.** A total of $62.25 million was deposited into the fund at the end of FY18 as a supplement to increase the likelihood the CTF will achieve its original goal to provide $15 million annually through FY44.

The Compact Review Agreement covering the period FY10-FY24 was ultimately funded entirely with a one-time appropriation of funds during FY18. Three of the four funding streams were completely fulfilled with funds transferred to Palau at the end of FY18. Only the infrastructure maintenance funding stream continues, at $2 million annually through FY24. Even this funding was fully funded with an FY18 US appropriation. The US provides annual distributions from FY19-24 presumably because the funding is contingent on Palau fullfilling its quarterly matching requirements. The CRA originally included a fifth funding stream, but it was reprogrammed and distributed to the existing four. The fifth stream would have provided $10 million to offset fiscal arrears that Palau had at the end of FY09. However, both parties deemed the allotment unnecessary given the passage of time and the fiscal surplus position of the Government of Palau as of the end of FY18. Palau had agreed to the CRA with the assumtion that the funding would be sourced on a “mandatory and permanent” basis, thus not subject to annual US appropriations and not subject to US government-wide sequestration events that can affect discretionary annual funding sources. Notably, all of the CRA funding was authorized and appropriated in FY18 from a discretionary funding source. Palau had no reason to dispute the discretionary funding source as the one-time, full appropriation for the period through FY24 eliminated any risk of delayed, reduced, or failed annual US appropriations or periodic recisions or sequestrations affecting the US budget.

Palau Compact Timeline: Trends over both Periods (FY95 to FY09 & FY10 to FY24)

Figure 2 provides four illustrative charts that cover the full timeline from FY95-FY24 for Palau.

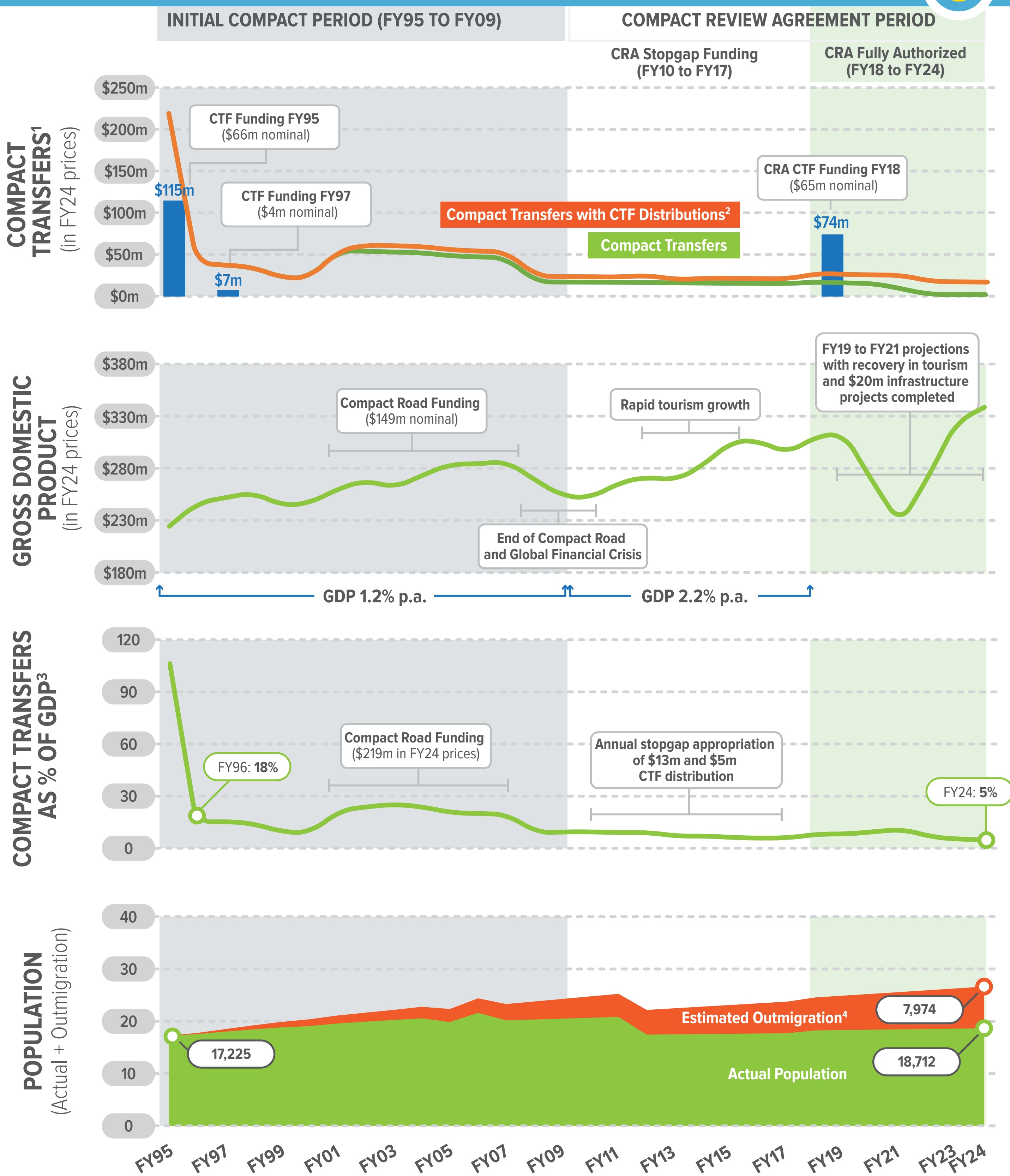
i. The first chart shows the transfers made available to Palau by the US under the initial Compact period from FY95 to FY09 and under the CRA period from FY10 to FY24. All values are expressed in FY24 prices.

ii. The second chart shows actual measured GDP from FY95 to FY18 and estimates through FY24, also in FY24 prices. A comparison of the two charts shows that Palau has achieved positive economic growth over the 24-year period to-date, which is expected to continue through the 30-year period from FY95 to FY24. This real growth was achieved while Palau received declining real transfers through the Compact.

iii. The third chart shows the combined impact of the declining level of transfers and the growing economy; specifically, the reliance of Palau on Compact transfers has declined from moderately high levels during the initial Compact period. Specifically, Compact transfers were equivalent to 18% of GDP in FY96 and have declined to a projected level of 5% of GDP at the end of the CRA period.

iv. The fourth chart shows the gradual—but mounting—effect of emigration from Palau. Palau’s population is expected to grow from 17,225 in FY95 to 18,712 at the end of FY24. However, direct emigration over the period will have totaled 7,974 by the end of FY24, not including children born to Palau Compact migrants overseas.

Figure 2: Palau Compact Timeline



1. Compact transfers are based on award levels, and are not precisely equal to annual expenditures and/or drawdowns, especially during the Amended Compact Period.
2. Compact Trust Fund distributions $5m per year FY02 to FY17; schedule grows from $9m in FY18 to $15m in FY24.
3. Compact Transfers as a % of GDP including distributions from CTF.
4. FY04-FY11 Palau outmigration averaged 1.7% based on reliable US data. All other periods estimated by the authors.

2

PALAU ECONOMIC STRUCTURE, PERFORMANCE, AND COVID-19 IMPACT

2 PALAU ECONOMIC STRUCTURE, PERFORMANCE, AND COVID-19 IMPACT

Palau's economy is projected to have recovered by FY24 but will operate from a lower base than anticipated before the COVID-19 pandemic. To undertake the impact analysis and interpret the results discussed in this study, it is beneficial to not only specify the nature of the potential changes in Compact provisions, but also the recent structure and performance of the Palau economy. This analysis[1], provides background as to the likely response of the economy to the different scenarios outlined in this study. The structural analysis is followed by a discussion of the impact of COVID-19 on the economy. The assumptions of the study are that by the end of FY24, the economy will have recovered from the impact of the pandemic[2]. However, the economy will be operating from a lower base than anticipated in the original projections presented in January 2020. Performance of the CTF has, however, been stronger than anticipated and the corpus projected for FY24 is now $332 million an $11 million increase on the pre COVID-19 projection.

Economic performance and structure

Palau's economic growth has been modest and comparable to that of the RMI and FSM. Palau's economic performance during the pre-COVID period FY00-FY19, has been modest with the economic growth averaging 0.6% during the period, see Figure 3. 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, information communication technology, and the construction industry.

During the last 20 years economic growth has been highly volatile. 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 percent during FY05-FY10. From this point going forward Palau underwent a tourism expansion phase growing by an average of 3.7 percent. 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 percent above the FY05 level. While Palau affords a relatively high level of Gross National Income (GNI) of $16,745 per capita in FY19 which places Palau in the World Bank's high-income category, economic growth performance has been modest and highly volatile.

1. See also recent GSUSA Economic Review of Palau for an in-depth analysis of economic structure and performance (https://pitiviti.org/initiatives/economics/palau.php).

2. See The Road to Recovery: *Further Updating the Economic Impact of COVID-19 and Strategies for Mitigation in the Republic of Palau;* EconMAP Technical Note; Honolulu; February 26, 2021.

Economic Structure

Private sector represents half of the economy, but government remains substantial. Figure 4 indicates the structure of the economy by institutional sector and the composition of the private sector by industry. The private sector represented an average of 50 percent of GDP during the FY17-FY19 period. The size of the private sector is larger than in either of Palau's two sister FAS, the RMI and the FSM, where the public sector dominates, with the private sector representing 33 percent of the RMI economy and 22 percent of the FSM economy. The government sector in Palau comprising national, state and agencies represents 24 percent, compared with 30 percent in the RMI and 26 percent in the FSM. As a measure of development, production of the household sector in both informal and non-marketed or subsistence production in Palau averaged 10 percent, compared with 13 and 25 percent in the RMI and FSM, respectively.

During the boom and bust cycle the large swings in the economy have been reflected by an even larger volatility in the private sector. Figure 4 also breaks out the structure of the private sector by industry. The large tourism sector is reflected in the accommodation, restaurant and transport industries with some production occurring in other sectors such as tourist related retail operations. Overall tourism activity represents about 37 percent of private sector activity. Construction is also a major driver of demand representing 11 percent of the private sector. While the retail segment is large at 33 percent servicing the local population, the remainder of private sector activities is small. During the boom-and-bust cycle described above, the large swings in the economy have been reflected by an even larger volatility in the private sector while the public sector has remained largely constant in real terms during each business cycle.

Fiscal Performance

Tax effort has increased in recent years with additional taxes on tourism. Figure 5 indicates recent trends in fiscal performance: current revenues, and expense together with capital grants and fixed assets as a share of the economy. After a long period of a relatively unchanged tax effort, taxes began to rise as a share of GDP after the tourism boom of FY15. This was largely due to increases in tourism-based taxes, the Pristine Paradise Environment Fee or departure tax, coupled with increases in taxes on tobacco. An additional important component has also been the increase in fishing fees arising out of the Vessel Day Scheme from the Parties to Nauru Agreement. While small compared with the other two FAS, fishing fees rose from close to zero in FY05 to close to $10 million in FY19.

While payroll has been held in check Palau has failed to maintain the level of infrastructure. Current expense has displayed a largely static relationship to GDP through FY14 but fell during the tourism boom years through FY17 as GDP grew rapidly. However, as economic growth weakened, expense continued to grow and expanded as a share of GDP through FY19. Within current expense, payroll has declined in

Figure 3: GDP growth and level, FY15 prices

Palau economy averges 0.6 percent annual growth between FY00 and FY19 with a high degree of volatility

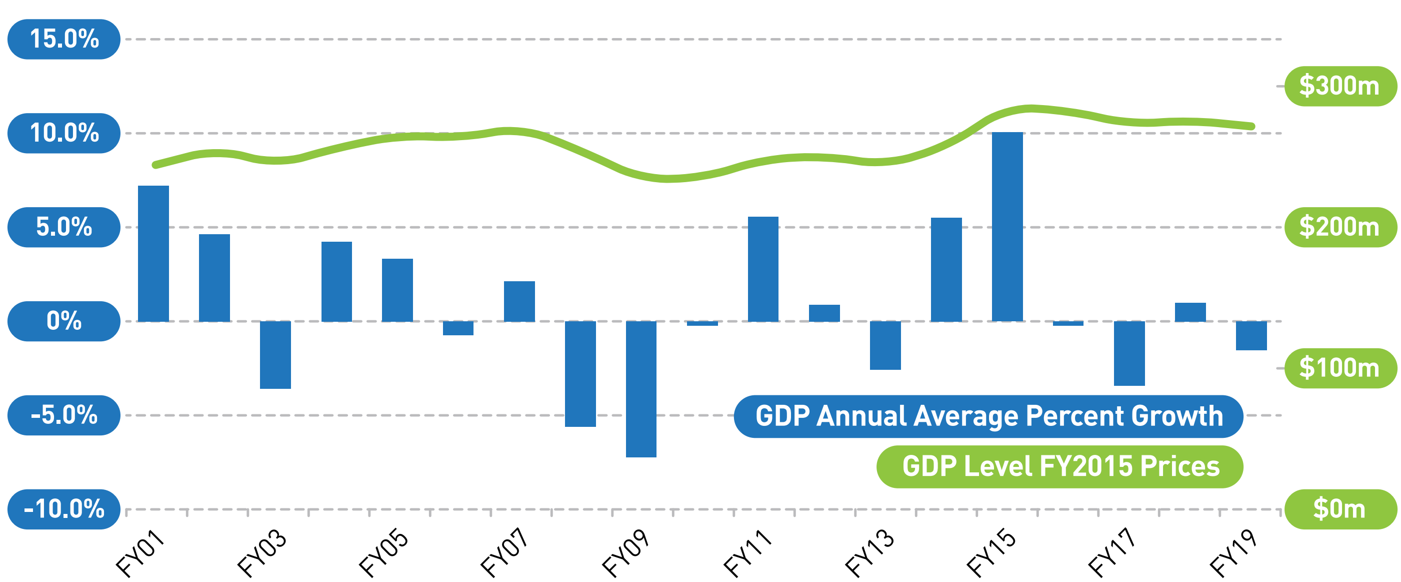
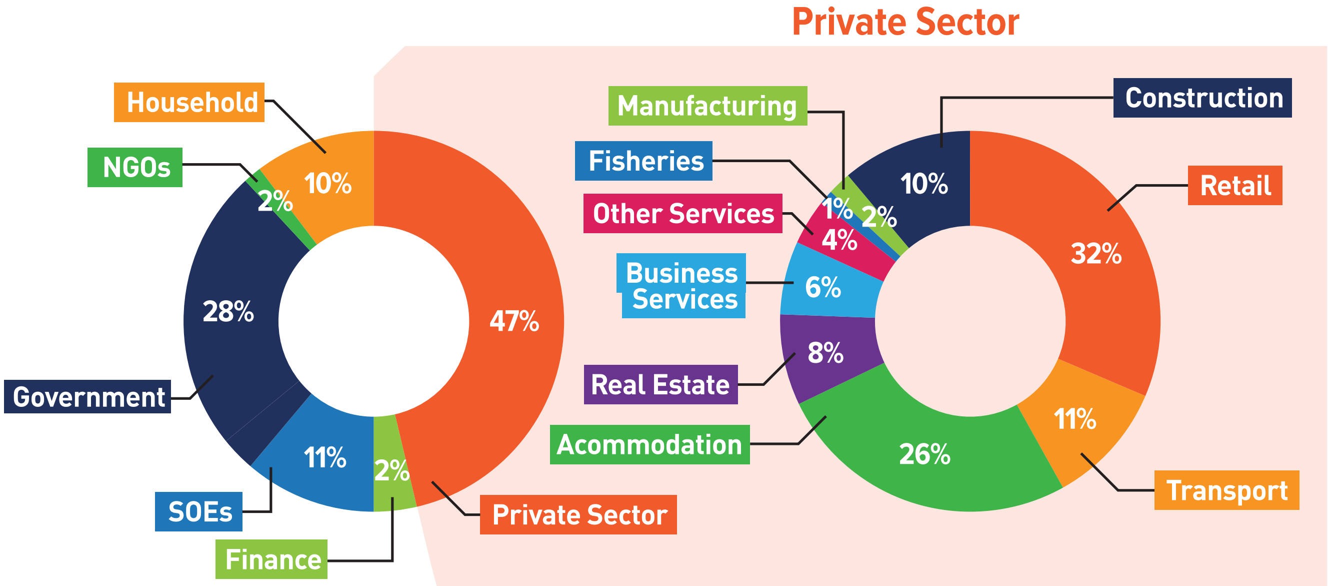


