Republic of Palau

Economic and Fiscal Update

FY 2022

Abbreviations

CURRENCY EQUIVALENTS

Currency unit: United States dollar (US$)

ABBREVIATIONS

ADB	—	Asian Development Bank
BPT	—	Business Profits Tax
BSCC	—	Belau Submarine Cable Corporation
CARES	—	Coronavirus aid, relief, and economic security
CCSP	—	Civil Service Pension Plan
COFA	—	Compact of Free Association
COVID	—	Corona Virus ID
CPI	—	Consumer Price Index
CPRO	—	Coronavirus pandemic relief option
CRA	—	Compact Revie Agreement
CROSS	—	Coronavirus One Stop Shop Relief Act
CSPP	—	Civil Service Pension Plan
DRP	—	Disaster Resilience Program
DSA	—	Debt Sustainability Analysis
EEZ	—	Exclusive Economic Zone
FAS	—	Freely Associated States
FDIC	—	Federal Deposit Insurance Corporation
FIC	—	Financial Institutions Commission
FPUC	—	Federal Pandemic Unemployment Compensation
FRDMA	—	Fiscal Responsibility and Debt Management Act
GDP	—	Gross Domestic Product
GNI	—	Gross National Income
HLDP	—	Housing Loan Development Program
KASP	—	Koror Airai Sanitation Project
KSG	—	Koror State Government
LIBOR	—	London Interbank Offer Rate
MTEF-mod	—	Medium-Term Economic and Fiscal Model
NDBP	—	National Development Bank of Palau
NIIP	—	National Infrastructure Investment Plan
OEK	—	Olbiil Era Kelulau
PBL	—	Policy Based Loan
PFI	—	Public Financial Institution
PGST	—	Palau Goods and Service Tax
PHA	—	Palau Housing Authority
PNA	—	Parties to the Nauru Agreement
PNCC	—	Palau National Telecoms Authority
PPEF	—	Pristine Palau Environmental Fee
PPP	—	Private Public Partnership
PPUC	—	Palau Public Utilities Corporation
PUA	—	Pandemic Unemployment Assistance
PVA	—	Palau Visitors Authority
RFP	—	Request for Proposals
RISES	—	Recovery through Improved Systems and Expenditure Support
RPPL	—	Republic of Palau Public Law
RUS	—	Rural Utilities Service

SOE	—	State-owned enterprise
TIS	—	Tax Information System
VDS	—	Vessel Day Scheme
WIOA	—	Workforce Investment Opportunity Act

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

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Foreword

The Fiscal Responsibility and Debt Management Act (FRDMA, RPPL No. 11-13) mandates that at the start of each administration or as circumstances dictate the President issues a Fiscal Strategy. The Fiscal Strategy outlines the broad fiscal policies that the administration intends to pursue during its four-year term. The Fiscal and Economic Update (the *Update*) which supplements the Fiscal Strategy as part of the annual budget cycle. It is intended to indicate the economic and fiscal health of our nation and provide key information concerning the level of resources available to fund the budget (fiscal envelope) that will ensure fiscal stability and sustainability over the medium-term.

The FRDMA specifies seven principles of Fiscal Responsibility against which fiscal policy can be assessed and evaluated. The *Update* provides a forecast of the economy based on current and intended policies over the medium-term and provides an assessment of whether our government is in adherence with the principles. In the case of departure from the principles the Minister of Finance is required to indicate the reasons for departure, planned actions and the time period required to return to adherence.

The onset of the COVID-19 pandemic and subsequent collapse of Palau's tourism industry precipitated an economic and fiscal crisis. With support from donor partners, both bilateral and multilateral, Palau has been able to maintain economic and financial stability, without severe impact on the social wellbeing of our population. However, this has not been achieved without significant cost; the fiscal deficit has risen to 17% of GDP and the debt to GDP ratio has risen from a low of 30% before the pandemic to a level that is projected to exceed 90% before declining with projected economic recovery. The *Update*, the first of its kind for Palau, has thus been formulated during a difficult period. Our government is clearly not in compliance with several of the principles, and uncertainty over the timing of our economic recovery indicates that specification of the period to a return to adherence is unavoidably uncertain.

Under such circumstances, our current fiscal policies have been formulated to keep expenditures within strict bounds, while maintaining essential services and continuing the mitigation programs our government has adopted. Under the FRDMA the Minister of Finance is required to include a statement of fiscal responsibility. My attestation has been included at the outset of the *Update* and detailed analysis is provided in part C below.