Figure 4: Economic structure: economy wide and private sector

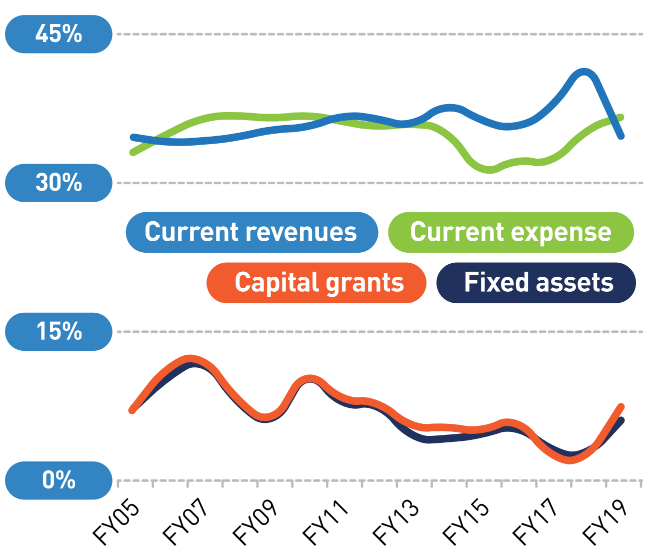
Private sector is largest in the economy with tourism biggest industry



relation to GDP falling from an average of 19 percent at the start the 2000s to 15 percent during the three years FY17-FY19. Use of goods and services has been largely constant while transfers to other components of government, NGOs and households has risen. On the capital side, both capital grants and expenditures on fixed assets have decreased as a share of the economy indicating a potentially worrisome lack of spending on public infrastructure.

Figure 5: Fiscal structure: current revenue, expense, capital grants and fixed assets

Palau operates balanced budget but saves resources during tourism boom



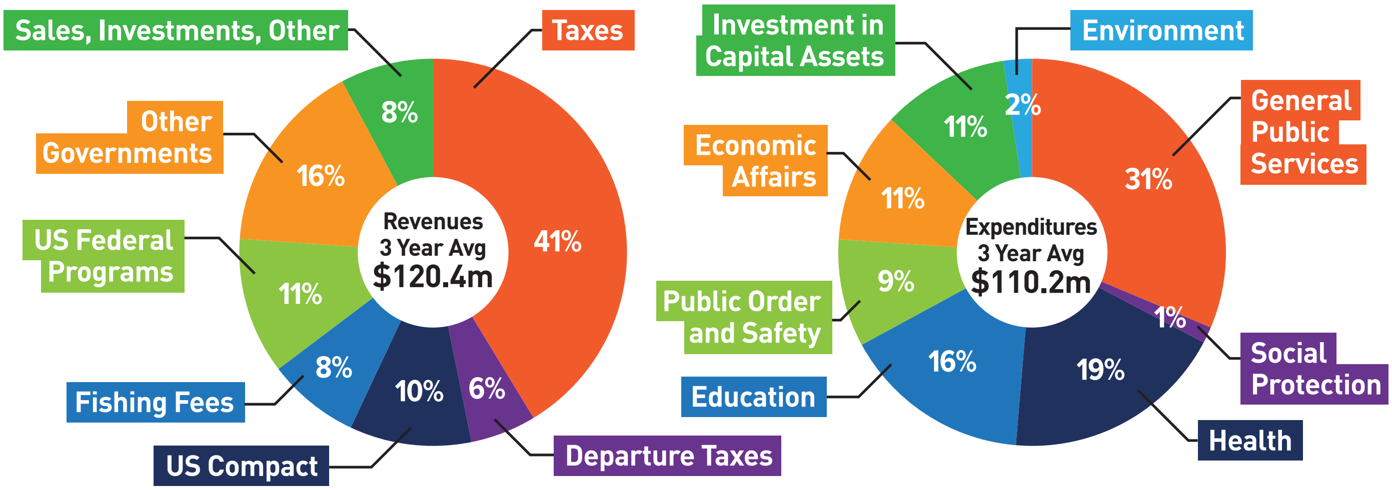
Palau runs fiscal surplus during the tourism boom years. While not directly indicated in Figure 5, the fiscal deficit (in essence the difference between current revenues and expense since the capital account is largely balanced) was largely in balance through FY14. From this point forward Palau ran significant surpluses as the tourism industry expanded rapidly but returned to balance as the tourism industry boom came to an end in FY19. Palau has displayed a significant degree of discipline in execution of the annual budget and during the FY14-FY19 period achieved significant savings, which enabled the accumulation of a significant fiscal reserve.

Fiscal Structure

Significant reliance on grants has resulted in inelastic revenue trend. Figure 6 indicates the structure of revenues by function. While the major item of revenue is taxes, it is a relatively low proportion of overall revenues. This feature has both strengths and weaknesses: it provides some insulation of the revenue base from declines in economic activity, but also leads to a lack of buoyancy with respect to economic growth as many of the other sources such as grants are fixed in nominal terms. Clearly, the economy remains highly dependent on foreign assistance from its donor partners: U.S. Compact grants, federal programs and other country grants represent a total of 37 percent of total revenues. As already noted, fishing fees have grown in significance while other government fees, sales, and investment earnings account for 10 percent.

Figure 6-7: Palau Revenues and Expenditures (FY17 to FY19, 3 Year Average)

Taxes are major compent of revenues but grants are large. Administration is the largest component of expenditures.



Administration expenses are high in Palau compared with health and education. Figure 7 provides a broad picture of government expense by function. Just over a third of expense, 35 percent, is allocated to social services in education and health. This compares with the FSM at 38 percent and RMI at 44 percent. The directed nature of Compact funding in the two other FAS may account for the higher level of outlays on these two priority areas. In Palau a significant proportion of expense, 31 percent is allocated to general administration.

The Impact of COVID-19 on the Palau Economy and Fiscal Balance

Economy contracts by 8.7 percent in FY20. 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 provisionally estimated to have contracted by 8.7 percent. In the previous section we discussed recent economic and fiscal performance of the economy and important structural considerations. In this section we attempt to estimate the likely impact of the COVID-19 pandemic on the economy through the remaining years of the CRA period through FY24.

Impact on the tourism sector

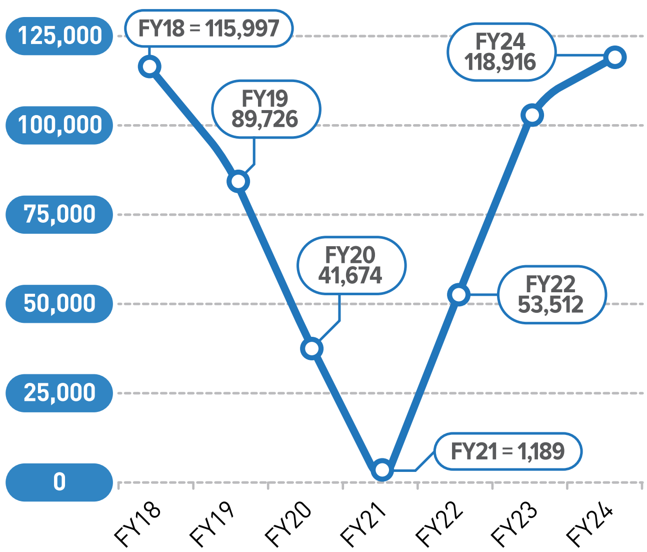
Between April 2020 and March 2021 no tourists visited Palau: This study follows the assumptions made in a recent Technical Note prepared by the Graduate School[3]. The first four months of the FY20 fiscal year were favorable with visitor arrivals reaching 32,255 and Palau was on track to attract 116,000 visitors by the end of FY20. Following the emergence of COVID-19, tourism numbers dropped by half in February, and by the end of March had collapsed. By the end of the FY20 the total number recorded visitors was 41,674 a 54 percent reduction from FY19, see Figure 8.

Sealed Corridor slow initial pickup. For the first six months of FY21 travel restrictions remained in place and apart from the occasional emergency workers and military personnel there was no recorded visitors. However, in April 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. Earlier projections had assumed that would generate some 14,000 visitors by fiscal year end. With the emergence of a significant community spread

3. Graduate School U.S.A., *“Where Do We Go from Here: Updating the Economic Impact of COVID-19 and Strategies for Mitigation in the Republic of Palau”*, EconMAP Technical Note, Honolulu, July 2020

Figure 8: Projected Visitor Arrivals

Visitors projected to disappear during the COVID-19 pandemic with full recovery not projected befor FY24.



in Taiwan, these projections have now been revised and it is assumed that no significant visitors from Taiwan will arrive during FY21.

Vaccination success will enable reopening of borders. Under the US vaccination program Operation Warp Speed, Palau had, by the end of April, attained a rate of vaccination of 75 percent of the adult population, and greater than all US states, territories, and FAS[4]. Once the program is complete including the remaining people wishing and not yet vaccinated, Palau will be in a strong position to open its borders once again to travel. Protocols for this eventuality are being worked out, and Palau should be able to initiate a program towards full recovery during the last quarter of FY21. Given the demise of the Taiwan market no additional visitor arrivals that source or elsewhere are projected for FY21.

Full recovery of the tourism economy projected by FY24. Following projections of international travel made by the International Air Transport Association (IATA)[5] we have assumed that in FY22 visitor numbers will attain a level of 45 percent of the pre-COVID-19 projected FY20 level (116,000), 95 percent in FY23, and full recovery in FY24.

Construction activity

Construction was strong in FY20 but is projected to taper down in FY21 and thereafter as the pipeline of projects dries up. In FY20 construction grew by 32 percent--a large acceleration on the prior year—that helped maintain the domestic economy as the COVID-19 global pandemic hit. In FY21 construction is expected to contract by 8 percent, but to remain above trend. It is assumed that several major projects will continue, but from FY22 onwards construction is projected to decline by 22 percent to pre COVID levels as the pipeline of projects dries up.

Fiscal policy

Fiscal policy actions were designed to support the domestic economy. In March of 2020, as the consequences of the COVID-19 global pandemic were becoming understood, the government designed a set of policy actions to support the economy and mitigate the negative consequences. The first objective was to limit the economic consequences of the crisis emanating from the tourism sector, through maintaining the level of government operations to support demand for the local economy. The policy to support the domestic economy through an accommodating fiscal policy can be considered successful. While the overall economy contracted by 8.7 percent, the domestic non-tourism sectors grew by 1.2 percent, implying the impact on the economy was contained within the tourism industry.

Fiscal policy stance assumed to remain accommodative. The projections assume there is no change in fiscal policy during FY21, and that the government continues to adopt an accommodating fiscal position to support the private sector and to maintain expenditures at current levels. While savings will continue to be made on travel-related items and other initiatives implemented in FY20, additional expenditures will be necessary resulting from the COVID-19 global pandemic. It is assumed that the government continues to finance the CROSS program at the current rate. The projections indicate that the original $20 million appropriation should finance the program through the end of FY21. However, there is likely to be a continuing need for the program, albeit at reduced levels in FY22, as the economy recovers. The U.S. CARES program is assumed to continue through the end of 2021 but thereafter to terminate.

4. In fact, the numbers of first dose vaccinations as of 5/10/2021 was greater than the estimated adult population from the 2015 census. This brings into doubt the size of the estimated Palauan population.

5. Brian Pearce, Outlook for Air Transport and the Airline Industry , IATA, November 24, 2020.

Mitigation programs

The CROSS Act provides support to the private sector to mitigate the impact of COVID-19. 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 originally projected and 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.

The US CARES program provides 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 original 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 FY2021.

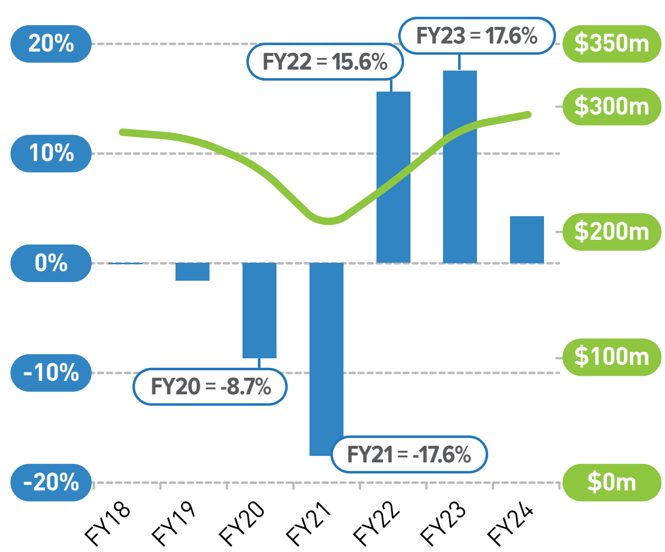
ADB provides critical funding to support government operations and the cost of the CROSS Act. In addition to its own mitigation effort Palau has been fortunate to have access to concessional donor loan financing. The Asian Development Bank has been the major supporter through a series of loan facilities: 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 sub program 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 through FY22 and until the recovery of the economy is well underway.

Economic Impact

In FY21 the economy experienced the full force of the collapse in the tourism industry. The outlook for the Palau economy is projected in Figure 9. After a reduction of 8.7 percent in FY20, the economy is again 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 without the benefit of 4-5 months of pre-pandemic economic activity that affected the FY20 results. The drop in FY21 reflects the disappearance of visitors throughout the entire fiscal year after the demise of the sealed corridor with Taiwan, a reduction in the level of construction activity, but assumes the continuation of the mitigation programs including both the CROSS and CARES Acts provisions.

Figure 9: GDP growth

Total reduction in GDP of 25% anticipated.

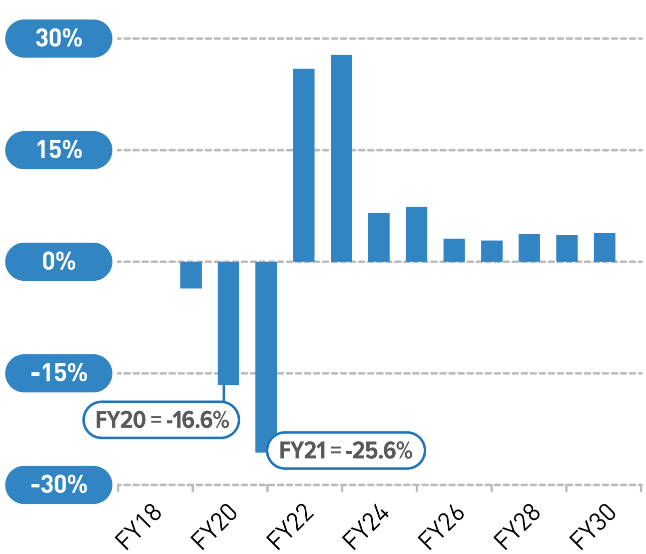


The economy is projected to start a slow recovery in FY22 and full recovery by FY24. In FY22 it is assumed that the process of a slow and gradual recovery commences and visitors to Palau achieve a level of 60,000 (50 percent of the projected level for FY20 before the pandemic). However, it is assumed that the stimulus provided through the U.S. CARES act and its subsequent acts are no longer available but that there remains a reduced need for the CROSS Act provisions. It is further assumed that the construction industry reverts to trend after the earlier projects close out and contracts by 22 percent. The partial recovery in the tourism industry leads to growth in the economy of 15.6 percent. By the end of FY23 the economy is close to full recovery and is again projected to grow by a large 12 percent. The recovery in the tourism industry over the FY22-FY23 period leaves the economy 1.2 percent below the depressed level of FY19.

Private sector experiences the brunt of the impact of the pandemic. Figure 10 indicates the impact of the pandemic on the private sector. While the public sector is projected to remain unchanged—due to donor financing to maintain basic services—the brunt of the COVID-19 impact is felt by 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 impact of the reduction in tourism. Overall, a massive loss in output of 38 percent has been projected for the private sector.

Figure 10: Private scetor GDP growth

Total reduction in private sector contributions to GDP of 36% anticipated.



Employment and Impact on Household Incomes

Early projections of job loss turn out to be overstated but the revised projection of 1,526 remains substantial: Initial projections of the loss of jobs suggested that total job loss of up to 3,100 could be anticipated or 27 percent of the labor force. However, as the FY20 employment data became available it revealed that for the year, average employment levels had only fallen by 3 percent with a loss of just 400 jobs. There are two main reasons for this result. Firstly, the Social Security-based employment figures are averages for the whole of FY20. Secondly, many of the beneficiaries of the mitigation programs received benefits on a part time basis. Thus, employers held on to employees but on reduced hours. During the last quarter of FY20 the SS data indicates a total loss of 1,143 jobs or 10 percent of the workforce. The projections in this review project a job loss in FY21 of 1,586 compared with FY19, i.e., a further 443 loss in jobs compared with the 4th quarter FY20 outturn. These figures are shown in Figure 11 which is indicated for both Palauan and foreign workers.

Mitigation programs had large beneficial impact on household incomes. Without the CROSS and CARES mitigation programs and unemployment benefits household incomes are 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 12. With mitigation and based on both the CROSS and CARES Acts provisions, however, average household incomes are projected to rise 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.

Fiscal Impact

The accumulated fiscal deficit resulting from COVID-19 is likely to reach $85 million or 36 percent of GDP. The fiscal outturn is shown in Figure 13. In FY20 a fiscal deficit of $28 million—11 percent of GDP—was attained. In FY21 the gap is projected to widen, and the deficit rises to $39 million, or 18 percent of GDP. Again, even in FY22 a significant deficit of $19 million, 7 percent of GDP, remains, which does not finally disappear until FY24. The emergence of a nascent recovery is not sufficient to eliminate the need for deficit financing. In total, an accumulated deficit of $85 million

Figure 11: Employment of Palauan and foreign labor

Palauan job loss projected to 615 with loss of 910 foreign worker jobs.

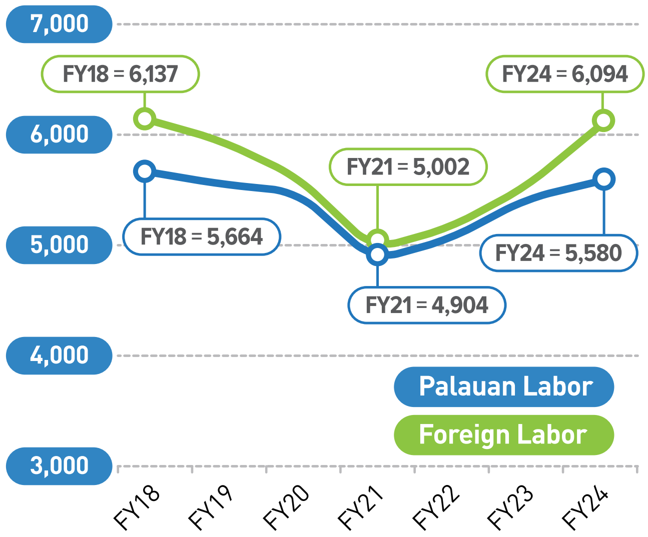
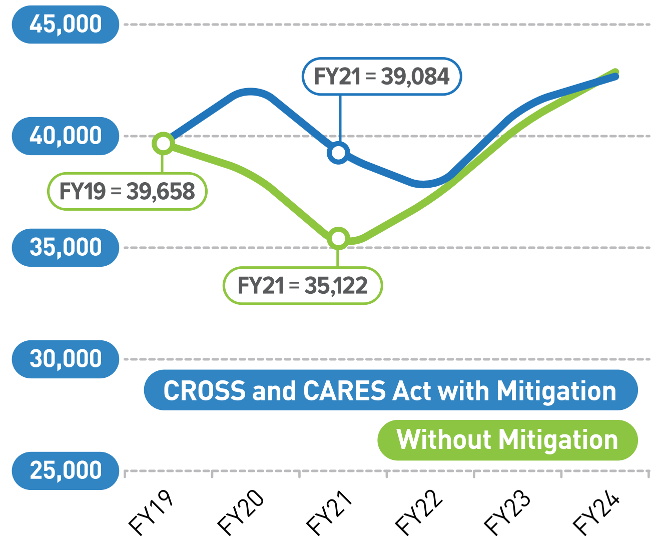


Figure 12: Household impact with and without mitigation

Household incomes fall by -6% between FY19 and FY22 with mitigation, and without mitigation by 11%.



or 36 percent of GDP is likely to result during the FY20-FY22 period.

Decomposing the deficit: 28 percent can be attributed to costs of operating the CROSS Act, 42 percent to tax revenue shortfalls, and 30 percent due to transfers to government agencies. The magnitude of the projected deficit reflects three major forces: (i) the cyclical impact of the loss of the tourism industry on government revenues, (ii) the event driven costs of the mitigation efforts, and (iii) an emerging structural deficit. Of a total projected deficit of $85 million over the three fiscal periods, FY20-FY22, the cost of fully implementing the CROSS Act is $23 million; this represents the event driven part of the deficit. The accumulated tax revenue loss, the cyclical part is estimated to $34, with a remaining $25 million of transfers to support water and waste-water production, Social Security shortfalls and to delay the looming collapse of the Civil Service Pensions Plan. The total of these elements of the deficit sums to $82 million implying offsetting savings elsewhere.

Financing

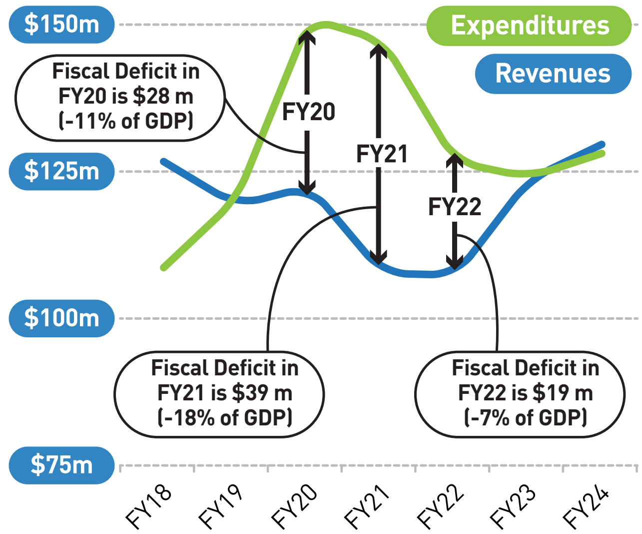
National government cash reserves should provide enough financing to support Palau through the recovery period. At the end of FY20, bank balances had risen to over $60 million reflecting unused portions of the two ADB loans: (i) The $15 million facility under the DRP (Disaster Resilience Program) and (ii) $20 million under the CPRO (COVID-19 Pandemic Relief Option). A further $55 million Policy Based Loan (PBL) has been agreed with the ADB to continue support for Palau through the pandemic, although up to $15 million of the program is earmarked to be on-lent to Koror state. Adding existing reserves to the resources under the PBL program (less Koror State) of $40 million suggests that, with careful management, Palau should have enough resources to finance the projected deficits of $39 million in FY21 and $19 million in FY22, respectively, see Figure 14. This would leave Palau with funds for other purposes such as tax reform implementation and replenishment of cyclical and climate resilience reserve funds, coupled with contingency funds to cover a delayed recovery.

External debt and debt service

External debt/GDP ratio projected to rise rapidly to nearly 90 percent of GDP to finance the impact of the COVID-19 global pandemic, but then to decline as the economy recovers. 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 15). External debt rose from a level of 33 percent to 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

Figure 13: Revenues and expenditures

Palau experiences large fiscal deficits during COVID-19.



indicates the structural level of debt/GDP is about 20 percent lower. After peaking in FY21, the ratio declines rapidly to 62 percent by FY24 as the economy recovers. While much of the rise in external debt, $90 million, is due to COVID-19, Palau is also borrowing heavily for other purposes: the Taiwan HLDP loan of $15 million, an additional ADB PBL for PPUC of $10 million, $15.4 million of the second internet fiber project, and a potential further loan from Taiwan of $10 million for a capital injection into the Civil Service Pension Plan. In all, recent additional non-COVID borrowing totals $50 million.

External debt service is projected to rise significantly but should not result in a high risk of debt stress, provided Palau implements offsetting fiscal measures. 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 will enable Palau to maintain fiscal and economic stability in the years ahead.

Figure 14: Government deposits

Deposits remain strong through the recovery.

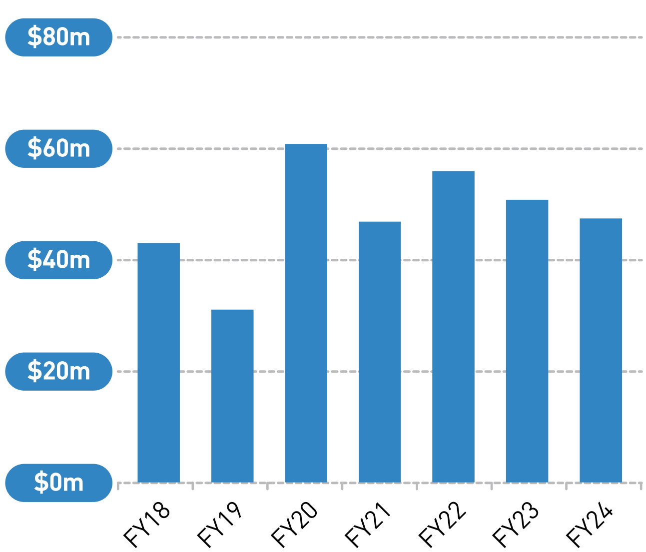
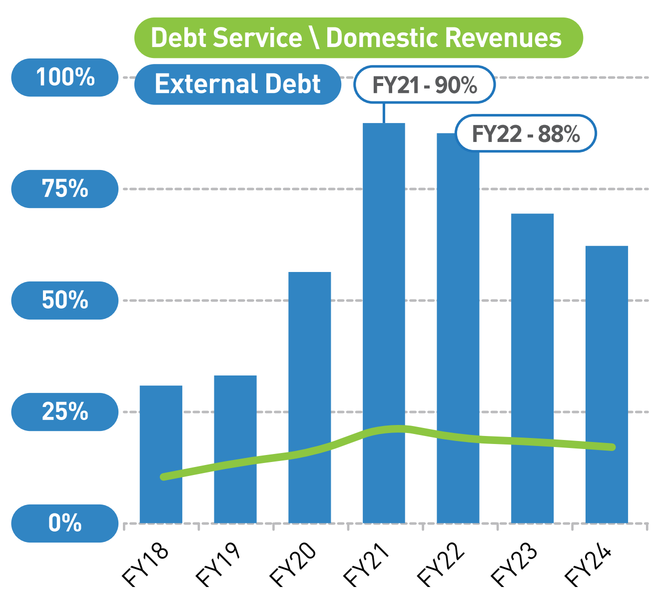


Figure 15: External debt and debt service, % GDP

External debt rises to high levels before recovery.