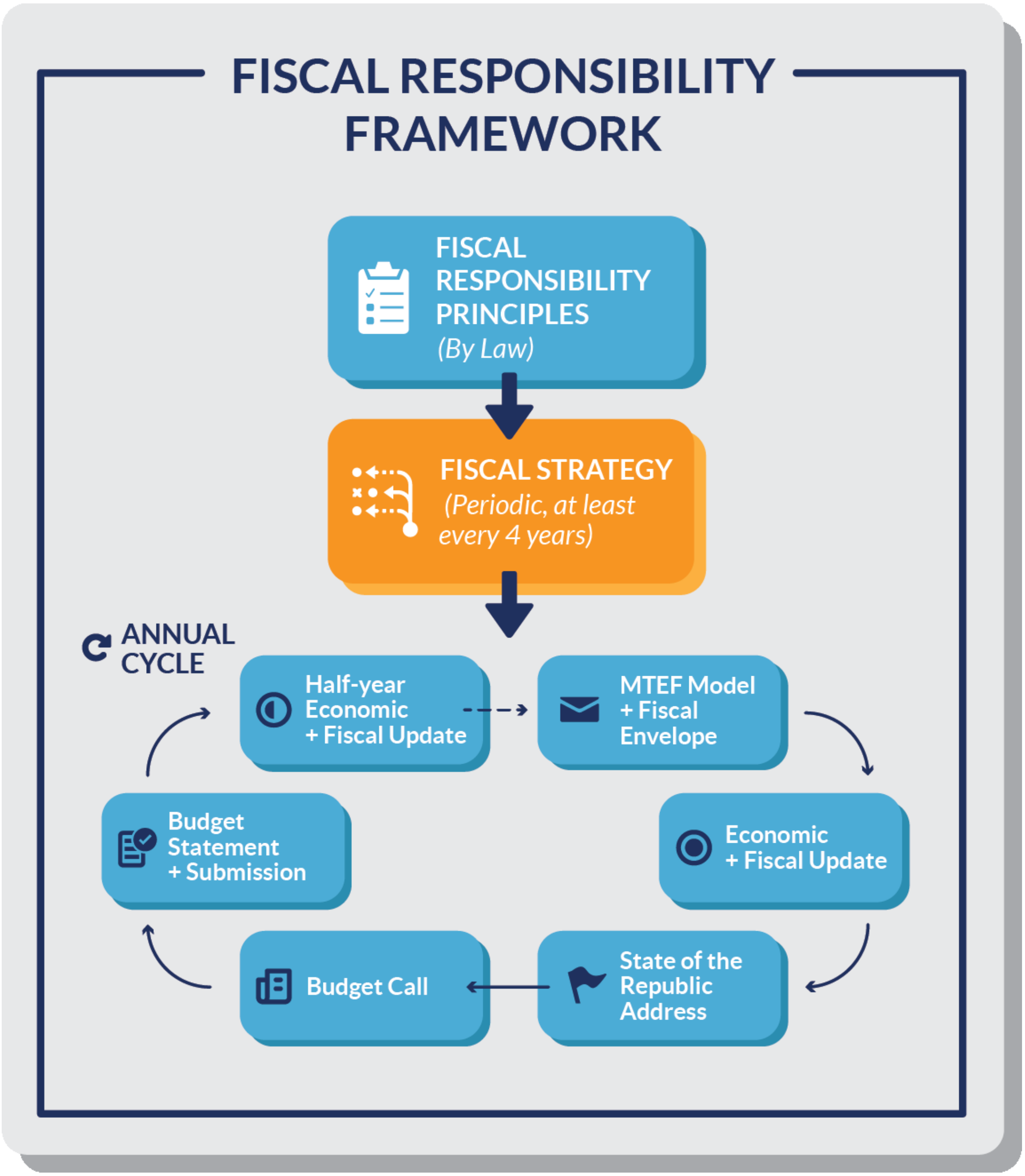
While this initial *Update* has been prepared in compliance with the FRDMA, it also fulfills certain requirements of the ADB Policy Based Loan "*Recovery through Improved Systems and Expenditure Support*". As part of the RISES program the government committed to passage of the FRDMA, preparation of the Fiscal Strategy, and completion of this initial *Update*. Sections of this *Update* thus are specifically added to address unique requirements of RISES.