3

MODELING THE IMPACT OF POTENTIAL COMPACT TRANSFER LOSSES

3 MODELING THE IMPACT OF POTENTIAL COMPACT TRANSFER LOSSES

This chapter outlines the potential impacts of changes in funding provisions associated with the Compact Review Agreement for Palau after FY24. The chapter explores two scenarios:

The first, **"Base Adjustment Scenario"** involves an initial distribution from the Palau CTF, which is estimated to be sustainable with a high degree of confidence based on the projected value of the CTF at the end of FY24 and with that (reduced) distribution thereafter adjusted to fully offset the impact of inflation.

The second, **"Severe Adjustment Scenario",** assumes that Palau will face the additional challenge of losing all US federal programs and services. This scenario is very unlikely, given the continued strength of the relationships between the US and Palau. The scenario is presented to show the ongoing value of the Compact relationships (and subsidiary agreements) to Palau and, conversely, the ongoing reliance of the Palauan economy on the continued relationship.

Analysis uses standard modeling techniques. The nature and magnitude of potential changes in Compact provisions, and avenues of adjustment to potential reductions in US support are discussed. Subsequently, the chapter analyzes the first two adjustment scenarios. The analysis utilizes a modeling framework developed by the Graduate School USA (GSUSA), which adopts a modeling system based on the economic sector accounts of the economy and utilizes financial programming techniques developed by the International Monetary Fund[1].

1. See recent GSUSA Palau Economic Review for a discussion of the model.

The Palau Base Adjustment Scenario

Full recovery of the tourism sector and economy is projected by the time Palau enters any Compact extension period after the completion of the CRA. The projections in the prior section set the likely path the economy may take for the remaining years of the CRA period although—based on historical experience—subject to a high degree of variance. This establishes the base year for the two scenarios examined in this chapter: the base adjustment and severe scenarios. It is to be hoped that the recovery of the Palauan economy and tourism sector follows our projection and is complete by the time any Compact extension may come into force in FY25. We are projecting full recovery from COVID-19 by the end of FY24 ahead of the Compact extension which will place less burden on the economy.

After recovery from COVID-19 the tourism economy is projected to expand rapidly from the weak position existing before the pandemic. However, the Palauan tourism sector was operating at low levels of hotel occupancy in FY19 before the COVID-19 pandemic, just 33 percent hotel occupancy, and we anticipate occupancy rates to rise to 55 percent by FY30. This imparts a strong upward growth path in the tourism sector and the economy at the same time Palau enters the post CRA period. There are thus two periods of recovery: (i) the recovery from COVID-19 during the remainder of the CRA period, and (ii) a broad tourism sector recovery during the early years of the post CRA period as the sector returns to normal levels of occupancy and profitability. For this study we will attempt to isolate and focus upon the impact of any adjustments to Compact funding levels even if such impacts will occur during a trend period of substantial tourism recovery and economic growth.

Projections include adjustments to increased debt service resulting from COVID-19 associated debt repayment. As indicated Palau will unavoidably take on significant additional external debt during the pandemic. That debt, albeit concessional in nature, will require servicing. Our model results thus include additional adjustments to be made on an ongoing basis for Palau in addition to those possibly arising from each Compact scenario. This is different for Palau as compared to the RMI and FSM which are projected to have reduced their external debt obligations due to the "grant only status" they operate under because of their lower level of GNI per capita.

Palau faces modest adjustment under base scenario although when coupled with increasing debt repayment will be signficant. Conversely, Palau faces the least severe potential consequences of adjustment after its current period of Compact funding assistance comes to an end after FY24 compared with the two other FAS. This is a result of Palau's lower reliance upon Compact assistance in relation to the size of its economy. Under the terms of the original Compact the level of distribution from the Palau CTF is limited to $15 million annually. Absent an amendment or extension to Compact economic assistance, in FY25 that annual distribution will not be adjusted for inflation.

COFA Trust Fund projected to be $332 million at the end of FY24 and will support a sustainable distribution of $10 million. Using the Monte Carlo method of statistical analysis, the median value of the Palau CTF at the end of FY24 is projected at $331.9 million, with a corresponding SAFER distribution of $10.0 million. This potential reduction in transfers to support government operations and capital investments is specified in Figure 16 as $5.0 million annually, which equates to 1.4% of projected GDP in FY25. The range of adjustments of course are many, but in this analysis the following assumptions are made[2]:

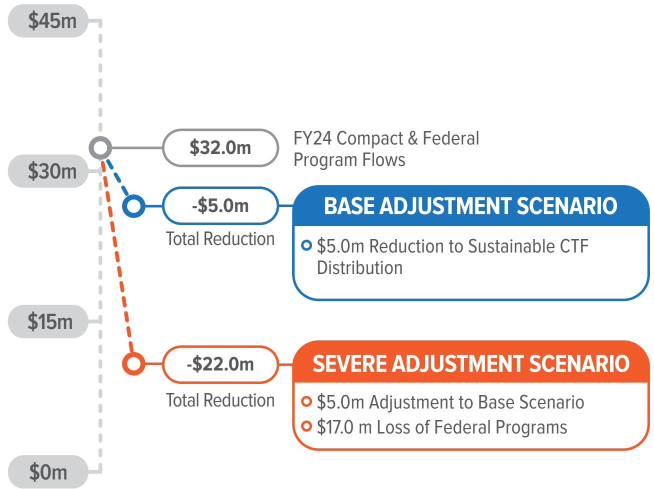
i. No new civil servants are hired to replace retirees, estimated to be 2 percent,

ii. Annual wage increments are not awarded, and

iii. A real cut of 2 percent is made on all purchases of goods and services, and transfers to government agencies, state governments and NGOs.

2. The adjustments in this and following scenarios are determined to maintain a level of government deposits similar to that under the modeled trend.

Figure 16: Palau downward adjustment scenarios: Components and Magnitudes



Note: Sustainable distributions from the CTF ($10.0 millions) is assumed to be available.

Analysis presented in comparison with model trend. In the analysis presented of the base and severe adjustment scenarios in this chapter and the Compact extension scenario of the following chapter comparison is made to the model trend. The model trend is that trajectory the economy might follow if Palau were to follow a path without adjustment to the transition adopted in any of the modeled adjustment scenarios. This implies that Palau would continue to drawdown $15 million per annum from the COFA Trust Fund and effectively abandon it is objective to create a perpetual fund and at some point, risk the total collapse of the Fund. Our analysis of the impact of the three scenarios involves a comparison to the model trend. In the graphics the projections are presented in level form. However, in addition the graphics show comparison to the model trend in percentage change terms. That percentage change from the model trend thereby isolates the impact of the Compact adjustment under each scenario.

The impact of the base adjustment scenario is a relatively small reduction in GDP of 0.4 percent. Figure 17 provides details of the impact of the base adjustment scenario on the economy, indicating both the trend and difference with the underlying trend. GDP growth is projected to grow by 4.3 percent in FY25, this is 0.4 percent below the rate that results under the modeled trend. Thus, the impact of the base adjustment scenario is that same 0.4 percent decline with respect to GDP. This result may at first sight appear surprising. However, the economy is projected to be recovering from the pre COVID-19 tourism reduction. Visitor arrivals are projected to rise by 10 percent to 127,000 comparable to the level attained in FY18; this has a strong stimulative effect on the economy.

The impact on household incomes is larger than GDP and fall by 0.9 percent; job losses are minor with no projected impact on migration. Figure 18 shows the base adjustment scenario results in a 0.9 percent decline in household incomes relative to the trend projection. The impact on households is larger than GDP as the adjustment mechanism entails a direct impact on civil service wage and salary levels. Reflecting the increase in GDP, the base scenario also generates jobs and opportunities without stimulating any significant migratory impact, see Figure 19 and Figure 20. Again, if we isolate the negative impact of the base adjustment scenario the model shows a small decline in jobs of 35 with no simulated impact on out-migration[3].

3. The migration function has a threshold of 1 percent change in employment before there is any impact on migration.

Government deposits are projected to decline during the early stages of recovery, but to grow after FY26. Government deposits are a measure of the need to finance the fiscal deficit after external debt obligations have been met. During FY20 and FY21, in the years before recovery, the government secured a series of loans with the ADB and despite the need to finance large fiscal deficits built up its reserves, see Figure 21. During the initial recovery phase and through FY27 government reserves are projected to decline as the level of economic activity is insufficiently strong to generate enough revenues to return the economy to fiscal balance. By FY27 the economy is back on a sustained growth path with occupancy rates approaching 49 percent and visitor arrivals approaching 159,000. From this point forward though the end of the decade, the economy continues to grow as visitors reach 185,000 and cash reserves grow. These results are based on limiting the real level of government at

Figures 17-20: Palau Base Adjustment Scenario: GDP Level, Household Incomes, Jobs and Migration

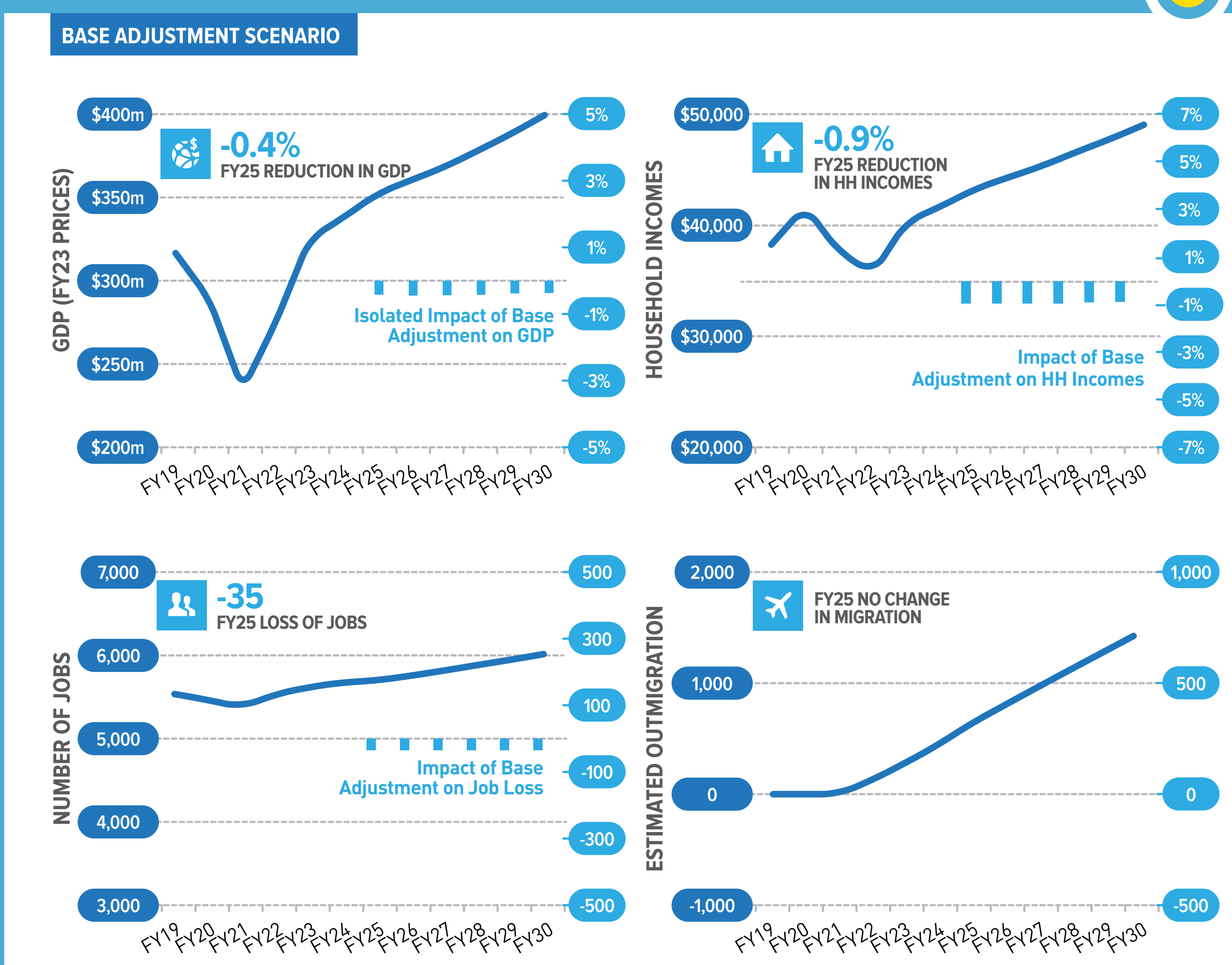
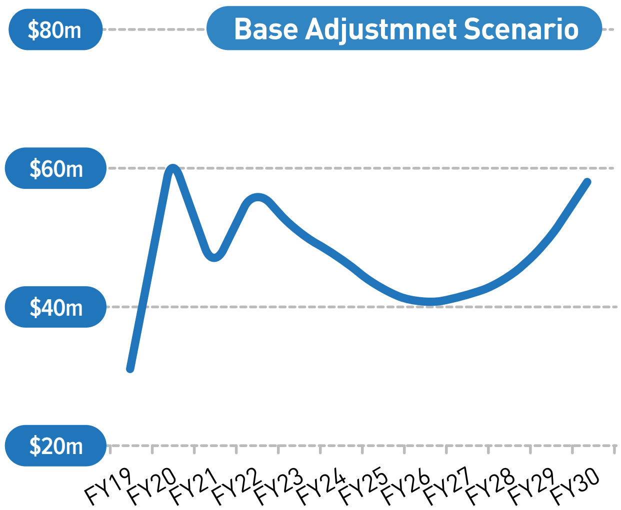


Figure 21: Domestic financing requirements under the base scenario

Government deposits are held in check but savings accumulate as the economy recovers from COVID-19.