Finally, I would like to take this opportunity to thank all those individuals and donors who supported Palau through the last two years during the COVID-19 period, without which the nation would have experienced severe hardship. I would also wish to give my thanks to the ADB for their support in the development of the Fiscal Responsibility Framework and in the preparation of this Economic and Fiscal Update.

June 7, 2022
Minister of Finance: The Honorable Kaleb Udui.

Background and Attestation to the Principles of Fiscal Responsibility by the Minister of Finance

The economic and fiscal update is required under the Fiscal Responsibility and Debt Management Act. The objectives of fiscal policy for the current administration have been specified in the Fiscal Strategy issued by the President and shared with the OEK and the public as required by law under the Fiscal Responsibility and Debt Management Act (FRDMA). These objectives and policies form the basis for the design of the annual budgets specified in the



FRDMA and follow the cycle indicated in the flow chart. This economic and fiscal update (referred to as the *Update*) is an integral part of the budget cycle. The initial step required is the creation and maintenance by the Ministry of a Medium-Term Economic and Fiscal Model: "MTEF-mod". The model provides the economic forecasts and fiscal envelope (the resources available to government to fund the budget), which underlies the economic and fiscal forecasts presented in this report.

Under law the ***Economic and Fiscal Update*** is required to:

1. Provide economic and fiscal forecasts based on current policies,
2. Provide projections of the impact of fiscal policy changes under consideration, and
3. Attestation by the Minister of Palau's current and planned adherence to the Principles of Fiscal Responsibility.

In addition, the FRDMA specifies requirements of the economic and fiscal forecasts:

Economic Forecasts

1. A five-year forecasting period: prior year, current year, budget year and 2 additional years,
2. A predetermined set of economic indicators: GDP, GNI per capita, CPI, population and employment, visitor arrivals, and money and credit statistics, and
3. Assumptions on which the forecasts are made.

Fiscal Forecasts

1. Five-year forecasting period: prior year, current year, budget year and 2 additional years,
2. A predetermined set of fiscal indicators: revenues, expenses, capital expenditures, financing, public debt, and overall fiscal position,
3. A comparison of actual and budget figures for the prior and current fiscal year,
4. Assumptions underlying the fiscal forecasts,
5. Sensitivity of the forecasts to changes in economic conditions, and
6. A comparison of prior year fiscal forecasts with actual results.

Economic and Fiscal Projections have been formulated on a conservative basis. The Economic and Fiscal Update including forecasts specified in law, requires the *Update* to be based on current polices. Where new policies are under consideration the economic and fiscal implications must be analyzed. Of course, the projection and timing presented in the *Update* for the recovery of the economy is only one of many possible pathways. However, the projections, which have been formed on a conservative but not unrealistic basis, suggest that Palau may need to undergo fiscal adjustment to restore fiscal balance and stability. This may require either an increase in taxation, a reduction in the provision of government services, or some combination of revenue and expenditure policies. Alternatively—and preferably—adoption of a growth-oriented economic strategy carries the promise, subject to external demand for tourism visits to Palau, of reducing or eliminating the need for restrictive fiscal policy.

The administration supports a growth-oriented economic strategy to reduce or eliminate the need for restrictive fiscal policy—economic growth will be targeted through implementation of the high value tourism strategy and diversification and support for prudently selected new

opportunities in the international finance sector. Clearly, the most favorable approach to recovery is for the economy to grow its way out of the COVID-19 crisis and build sufficient fiscal resilience to avoid painful adjustments, albeit not at the cost of the nation's health in the short-run or Palau's pristine environment in the long-run. Rather the option of combining a planned approach to achievement of the high value tourism concept together with the prudent pursuit of new opportunities that Palau's inherent sovereignty and enhanced communications capacity now provide. The administration has focused on the international finance sector with new initiatives like the Digital Residency and possible issue of a US dollar-based and dollar-backed Stable Coin together with legislation laying the groundwork for Private Banking and Trusts.

An outline of the material presented in the Economic and Fiscal Update: The *Update* is comprised of a summary section of key features and a main section comprised of three parts: Part A provides an analysis of current economic and fiscal trends which form the foundation for the forecasts, Part A also provides material and analysis required for Palau to qualify for Sub-Program 2 of the ADB Policy Based Loan "Recovery through Improved Systems and Expenditure Support Program" (RISES); Part B provides the economic and fiscal forecasts in fulfillment of the requirements of the FRDMA and also, in this instance, fulfills the RISES requirement for completion of an FY2021 Economic and Fiscal Review; and Part C provides an analysis of the *Update* and adherence to the Principles of Fiscal Responsibility.

Minister attests that the forecasts made in the economic and fiscal update fulfill the requirements of the FRDMA. In section B.1 a forecast is made based on current policy for the economy over both the medium-term, FY22-FY25 and beyond through the end of the decade. In section B.2 major policies under consideration by the administration are examined together with an analysis of the sensitivity of the forecasts to changes in economic conditions. Finally, in Part C the *Update* together with forecasts are reviewed and examined in light of the principles of fiscal responsibility. Since current fiscal policies have unavoidably driven Palau into a position not in adherence with all seven of the principles of fiscal responsibility, due to the impact of COVID-19, the Minister indicates how and when Palau will return to adherence with each of the principles.

Attestation by the Minister

The Economic and Fiscal Update is mandated under law to provide an attestation by the Minister to the adherence of the Principles of Fiscal Responsibility:

> *The update shall also include a statement of fiscal responsibility attested to by the Minister and reporting on Palau's current and planned adherence to the Principles of Fiscal Responsibility and on such other matters as may be specified by regulation.*

I hereby attest that this Economic and Fiscal Update fulfills the requirements of the Fiscal Responsibility and Debt Management Act specified in law: RPPL No 11-13.

Kaleb Udui

Minister of Finance: The Honorable Kaleb Udui
June 7, 2022

Key Features of the Economic and Fiscal Update

1 Recent Economic and Fiscal Developments

The collapse of the tourism industry. The number of visitors rose rapidly in the FY10-FY15 period from 81,000 to 169,000, largely reflective of expansion of the low-end Chinese market. From FY15 through FY19 visitor numbers dropped to 90,000 as both the Chinese market and Palau's more traditional markets contracted. FY20 was set to be a better year with 120,000 visitors anticipated, but with the advent of the COVID-19 global pandemic that number dropped to 41,674 in FY20 and in FY21 recorded a level of 3,412 for the fiscal year.

Palau's economy is projected to decline by a two-year total of 21% in FY21 compared with pre-pandemic levels of FY19. Due to the impact of COVID-19 GDP contracted by 9.1 percent in FY20 and a further 13.3 percent in FY21, despite the positive support of the mitigation programs: the CROSS and US CARES Acts.

The private sector experienced most of the impact of the pandemic and is projected to have fallen by 39%. While the public sector has been largely unaffected—thanks to donor financing to maintain basic services—the brunt of the COVID-19 pandemic impact fell upon the private sector. Overall, a massive loss in output of 39 percent hit the private sector through FY21.

GNI is projected to decline to $13,785 in FY21 reflecting the impact of the COVID-19 pandemic but remaining within the World Bank's grouping of high-income economies. Gross national income will still have remained 10% above the World Bank FY21 threshold of $12,535. This level of GNI per capita has important implications for the eligibility of Palau for assistance from both multilateral and bilateral donors.

Early projections of job losses turned out to be less dire than the original estimates Initial projections of the impact of the pandemic on employment suggested that a total job loss of up to 3,100 could be anticipated or 27 percent of the labor force. However, final employment data for FY21 indicates that 1,245 jobs were lost or 11% of the FY19 level.

Inflation in Palau has been historically low, but prices are rising rapidly reflecting increasing oil and food prices. Inflation has traditionally been modest in Palau and even though fuel prices were rising globally in FY21, Palau's CPI only rose by 0.5%. However, in FY22 prices began to rise rapidly recording an 11.9% annual change by the end of 1st quarter of the year.

Total financing needs of 23% of GDP have been required to support the fiscal deficit in FY20 and FY21 during the COVID-19 crisis. Palau has generally run a conservative fiscal policy and maintained fiscal balance. By the end FY18, government deposits had risen to $43 million, up from a level of $9 million five years earlier. With the onset of the pandemic the fiscal position deteriorated rapidly.