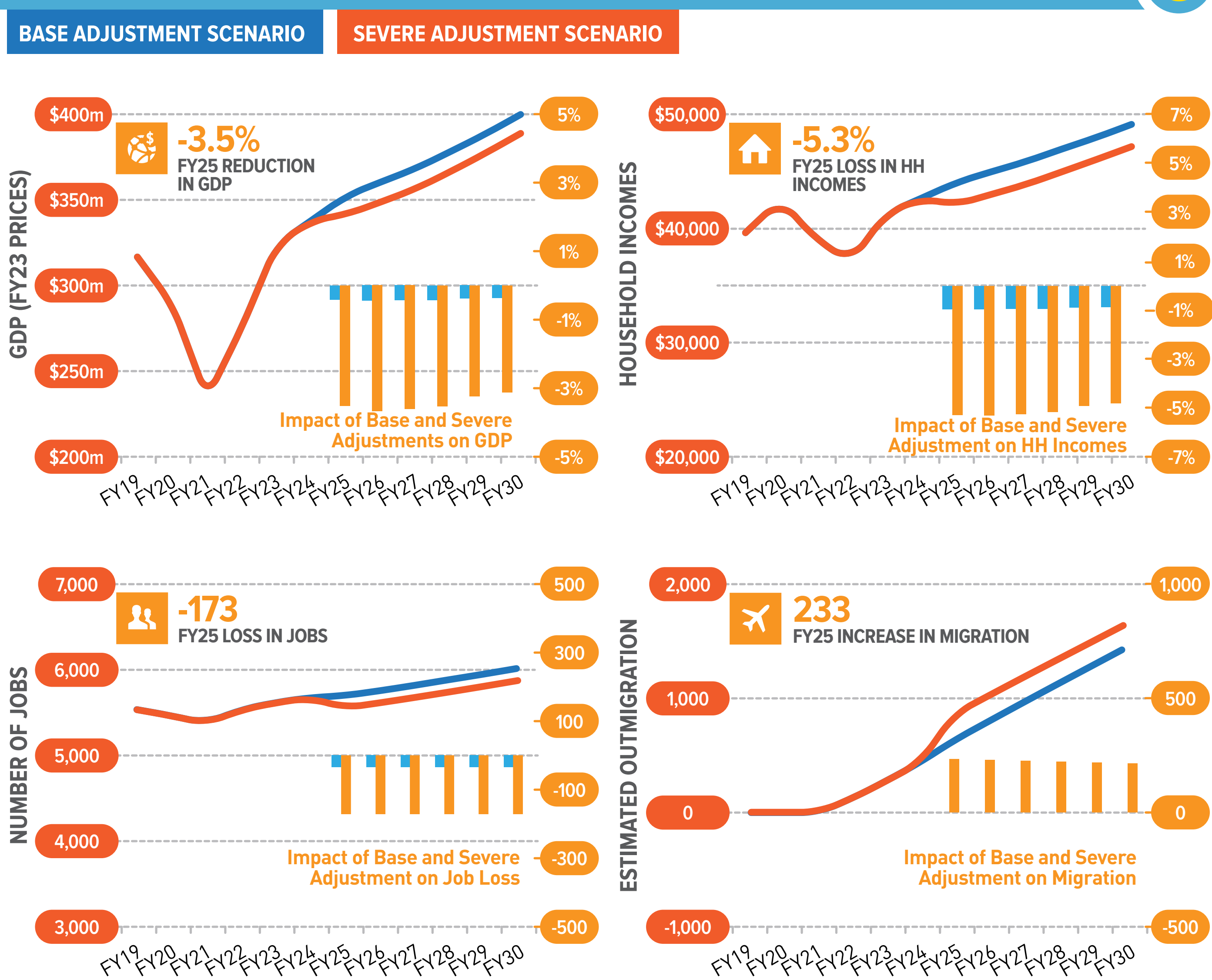


pre-pandemic levels and continuing to implement a prudent fiscal strategy.

The Palau Severe Adjustment Scenario

Severe scenario entails a further loss of Federal programs and services equivalent to 4.9 percent of GDP. Under the unlikely, but important-to-model severe adjustment scenario, the potential additional reduction in US funding to support nearly all of the listed programs and services totals $17.0 million annually which equates to 4.7% of projected GDP in FY25. Taken together with the base adustment, the total annual reduction in transfers would be $22.0 million annually, or 6.1% of projected GDP in FY25.

Figures 22-25: Palau Severe Adjustment Scenario: GDP Level, Household Incomes, Jobs and Migration



Impact of loss of postal services has not been included in the severe scenario but would incur a considerable increase in cost. Palau benefits from the provision of US postal services, the future of which is uncertain. Loss of postal services would imply higher costs for Palauan consumers; however, the cost of subsidizing postal rates in Palau is not known and modeling the impact on public services, businesses and households is beyond the capability of the GSUSA macroeconomic modeling framework as currently developed.

Severe adjustments are required in delivery of public services to restore fiscal balance. In order to restore fiscal balance under the severe adjustment scenario the following assumptions have been made:

i. The national government reduces the number of civil servants by 10 percent coupled with a wage freeze and additional 10 percent cut in salaries.
ii. Reduction in all purchases of goods and services, transfers to government agencies, state governments and NGOs of 20 percent.
iii. In the case of Pell, it is assumed the national government funds the former grant levels with a transfer to Palau Community College to fully make up the loss.
iv. The same assumptions are made with respect to the Palau Community Action Agency to maintain Head Start (pre-K) programs.

Under the severe scenario the public sector contracts strongly as the private sector grows with continuing recovery in tourism. Under the severe adjustment scenario Palau's GDP continues to grow in FY25 grows by 0.8% compared with FY24 due to the recovery in the tourism sector, see Figure 22. Compared with the model trend and before any cuts in payroll or expense GDP is lower by 3.5%. However, the impact of adjustment is quite different between the private and public sectors. Given the forced nature of adjustment, the public sector contracts by 6.7% at a rate proportional to the real cut in civil servants. On the other hand, the private sector comes out relatively unscathed given the strong expansion projected in the tourism economy. This of course is completely the opposite of the impact of COVID-19 where the brunt of adjustment has been felt by the private sector. Figure 23 indicates the impact of the severe adjustment scenario on household incomes and impacts are similar to that on GDP with the isolated impact projected as a 5.3 percent decline in household incomes.

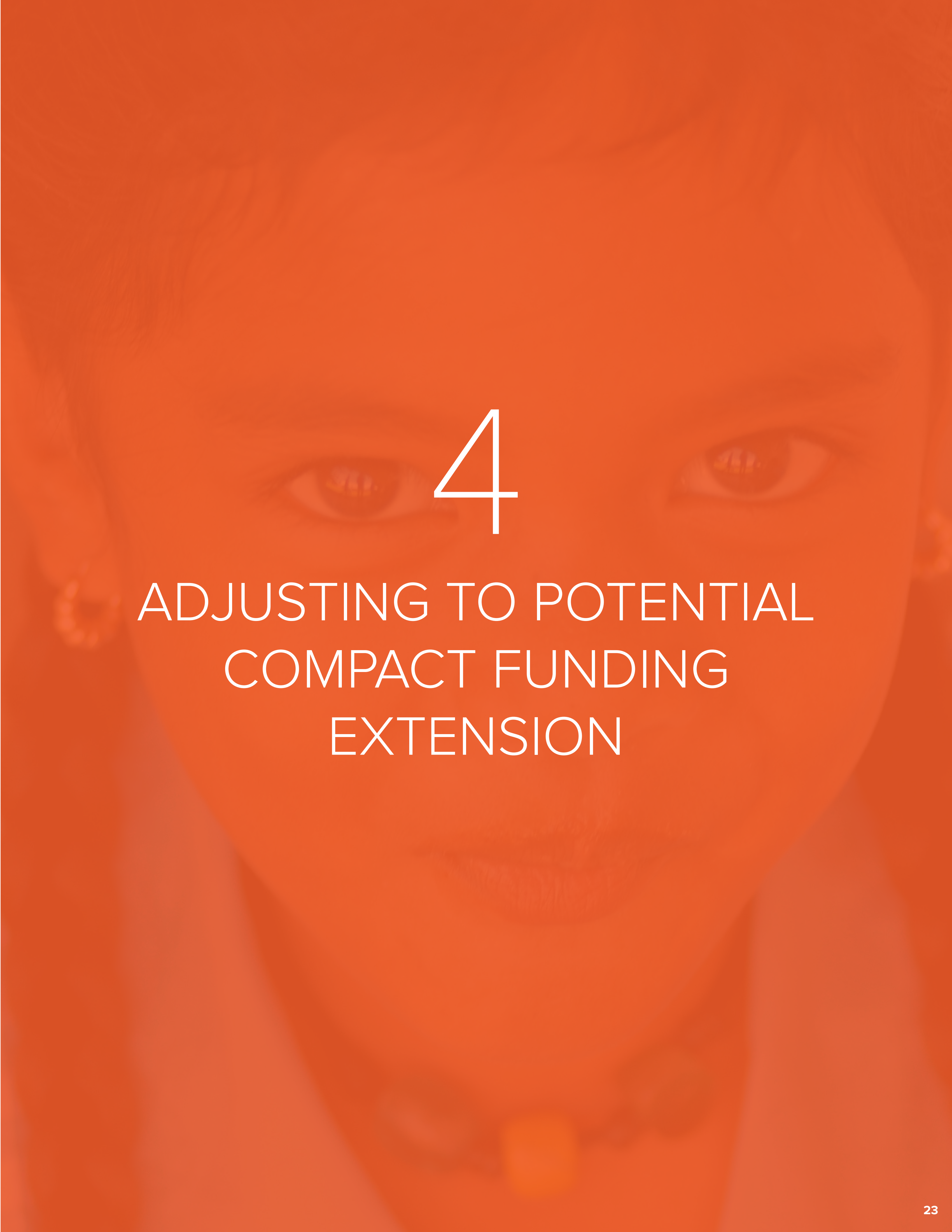
Significant reduction in Palauan jobs are projected under the severe scenario. Figure 24 indicates that under the Severe Adjustment Scenario, there could be a loss of 117 Palauan jobs, but this level of job loss is 173 jobs below the model trend. Based on FY19 data, Palau's labor market has more foreign workers (5,943) than Palauans (5,549). However, the civil service is dominated by Palauans, while the private and tourism sectors utilize a high proportion of foreign workers. The impact of the severe adjustment scenario is thus felt disproportionately in the Palauan segment of the labor market, with some of the displaced workers switching to the private sector.

Under the severe scenario significant Palauan migration would be anticipated. As a result of the job losses in the public service, many of the displaced workers are likely to migrate with their dependents (see Figure 25). The labor dependency ratio in Palau is 2.0. The Severe Adjustment Scenario projects that an additional 233 Palauans would migrate to the US.

Conclusion

While impact of potential adverse impact of the base and severe scenarios is masked by tourism recovery, impacts on employment, migration and incomes would be large. The impact of the base and severe adjustment scenarios has important differences compared with our earlier 3-country study[4]. The Palau economy is projected to experience two recovery phases. The first is the recovery of the economy from the impact of COVID-19. Tourism is projected to return to the levels that had been projected for FY20 before the downturn. The second phase of recovery is a further increase in visitor arrivals as the hotel sector returns to normal levels of occupancy that averaged 55 percent during the FY12-FY16 period. The impact of these assumptions is that the economy is projected to be on a rising trend as it enters the new phase of Compact relations with the U.S. The negative impact of fiscal adjustment is thus strongly masked by the positive impact of the recovering tourism sector. However, the drag on growth, household incomes and employment are significant and have been outlined in the discussion above. Under the base adjustment scenario, the Palauan economy is able to manage the adjustment with only limited impact. However, the severe adjustment scenario brings the growth in the economy and household incomes to a halt. Jobs are lost and migration grows. The model assumptions have projected the trend during this period as favorable. However, should the recovery be delayed and take longer than assumed the impact of the two Compact adjustment scenarios would be more adverse.

4. *The Economic Impacts of the End of Compact Grant Assistance in the Freely Associated States*, Graduate School, U.S.A, Honolulu, May 2020.



4

ADJUSTING TO POTENTIAL COMPACT FUNDING EXTENSION

4 ADJUSTING TO POTENTIAL COMPACT FUNDING EXTENSION

Base and severe scenarios assume brute force of expenditure cuts and job losses to restore fiscal balance. Chapter 3 outlined a response on the part of Palau to reduced Compact funding without any modified development partner support and based on a program of fiscal austerity to achieve fiscal balance, especially in the severe adjustment scenario. The base adjustment scenario outlined in Chapter 3 assumed the government implemented a program of modest expenditure adjustments, while under the severe scenario the adjustment was assumed to take place through painful forced expenditure compression. Fiscal balance was restored through the brute force of expenditure cuts and job losses. Leaving behind those painful scenarios it is possible to look forward with some optimism, using the GSUSA economic models to project the impact of a funded extension of the Compact for Palau.

The Compact extension scenario assumes CTF funded to achieve perpetual status. At the outset of this chapter the potential impact of a Compact funding extension is described for the Palau economy. Clearly, continued Compact resource transfers would improve the outcome and avoid the need for the forced adjustments described in Chapter 3. Compact funding extension would also, if designed appropriately and funded sufficiently, fulfill the desirable objective to establish the Palau CTF as a perpetual trust fund, that would provide secure flows of resources with a high degree of confidence and without any reduction in FY25. While the provision of a more secure future would avoid a shock, it would not in itself place Palau on a higher long-term growth trajectory. That must arise from within Palau itself with targeted infrastructure development and additional development partner support through programs to support and reward pro-growth policy reforms.