2 The Mitigation Programs

Mitigation programs including the CROSS Act and U.S. CARES Act proved highly effective with the CROSS Act receiving a very favorable international reaction. At the start of the pandemic Palau reacted quickly with the passage of the CROSS Act by the end of April 2020 and the first benefits were paid in May. The combination of the use of Palau's internal savings, donor support through the Asian Development Bank, and eligibility under the U.S. CARES Act enabled Palau to maintain momentum in the domestic economy, increase household incomes, avoid widespread poverty, and maintain the social fabric. Palau's performance to support not only its own citizens but also foreign workers was widely recognized by the international community and has generated good will and a favorable reputation.

CROSS Act provides for a variety of benefits. The law provided a variety of programs to mitigate the impact of the COVID-19 global pandemic: (i) unemployment benefits, (ii) temporary jobs program, (iii) private sector relief through the NDB, and (iv) Lifeline utility services.

US CARES Act provided substantial benefits to unemployed Palauans. Under the U.S. CARES Act 2020, the citizens of the Freely Associated States were eligible for certain unemployment benefits under two facilities: (i) The Pandemic Unemployment Assistance program and (ii) the Federal Pandemic Unemployment Compensation.

Significant numbers of foreign nationals departed Palau since the start of the pandemic. At the start of the COVID-19 global pandemic, it was debated whether there would need to be widespread repatriation of foreign workers. The availability of funds both through the donor community and the US government enabled Palau to avoid widespread repatriation and maintain the foreign work force for recovery. However, it is estimated that 1,074 foreign nationals returned home voluntarily since the start of the pandemic.

3 Impact of the Pandemic on the FY20 and FY21 budgets

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 in the local economy. The second objective was to mitigate the adverse impact on the unemployed and was legislated through the CROSS act. Both actions are generally considered to have been successful.

The impact of the pandemic on tax revenues largely reflected the impact on the economy and fell by 21% FY21 compared with FY19.

Large funding increases flowed in grants from the U.S. for health purposes and under the CARES Act. Offsetting the reductions in tax revenues has been a large increase in grants. The most significant increase in grants was recorded under federal programs and includes revenues under the U.S. CARES Act for other health related purposes. From a level of $9.6 million in FY19 federal programs rose to $27.2 million in FY20 and $25.2 million in FY21.

Expenses grew by 25 percent in FY21 compared with FY19. In response to the COVID-19 global pandemic, it would be expected that expenses would increase as greater outlays were required to fund the various mitigation efforts. However, while this was certainly true and expenses were 31% and 27% higher in FY20 and FY21 compared with FY19, respectively, large increases also occurred in subsidies to SOEs, transfers to state governments, the social insurance and pension sector, and funding for housing.

Core government expense in payroll and use of goods and services remained well disciplined. Payroll represented 44 percent of expenses in FY19 before the pandemic, but payroll growth was modest between FY19 and FY21 growing by 1.9%. The second most important item of expense is outlays on goods and services, which represented 26% of expense in FY19, and fell by 1.8% in FY21 compared with FY19.

Subsidies to SOEs grew rapidly in FY22 and pose significant fiscal risk. Subsidies to the SOE sector were zero for many years until FY19 when they recorded $0.5 million and rose to $3.5 million in FY20 (zero in FY21).

Grants and transfers to state governments, social insurance and pensions funds rose rapidly between FY19 and FY21.

Palau borrowed a record $50 million in FY20 and a further $35 million in FY21. On the finance account the major component was the large external borrowing of $50 million in FY20 including $15 million from the ADB under the Disaster Resilience Program (DRP), $20 million under the COVID-19 Pandemic Relief Option (CPRO), and $15 million under the Housing Development and Loan Program (HLDP) sourced from Taiwan. In FY21 there was further borrowing from the ADB under a Policy Based Loan (PBL) of $25 million to maintain government operations during COVID-19, $5 million from ADB under a PBL to support a PPUC reform program, and a further $5 million from Taiwan for on-lending to the NDBP.

4 Economic and fiscal forecasts of the Economy over the medium-term and beyond

i Assumptions

Full recovery of the tourism industry is not projected until FY25. The level of visitors to Palau is projected to remain close to zero in FY22 while eventual recovery is projected for FY25 with the number of visitors returning to 111,000, a level not far below the FY18 level. In the long-term through FY30, it has been assumed hotel occupancy rates return to 50% and there is some modest investment in new hotel rooms.

Construction demand is projected to contract in FY22 by 20% but remain above pre-COVID levels.