Palau Compact Funding Extension

Compact extension scenario chosen to equate the structure to that of the RMI and FSM. As described below, the structure of support under an extension of the Palau Compact would differ from that for the RMI and FSM; but with the same objective of steady-state budgetary support, infrastructure funding in proportion to that budgetary support, audit, and contributions to the CTF. The different approach assumed for Palau is necessitated by the fact that Palau received “lumpy” or front-loaded transfers, especially for infrastructure, under both the initial Compact period and during the CRA period. The specific amounts modeled have been chosen to equate the structure during the Compact funding extension period to that of the RMI and FSM. Operating grants are assumed to be $15 million plus $2 million for infrastructure maintenance and $0.5 million for audit in FY24 prices and infrastructure is specified in proportion to the 70:30 percent operating grants-to-infrastructure grants ratio prevailing in the FSM and RMI. This leads to an estimated $6.5 million for infrastructure in FY24 prices. The $6.5 million infrastructure allocation in this scenario is obviously greater than the “nil” allocation for infrastructure in FY24; however, it is less than the $10.1 million (in FY24 prices) Palau received from the US for infrastructure over the 30-year period through FY24.

Additional contributions included for the CTF. An additional annual contribution to the CTF is estimated at $3.5 million annually. This defines a "topline" annual funding amount of $27.5 million. Following the rules anticipated for the FSM and RMI Compact extensions, the topline contribution is adjusted for inflation using the two-thirds of the U.S. GDP deflator rule, while the transfers available to Palau annually would be fully inflation-adjusted. The CTF contribution is thus projected to gradually decline in real terms over the 20-year extension period. Simulations conducted by the GSUSA show that the CTF score achieved under the modeled 20-year period is 93.2%.

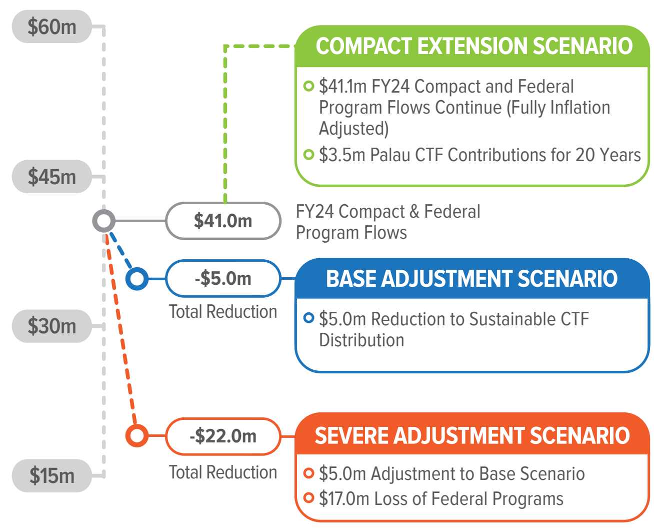
Under the Compact extension scenario, we do not account for the costs of achieving climate resilience. Credible institutions such as ADB and the World Bank are working to model—and insure against—the costs to nations to better prepare for climate events; however, the modeling approach used for this study cannot account for this important matter. While resources are being made available to the FAS by donor partners, it is unclear if such assistance will be sustained at levels sufficient to offset the actual magnitude and frequency of climate events.

The Compact funding extension scenario for Palau considers continued US support to establish a perpetual Palau CTF and a further program of investment in infrastructure. Figure 26 shows the Compact funding extension scenario in comparison to the adjustment scenarios outlined in Chapter 2. The program entails the following components:

i. US operating grants are set at $15 million annually in FY24 prices.
ii. As noted, the level of infrastructure grants is modeled at $6.5 million annually in FY24 prices so that the same 70:30 ratio for operating grants to infrastructure grants is established for Palau as exists already for the RMI and FSM.
iii. Specific grants for infrastructure maintenance of $2 million and audit of $0.5 million.
iv. Annual contributions to the Palau CTF are set at $3.5 million in FY24 prices. Since the topline level of transfers from the US is presumed to maintain a two-thirds inflation adjustment, this component is modeled as the residual of that adjustment while allowing the other three components to be fully inflation adjusted.

Economic growth projected to increase by a modest 0.4 percent p.a. under the Compact extension scenario. Figure 27 shows the potential benefits of such an extension. As in all other scenarios, the projections assume a similar trajectory for fiscal balance as under

Figure 26: Palau Compact Funding Extension Scenario



the model trend. Without the need for adjustment in FY25 to a lower real distribution from the Palau CTF, the economy maintains its forward momentum, including the projected recovery of the tourism sector through the remainder of the CRA period. GDP is projected to grow by an average of 3.3 percent per annum during FY25-FY30. In comparison with the modelled trend, this equates to a 1.1 percent increase in FY25 and a sustained average 0.4% annual improvement over the model period. This outcome is based on a small improvement in the level of private sector activity due to the increased infrastructure spending, and additional Compact funding which supports a modest expansion in the provision of public services of 1.5% per year from FY24 to FY30. Figure 28 indicates the isolated impact of the Compact funding extension is an increase of 1.0 percent increase in household income in FY25.

Compact extension provides a modest rise in employment and retention of Palauan jobs. In the case of employment, Figure 29 indicates the additional hiring associated under the Compact extension scenario with modest expansion in the provision of public services add an estimated 17 Palauan jobs in FY25 which rises to 106 Palauan jobs by FY30 compared with the model trend. Since most workers in the construction sector are foreign labor the enhanced infrastructure program does not generate a significant increase in jobs for Palauans. As result of the increases in both civil servants and construction workers the labor market expands by an additional 338 jobs by FY30 or 2.6 percent of the size of the labor market. The projections show a small decrease of 37 fewer migrants in FY25 under the Compact funding extension scenario compared with the model trend. This is shown in Figure 30.

Additional infrastructure helps strengthen the economy under Compact extension. Finally, in Figure 31 the level of investment is indicated under the three scenarios. Public investment in infrastructure grows at the start of the projection period going into the COVID-19 period and helps sustain economic activity. However, from FY22 through FY25 a paucity of both private and public sector projects is indicated, reflecting the lack of demand for investment in the tourism industry, and a lull in the public projects. From FY25 both private and public projects re-emerge as the economy gains momentum and demand for new tourism plant is felt. However, the significant impact of the Compact extension with the provision of the additional infrastructure projects is clearly indicated helping to lay the groundwork for future expansion in the economy.

Compact Trust Fund Issues

Different CTF scenarios are modelled and scored. If the described extension of Compact funding scenario were to last for another 20-year period, the Palau CTF is likely to have achieved a high degree of sustainability at the end of FY43, see Table 1. The scoring methodology used to optimize for the SAFER method uses scores for three categories: real value of the Palau CTF, value of annual distributions, and (lack of) volatility of annual distributions. Each of these in turn is broken out into a set of sub-measures: the first an intergenerational measure estimated over the distribution period and the second a measure of long-run sustainability. A score of 95% is analogous to a 95% statistical confidence level.

Under the modeled Compact funding extension, the Palau CTF using SAFER rules achieves a high score of 93%. In the absence of Compact funding extension,

Figures 27-30: Palau Compact Extension Scenario: GDP Level, Household Incomes, Jobs and Migration

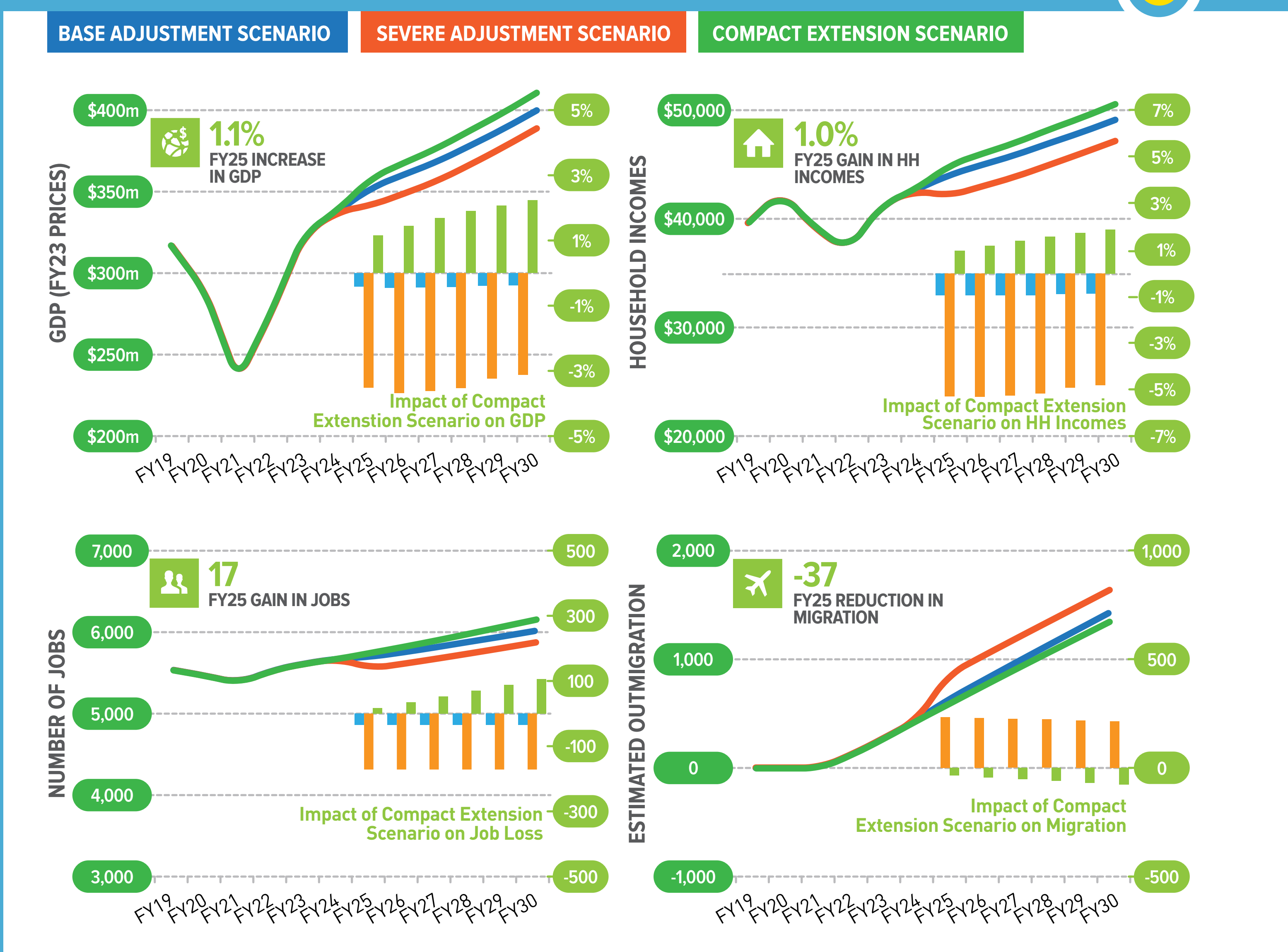
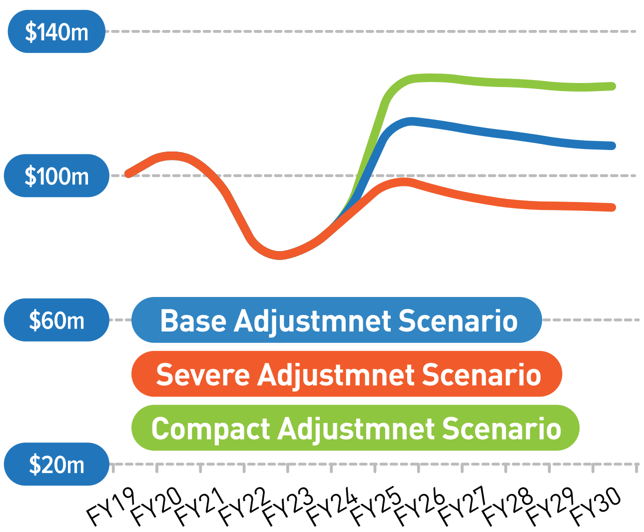


Table 1: Compact Trust Fund Performance under the existing arrangements and assuming Compact extension

Performance Measures	Compact extension	No extension COFA rules	No extension SAFER rules
Evaluation period	**FY45-FY64**	**FY25-FY64**	**FY25-FY64**
Percent cases where real CTF in FY64 is above FY2024 sim value	89%	79%	89%
Percent cases where CTF value is above the PT in FY2064	97%	80%	91%
Average distribution through FY2045-FY2064 percent target	94%	65%	80%
Probability of attaining target distribution in FY2064	84%	0%	78%
Percent of cases with zero distribution in FY2025-FY2064	0%	8%	0%
Val of distribution % prior year counted for reduction years only	1%	2%	1%
No of years with reductions in distributions % total years	7%	97%	13%
CTF Performance Index	93%	61%	88%

Figure 31: Investment under the three scenarios, constant prices

Investment gets a large boost of 15% under Compact extension to support development



If the described extension of Compact funding scenario were to last for another 20-year period, the Palau CTF is likely to have achieved a high degree of sustainability at the end of FY43

the Palau CTF would score 61% using COFA rules and in 7% of cases result in fund collapse during the period FY24-63. While the 20-year extension of the Compact simulated coupled with small additional contributions achieves a score close to the target, it falls just short of the aspirational goal of a "perpetual" fund with a score of 95 percent. Table 1 indicates the near miss of the projected arrangements to achieve a sustainable and perpetual trust fund safeguarding the long-run interests of the people of Palau. Greater detail on the Trust Fund simulations, measures and methodology employed by the Graduate School can be found online[1].

1. Graduate School U.S.A., Compact Trust Funds in the Three Freely Associated States: A Briefing Note, 2020 (forthcoming), Honolulu, Hawaii (https://pitiviti.org/initiatives/economics/palau.php).

Table 2 shows the estimated costs to the US for the modeled Compact funding extension scenario together with some comparative cases:

i. A lump sum contribution in FY25 that achieves a 95 percent score of the performance measure,
ii. The level of trust fund annual contributions required to achieve the 95 percent score, and
iii. A graduation scenario through which the U.S. would contribute an agreed amount until a performance score of 95 was achieved from which time further annual grants or contributions to the CTF would cease.