The outcome of the negotiations for Compact funding renewal is projected to be favorable. With the appointment of a US special Presidential envoy, negotiations between Palau and the US are set to ramp up with the US intention to complete the negotiations before the end of CY2022. Reflecting current sentiment in the US and relations between the two nations, it is anticipated that the Compact will be renewed for a further period of 20 years.

Fiscal policy stance assumed to remain in line with the FY22 budget and to remain in place through FY23 until recovery is established. The projections assume the provisions of the FY22 budget remain in force and the 10% reduction in appropriations, estimated to be $5.2 million, is maintained. Given the weak fiscal outlook, it is assumed that no increase in departmental budgets is allowed in FY23, but that in FY24 the 10% reduction is restored.

Tax reform is assumed to be implemented in 2023. A major policy initiative of the government has been the passage of the tax reform legislation in September of 2021. This is assumed to be implemented on target by the start of CY2023

ii Economic and Fiscal Outlook

The economy is projected to contract by a further 3.6% in FY22.

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

The accumulated fiscal deficit resulting from COVID-19 is likely to reach $94 million, equivalent to 39 percent of GDP. With the delayed recovery now not assumed until FY25 a significant deficit of $22 million, 10 percent of GDP, is projected for FY23. In total, an accumulated deficit of $97 million or 41 percent of GDP is likely to result during the FY20-FY23 period.

Fiscal deficit is comprised of three major categories. Analysis of the fiscal deficit incurred during COVID-19 can be decomposed into three major categories: (i) *event driven* costs of the health response and mitigation efforts ($27 million), (ii) the *cyclical impact* of the loss of the tourism industry on government revenues ($31 million), and (iii) an emerging *structural deficit* ($34 million). The structural deficit is of greatest concern looking forward as it results from subsidies to SOEs and transfers to the Social Security and Civil Service Pension Plan.

National government cash reserves, combined with resources from sub-Program 2 of the ADB Policy Based Loan (PBL), are projected to provide sufficient financing to support government operations until full recovery has been achieved in FY25.

External debt/GDP ratio is projected to rise rapidly to 93% of GDP to finance the impact of the COVID-19 global pandemic, but then decline sharply to 56% in FY25 as the economy recovers and is projected to fall steadily to 36% of GDP by FY30.

5 Impact of policy changes under consideration by the government and sensitivity of the projections to variation in assumptions

Economic model is used to estimate impact of minimum wage increase on the economy. A major policy change under consideration by the administration is the increase in the minimum wage from $3.50 an hour by $0.75 in FY23 and a further increase of $0.75 in FY24 bringing the new minimum wage to $5.00 per hour. The economic model is used to simulate the impact of the wage increase assuming that all wage earners, regardless of wage level, benefit from the increase in both private and public sectors. The following list indicates the impact on the economy and fiscal balance in FY25 and after the full impact of the changes has worked its way through the economy.

i. It is estimated that the total wage bill for the economy will rise by 17%,
ii. GDP is projected to fall by 1.5% and visitor arrivals by 6.6% or a loss of 7,343 visitors in FY25,
iii. Real household incomes are projected to rise by 5.9% by FY25,
iv. The accumulated government's wage bill is estimated to rise by $7.8 million in FY25,
v. Tax collections (wage taxes and PGST) rise by $3.5 million in FY25 and partially offset the increase in wage costs,
vi. Total increase in cost to the national government in FY25 is projected to be $4.1 million, and
vii. The Social Security system and Civil Service Pension Plan are significant beneficiaries of the increase in the minimum wage.

Fiscal policy assumptions. A series of important assumptions underlie the projections:

i. The 10% reduction in the FY22 budget appropriation will remain in force during FY22 and FY23.
ii. The government will continue to support water and wastewater operations of PPUC through a $2.1 million annual transfer to cover operating losses.
iii. No further subsides for power will be legislated by the OEK and the full-cost recovery tariff will be implemented without adjustment.
iv. The government will maintain the current level of transfers to SS through FY23 at which time the SS reform bill is assumed to be passed.
v. An annual transfer of $2.5 million will be made to the CCSP.

These elements of expense are subject to a high degree of uncertainty, and deviation from the assumptions would have a significant impact on the fiscal outcome.

As the pandemic has dragged on and the outlook for recovery has been pushed back, Koror State Government (KSG) is facing a deteriorating fiscal position.

The probability of the need for further fiscal adjustment is on the downside, implying a potential for painful adjustment.