Compact extension scenarios come with high cost, but savings can be achieved. Under the assumptions outlined in this paper the total cost to the U.S. in FY25 dollars would $550 million. Annual grant transfers to Palau would be $27.5 million partially indexed for inflation of which include annual contributions to the CTF. As a benchmark figure should the U.S. choose to provide a lump sum that achieved the 95 percent score the cost would be $541 million in FY25 prices. The third scenario which solves for an annual grant stream that attains a 95 percent score would require an annual grant stream of $32 million of which $8 million in FY25

Table 2: Cost to the US of a 20 Year Compact Funding Extension (as Modeled)

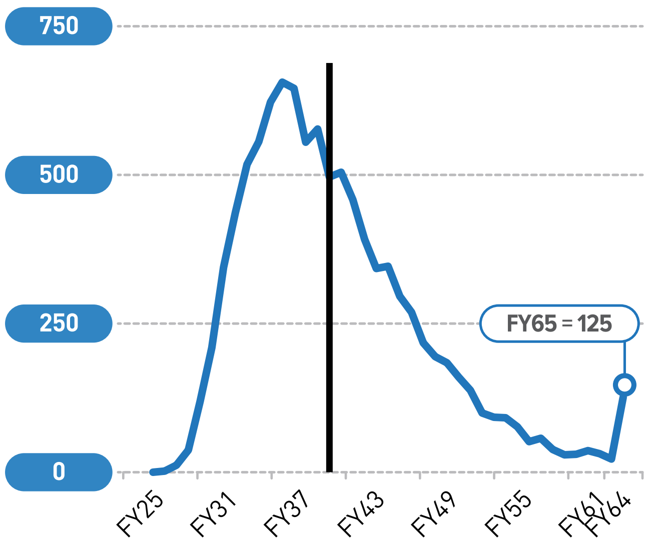
	Compact extension	Lump sum	Solved	Graduate
Cost of Compact extension in FY25 $s	$550m	$541m	$640m	$490m
Cost of Compact extension in current prices	$681m	$541m	$792m	$559m
Drawdown in FY25	$24m	$24m	$24m	$24m
Years of Compact extension	20	20	20	11
Probability of not attaining SAFER by FY45	31%	15%	21%	17%
Probability of not attaining SAFER by FY64	11%	7%	7%	9%
Contribution in FY25	$28m	$541m	$32m	$43m
CTF Performance Index	93%	95%	95%	95%

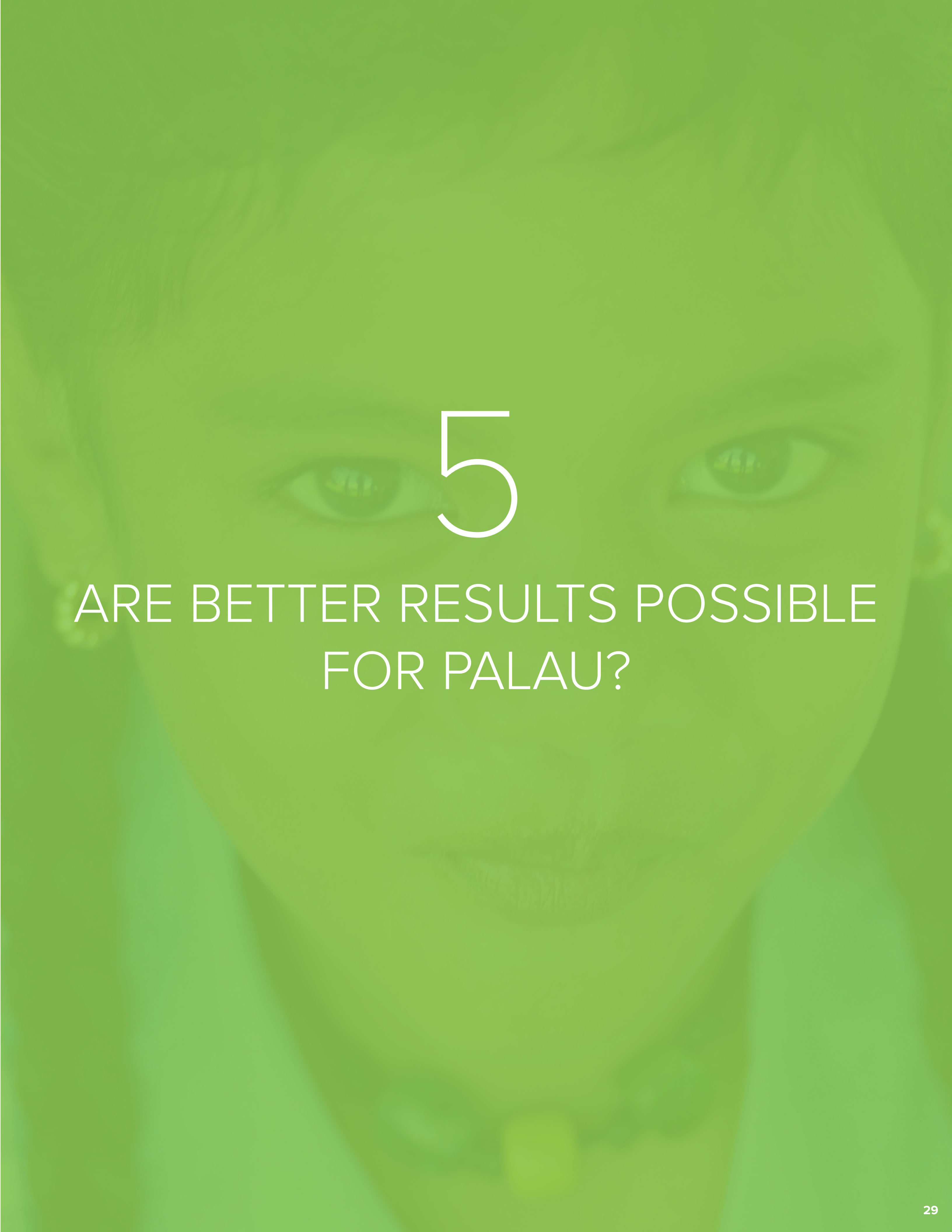
would be deposited in the CTF. This would come with a total cost estimated at $640 million in FY25 prices. The example indicates the high cost of attaining increases in performance the closer the score converges to the 95 percent target. To increase the score by 2 percent and travel from 93 to 95 percent would cost an additional $90 million or 16 percent.

Graduation scenario achieves target of 95 percent sustainability with least cost. Finally, the graduation scenario indicates a 95 percent performance score can be attained through a continuation of the contributions assumed in this paper until the SAFER target is attained. The total stochastically projected cost to the U.S. falls to $490 million a considerable saving, assuming that on average the target is attained after 15 years (median value). However, this beneficial result needs to be conditioned that while in some cases, 50 percent, the target would be attained before FY40, in 50 percent it would not. The distribution function of the number of years to attain SAFER is indicated in Figure 32. For the favorable outcome years, the target is attained relatively quickly, but under less favorable market performance attainment drags out. While the approach has attractions, it also causes issues from a legislative perspective where uncertainty is introduced into the required appropriation period.

Figure 32: Distribution of attainment of SAFER under the graduation scenario (10,000 cases)

Median value of graduation ocurrs in FY40.





5

ARE BETTER RESULTS POSSIBLE FOR PALAU?

5 ARE BETTER RESULTS POSSIBLE FOR PALAU?

This chapter begins with a brief description of the preparatory actions taken by the affected parties to prepare for potential outcomes at the end of the current CRA period under the Palau Compact. Subsequently, this chapter provides a summary of the policy agenda Palau, and the development partners, might undertake to achieve improved performance. Finally, the authors offer some concluding remarks.

Current State of Preparedness of the Parties

Palau

Palau and the US are preparing to re-engage in the "Second Compact Section 432 Review" to extend economic assistance beyond FY24. Palau initially got off to a later start than its two sister FAS-nations in preparing for scenarios that may arise in FY25 after the end of its 30th year of a 50-year Compact of Free Association. The primary reason is that the CRA that Palau and the US signed on 3 September 2010, was not fully funded until late September 2018. Some of the terms of the CRA are just now being discussed for implementation. In terms of preparing for an early start to negotiations (or, more specifically, an early convening of the next mandated section 432 Review), Palau has not created a statutory or officially designated entity. However, the President has designated a team to meet with US officials and to make recommendations about next steps. Through December 2020, the members were led by the Vice President and included the Minister of Finance and the two Chairmen of the Ways and Means Committees in the Senate and House. Under the new President, the Minister of Finance has been designated to lead Palau's negotiating team; however, only minimal technical discussions have been recently held as the US government, also under new administration, settles on its approach to the FAS Compact renewal negotiations as a part of its larger Indo-Pacific Strategy described below.

Reforms under implementation to mitigate the impact of COVID-19 also provide a means for possible adjustment under the base and severe adjustment scenarios. The impact of COVID-19 and the need to develop an economic and fiscal response has absorbed the policy and legislative agenda. With support from the ADB under a Policy-Based Loan, Palau has developed a program of reforms to assist in the nation's fiscal and economic stabilization needs, and to develop long term instruments to fulfill and reduce debt service obligations as the economy recovers. As the earlier chapters have indicated, it is projected that the economy will have fully recovered by the time the new phase of the Compact comes into effect. The reforms under the PBL to implement a modern tax regime, reforms to Social Security, and the private sector regulatory environment would enable Palau to adjust to the base adjustment scenario effectively. The program would further leave Palau with some "fiscal space" to mitigate the greater impacts of the severe adjustment scenario. However, the severe adjustment scenario, especially if associated in time with a slower than projected tourism recovery, would result in significant disruptions to public services, significant job losses, especially in the public sector, and a spike in out-migration.

USA

The US has prioritized the partnership it has with Palau within the larger context of its Free and Open Indo-Pacific Strategy. The US has a standing mechanism to monitor and implement its policies toward the three FAS—an Inter-Agency Group (IAG) that is led by the White House (National Security Council) and has both a small group with key agencies and a broader group meant to encompass all agencies with programs or interests in the FAS. The IAG holds meetings on an as-needed basis. Over the past two years, the IAG has scaled up engagement due to one key policy factor and one major timing factor.

The policy factor of most concern to the US is the need to offset China's growing influence in the Pacific region as a whole, and specifically in the Western Pacific. This policy concern is captured by the US government's "Free and Open Indo-Pacific Strategy," which is shared in name or effect with key regional allies, including Japan, Australia, and New Zealand. This policy concern as it relates to the FAS clearly raises the visibility and importance of the relationships with each nation and with the combined land and ocean space controlled through the three Compacts of Free Association with the FSM and the RMI until mutually dissolved and with Palau until that Compact expires at the end of FY44.[1]

Current US economic assistance arrangements with FSM and RMI end after FY23 and with Palau after FY24. The timing factor which has led to the increased frequency and urgency of IAG meetings is the timing built into the three Compacts of Free Association. The inflection point for a change in funding arrangements happens after FY23 for the FSM and RMI and for Palau after FY24. As described in chapter 3, the consequences of letting the existing terms of each Compact prevail are significant—especially in the model results of the severe adjustment scenario for each nation. Alternatively, the benefits to an extension of substantial US funding are shown in chapter 4. The IAG is considering the possibility that a cessation of US funding could create a funding gap, which China could, in turn, leverage to increase its presence and influence in the FAS.

The US had hoped to conclude its review process with Palau by 31 December 2020. The US established a negotiating team led by co-lead negotiators: one from the Department of State and one from the Department of the Interior. The US completed a listening tour to each FAS just prior to the outbreak of COVID-19 and subsequently opened negotiations with each of the three FAS with an avowedly optimistic objective of completing Compact renewal agreements with each FAS by 31 December 2020, i.e., during the previous administration for both the US and Palau. Such a timetable left the two additional steps of: (i) approval by the US Congress, and (ii) subsequent approval in Palau of the agreed, authorized, and appropriated renewal arrangement. As of December 2020, the US government had, indeed, made written offers to extend funding under specified conditions to each of the three FAS. Those offers remain confidential outside of the parties to each bi-lateral negotiation. As of June 2020, the US government is preparing to re-engage with the three FAS, though no (virtual) formal review meetings have been confirmed.

1. For Palau, the US maintains that Compact Title III-specified rights of military strategic denial persist after FY44 in perpetuity.

Major multilateral donors: World Bank, ADB, and the European Union

Major donor involvement in the North Pacific has increased markedly in recent years. The FSM and the RMI have recently benefited from a large increase in funding commitments from the World Bank and an unrelated, but timely, designation that allows for grant-only assistance. The grant-only status is the result of a joint World Bank-International Monetary Fund Debt Sustainability Analysis (DSA). The risks faced by the FSM and the RMI after FY23 contribute substantially to the debt stress finding. Palau, with a much higher level of Gross National Income on a per capita basis is not eligible for a similar grant status from the World Bank or other donors.

While FSM and RMI receive grants, Palau is eligible only for concessional loans. Palau has the potential to borrow at non-concessional rates from the World Bank in the range of $12 million annually. To date Palau, has chosen not to borrow from the World Bank. Indications are that each FAS could, potentially, receive as much as one-third of its program support in the form of budgetary support in the event of a major fiscal shock; however, such support would typically be associated with macroeconomic or sector policy reforms that had already been achieved. This remains a borrowing source that Palau may choose to tap in the future; however, as noted below, total external debt needs to be managed prudently in the light of COVID-19 pandemic-related borrowing.

ADB has provided significant loan-financed funding to support Palau through the COVID-19 economic and fiscal crisis. ADB has provided long-standing support to all three FAS. ADB follows the DSA finding and thus currently provides concessional loan funding to Palau along with periodic country-specific and regional technical assistance programs. Palau can borrow roughly $20 million annually from ADB. Prior to the COVID-19 pandemic, Palau had outstanding balances of $51 million with the ADB for loans that supported water and sanitation improvements and ICT investments. Under COVID-19 pandemic-related facilities, the Disaster Resilience Program, and the Covid-19 Pandemic Response Option, that level of indebtedness to ADB has increased markedly. Palau has also undertaken a Policy-Based Loan (PBL) in the form of budgetary support to operate through the period of severe fiscal shock; such borrowing of course has involved mutually agreed economic and fiscal policy reform to improve recovery, debt service capacity, and long-term enhanced growth. The PBL is structured into two sub-programs with the policy reform requirements now completed for the release of sub-program 1 funding and work on-going for the fulfillment of sub-program 2.

O**bjective and professional economic policy reviews can be expected from the ADB and World Bank.** The increased presence of multilateral donors creates an opportunity for those donors to play an increased role in development partner collaboration. Beneficial collaboration is dependent upon strong macroeconomic and sector data systems and policy analysis capacity within each FAS. There is an important role for support to fiscal and economic management in all three countries with a focus on capacity supplementation and, more importantly, long-term capacity-building.

The RMI and FSM have experienced donor-supported policy consultations on several occasions, while for Palau such support is relatively new. ADB has a history dating back to 1996 of supporting development partner meetings in the FSM and RMI. Periodically, ADB supported each country with technical support through resident advisory teams. There is a correlation between that level of intensive support with periods of effective reform and accelerated improvements in public financial management (PFM). Government commitment to policy reform and PFM improvements is a necessary condition; however effective implementation of country commitments is also associated with extended technical support that involves substantial investments in local hire counterparts and advanced training. Donor coordination efforts to support improved policies based upon strong macroeconomic and sector data systems and policy analysis capacity would surely prove beneficial to Palau.

Major Bilateral Donors

The Japan aid program to Palau is currently unaffected by the potential end of US assistance arrangements after FY24. Japan aids all three FAS. Infrastructure projects remain the largest share of support. Japan also provides support for sector projects, equipment purchases, and scholarships. Indirectly, Japan funds UNDP for support to the FAS in disaster preparation and through Australia to support operating costs under the maritime patrol boat program. The Government of Japan has initiated its own "Free and Open Indo-Pacific Strategy." While its aid levels to the Pacific will increase, modalities will remain the same. There is no direct mechanism for Japan to provide budgetary support in the event of a major fiscal adjustment, and embassy officials in two of the three FAS embassies indicated they have received no requests related to the potential FY24/FY25 adjustments. Officials indicated they are tracking the matter closely with each FAS and through dialogue with their US embassy counterparts.

Taiwan,China is an important development partner for the RMI and Palau. Programs to support RMI and Palau were recently renewed (after 20 years) to maintain a similar level of annual funding. All the support to Palau is in the form of projects. Taiwan,China has also committed a total of $40 million to the RMICTF. Taiwanese embassy officials in both countries indicated they have received no requests related to the potential FY23/FY24 adjustment.

China is an important development partner for the FSM. The focus of China's aid program in the FSM is large, visible construction projects. Examples include: a multi-purpose gym at the national campus of the College of Micronesia, vital ships for inter-island transportation; homes at the Palikir capital for the leadership of all three branches of the FSM national government; and state capital complexes for Pohnpei and Chuuk. The FSM currently receives grants from China and is thus not subject to any risk of debt stress. China has announced its intention to continue its program of support to the FSM through major projects, sector projects, and scholarships.

Australia provides a relatively small, but potentially growing, amount of support to the FAS. All three nations share an annual direct and regional aid allocation of $5 million to support regional projects, scholarships, and PACTAM advisors for capacity-building. All three of the FAS also benefit from Australia's Maritime Patrol program. In 2019 Australia renewed support for that maritime program to include a new fleet of boats and associated surveillance equipment. There is no direct mechanism for Australia to provide budgetary support in the event of a major fiscal adjustment and officials from Australia's embassy in the FSM, covering all three FAS, indicated they have received no requests related to the potential FY23/FY24 adjustment. The same officials referred to the Australian Prime Minister's plan to open an embassy in every Pacific Island Forum nation. Thus, Australia plans to open new embassies in the RMI and in Palau with a likelihood that direct aid budgets will be enhanced accordingly.

Potential Reform Agenda for Improved Performance with Compact Funding Extension

Extension of economic assistance after FY24 now seems likely though not guaranteed. The discussion in the previous section indicated potential economic benefits of the modeled Compact funding extension. As chapter 1 outlined, the potential outcomes of the coming negotiations are not known with certainty. It is clear, though, that the US is committed to a negotiation process likely to lead to an extension. While the severe scenario is unlikely, the eventual outcome of negotiations might lie anywhere between somewhat worse than the base adjustment scenario and the best-case robust Compact funding extension scenarios.

A favorable Compact extension coupled with policy reforms would likely lead to a higher economic growth outcome. The growth projections in chapter 4, although an improvement over the downward adjustment scenarios of chapter 2, indicate the impact of public sector-led growth through a sustained fiscal stimulus rather than through enhanced private sector activity. The initial and CRA Compact periods both placed emphasis on economic sustainability and development. These important objectives will likely continue to feature in any mutually agreed Compact funding extension. Implementation would, therefore, entail reform programs to improve not only the efficiency and effectiveness of service delivery in the public sector, but also reform to support private sector development. In the case of favorable Compact negotiations, reforms coupled with a secure and known future, would place Palau on a higher growth trajectory. In the case of less favorable Compact funding extension terms, donor assistance and domestic reform will become essential to sustain even disappointing economic performance.

It is not within the scope of this study to outline a specific program of reform for Palau. Rather, an indicative list of key areas of reform is provided.

Key Areas of Palau Public Sector Reform

The following list indicates some of the areas with potential for improvement within the public sector:

i. Fiscal responsibility
ii. External debt
iii. Tax reform
iv. Public financial management
v. Infrastructure planning
vi. Fiscal and climate related reserves
vii. Social security and pension reform
viii. State-owned enterprise reform

The ADB PBL has addressed many of the needed public sector reforms for Palau, but notable areas of weakness remain. The recent ADB PBL has been designed to specifically address the issues of fiscal responsibility, external debt management, tax reform, infrastructure planning, and social security reform. As part of the proposed fiscal responsibility and external debt management act, Palau has also incorporated provision for the establishment of cyclical and climate related reserve funds. Areas that are not covered under the ADB PBL include PFM reforms, the Civil Service Pension Plan, and state-owned enterprises. The CSPP is in dire need of reform to avoid collapse and the SOE sector operates below full cost recovery and also poses significant fiscal risk.

Key Areas of Reform for Palau Private Sector Development

World Bank 2020 "Doing Business Survey" ranks Palau 133 out of 190 countries suggesting room for improvement. The recent World Bank 2020 "Doing Business Survey"[2] provides an overall assessment of the environment for private sector development in the three FAS. Palau ranks 145 and compares with the Marshall Islands and the FSM which rank 153, 158, respectively, out of the total 190 countries included in the study, indicating a weak environment for private sector growth. Palau's score has been steadily dropping from 2012 when it scored 111. This likely reflects improvements in third countries rather any deterioration in the environment in Palau. A further study conducted by the Pacific Private Sector Development Initiative provides a useful analysis of the environment for private sector development in Palau[3], confirming the picture presented in the World Bank overview. The following

2. World Bank, *Doing Business 2019; Training for Reform*, The World Bank, Washington DC, 2019

3. Asian Development Bank, A private sector assessment for Palau: Policies for sustainable growth revisited, Mandaluyong City, Philippines, 2017.

are some of the issues affecting private sector growth in need of reform:

i. The regulatory environment
ii. Land reform
iii. Credit availability
iv. Foreign direct investment
v. Domestic fishing policies

ADB PBL includes private sector reforms that should improve Palau's DBS score. The ADB PBL is also addressing a limited range of actions to improve the regulatory environment for the private sector. These include development of a framework for private public partnerships, arbitration law and corporations law including establishment of a corporation's registry. Including the tax reform initiative, the private sector reforms should enable a higher score on the World Banks "Doing Business Survey".

Development Partner Support and Coordination

The former section is intended to provide an indication of the breadth of reform issues that require attention and resolution for the economies to function well and to achieve sustained improvements. The development partner community has supported reforms in the past, but the opportunity provided by a Compact funding extension could be an impetus to accelerate the reform agenda. While opportunities for growth in small remote island economies are limited, reforms in both the public sector and the environment for private sector growth could bring about better results. The development partner community has a vital role to play in building capacity and supporting reforms.

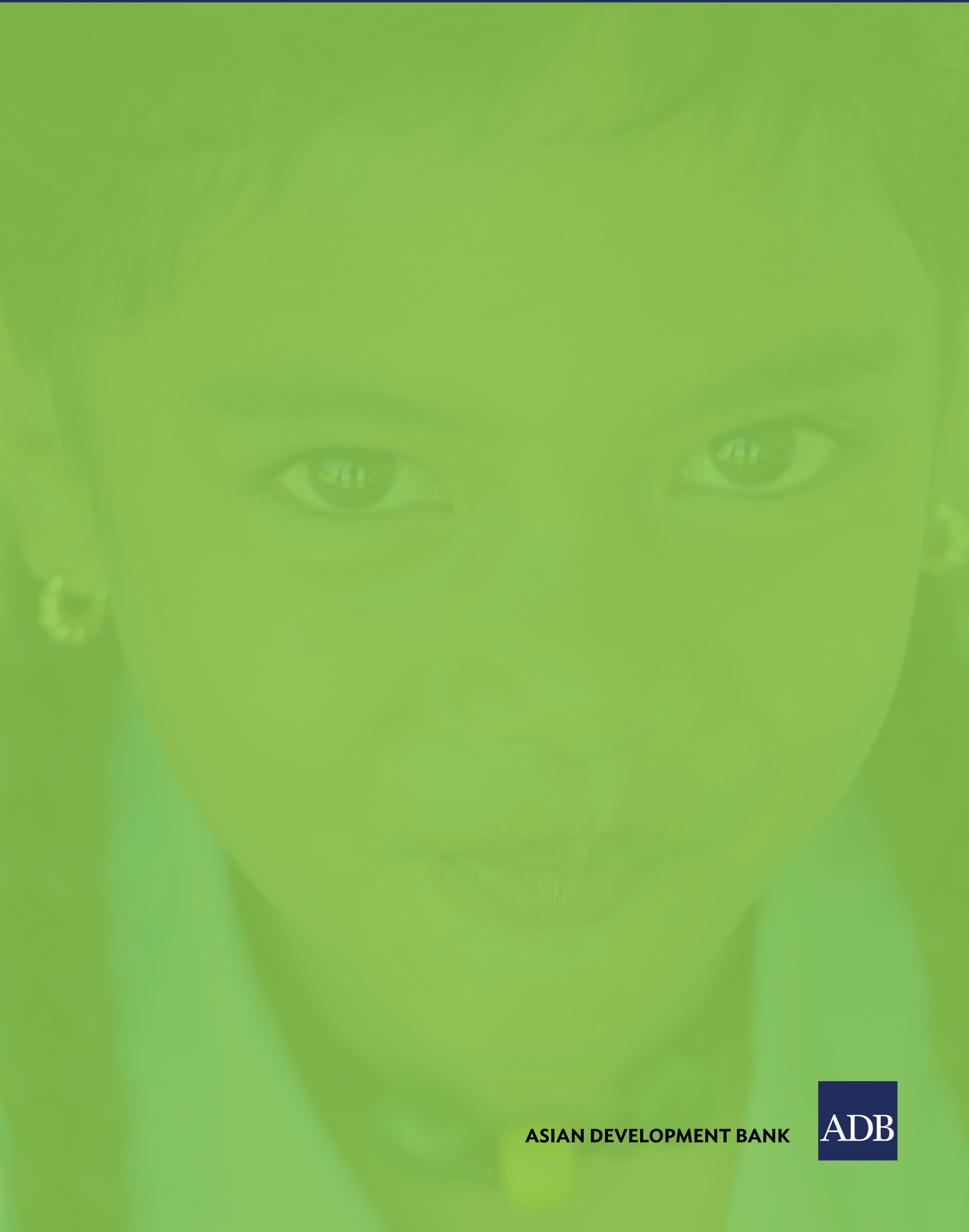
Palau will receive funding for its first policy-based program as part of COVID-19 pandemic relief. During the last few years—with the emergence of the World Bank as a major player in the subregion, coupled with additional resources from ADB—the development partner community has been well placed to finance public infrastructure alongside sustained, complementary technical assistance. While budgetary support has not been a part of the recent development partner programs, it could be used to support and reward the implementation of long-delayed reforms. Palau will have an opportunity to experience such support through its COVID-19 pandemic-related borrowing from ADB (and World Bank, if desired). In summary, in the case of less favorable compact negotiations, coordinated donor action will be essential for mitigating shocks and smoothing adjustments. In the case of a favorable outcome of Compact funding extension, development partner actions can assist each FAS to improve its economic growth rates and help ensure growth is increasingly driven by the private sector.

Concluding Observations

In conclusion it is worth reminding the reader that this study has attempted to provide relevant and timely analysis of just three scenarios. Already, in discussions with the principal parties, it has become clear that the range of likely scenarios differs in some important ways from those specific scenarios modeled in this study. Still, it has been the stated purpose of this study to provide scenarios that would, in effect, "bracket" the likely outcomes. It seems clear that all the likely outcomes will be an improvement on the "severe adjustment scenarios." It may be possible that the assumptions used and the US funding level implicit in 20-year versions of the "Compact extension scenarios" will prove to have been overly optimistic. If so, then the study will have succeeded in providing both a lower bound and an upper bound. It is hoped that the analysis may thus prove useful to the affected parties as they negotiate provisions of Compact renewal. The announcement by the US government that it seeks negotiations to extend all three Compact funding periods has been welcomed by all three FAS governments. The modeling shows that the opportunities for improved economic performance, job creation, and perhaps even a modest reversal of out-migration trends for Palau are enhanced in proportion with the level and length of ongoing Compact and related federal funding.

This study has also attempted to avoid offering recommendations or proffering advice. The authors confess that the scenario analysis used in this study relies heavily on a specific approach to how the Compact Trust Funds may be managed in the future. It is recognized, for example, that in the "base and severe scenarios" the immediate shift to what is defined as a SAFER distribution rule calls for a potentially severe, one-time adjustment at the very outset of the period. Palau could choose to take larger—even maximized—distributions in the early years. However, the modeling indicates that such an approach increases the likelihood of failure of the Palau CTF entirely. The approach modeled—with an insistence on shifting immediately to a sustainable distribution level—may lead to an overstatement of the adjustment that might be required in the near-term. But this approach has an important virtue. Painful adjustments are not masked by pushing them just beyond the horizon of the modeling results. In the event of a robust Compact funding extension, the benefits of a SAFER distribution rule will remain while the immediate pain of a substantial adjustment would be either mitigated or eliminated entirely.

The authors remain optimistic that an "all good things go together" scenario is possible. The combination of a robust Compact funding extension will likely be coupled in time with the increase in major development partner financial and technical assistance. This will allow for Palau to prioritize and consolidate its efforts with respect to fiscal and economic reforms consistent with its own desired path to sustained economic growth.



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