6 Current and Planned Adherence to the Principles of Fiscal Responsibility

i MANAGE OPERATING EXPENDITURES OVER THE MEDIUM-TERM WITHIN OPERATING REVENUES AND IN RELATION TO THE RATE OF GROWTH OF THE ECONOMY

The COVID-19 pandemic forced an unavoidable departure from the first principle of fiscal responsibility. The departure for this principle is intended to last only as long as the pandemic lasts and only until the recovery of the economy is complete.

ii MANAGE NET CAPITAL AND FINANCIAL ASSETS, INCLUDING THE COFA TRUST FUND, TO ACHIEVE RISING REAL NATIONAL NET WORTH OVER TIME

Real net national wealth has fallen significantly in recent years and especially since the onset of COVID-19. Net national wealth has deteriorated for two main reasons: (i) capital expenditures or public infrastructure has declined as a share of GDP, and (ii) the onset of COVID-19 has required significant incurrence of debt and hence reduction in net financial assets. The first component is intended to last only as long as the pandemic lasts and only until the recovery of the economy is complete. The second component requires Palau to identify new sources for investment which effort is underway.

iii MANAGE DEBT PRUDENTLY

External debt has been well managed in Palau, but recent financing needs to mitigate the impact of COVID-19 have resulted in high levels of debt to GDP. The return to the level of debt Palau admirably maintained in the past will be based upon economic recovery and may extend to FY30.

iv MANAGE THE REVENUE REGIME TO BEST FIT THE STRUCTURE OF THE ECONOMY, TO PROVIDE FOR AN EQUITABLE ALLOCATION OF TAX BURDENS, AND TO ALLOW FOR PREDICTABILITY OVER TIME

Tax reform has been a key achievement of the administration's fiscal reforms. The passage of the Palau Goods and Services Tax, RPPL No. 11-11, marked a milestone in Palau's financial history. The key challenge for successful implementation is the tight schedule requiring the reforms be fully ready for implementation by the end of 2022.

v MANAGE RESERVES AND INSURANCE COVERAGE TO OFFSET CYCLICAL VOLATILITY, THE COSTS OF NATURAL DISASTERS, AND THE IMPACT OF CLIMATE CHANGE

The General Fund Reserve is being replaced with a Cyclical Reserve and a Climate Resilience Fund. Palau has reformed the prior general fund reserve and introduced two new special funds: (i) the cyclical reserve fund, and (ii) the climate resilience fund. Refunding these reserves under the current circumstances has not been possible but once recovery has been accomplished accumulation of funds in the reserves will proceed according to law.

vi MANAGE THE NON-PRIMARY GOVERNMENT PUBLIC SECTOR PRUDENTLY, INCLUDING ENSURING STATE OWNED ENTERPRISES AND PUBLIC FINANCIAL INSTITUTIONS ARE MANAGED TO DELIVER SERVICES ON AN EFFECTIVE AND FINANCIALLY SUSTAINABLE BASIS

The main area of fiscal weakness lies in management of the State-Owned Enterprises and Public Financial Institutions. While the Telecom sector, PNCC and BSCC, have been financially well managed and operate on a commercial basis at full cost recovery, the PPUC in both the water and power divisions has failed to operate on a fully commercial basis. During the previous administration an SOE policy statement was issued to establish a guidance framework for the SOE sector. This will be re-issued in a legislative format for consideration by the OEK as an SOE Reform law.

A recent actuarial assessment of the Republic of Palau Social Security Administration established that as a result of recent awards of supplemental benefits, RoPSSA was likely to collapse within 10 years without reform. A national consultative workshop held in November 2021 resulted in building consensus for reforms to place RoPSSA on a financially sustainable path. Legislation has been drafted and submitted to the OEK.

The financial position and potential near-term collapse of the Civil Service Pension Plan poses a huge fiscal risk to Palau. It has long been established that the CSPP is in greater financial distress than RoPSSA and is projected to collapse within 5 years without reform or additional transfers. It is the intention to conduct a parallel process to the RoPSSA consultations to establish a consensus on reforms to place the CSPP on a financially sustainable path. It is anticipated that deep structural changes will be required, including a move away from the current defined benefit approach toward a defined contribution approach.

vii MANAGE FISCAL RISKS AND CONTINGENT LIABILITIES PRUDENTLY

There are a variety of areas that pose significant and special fiscal risks to Palau that require careful monitoring. Analysis of these risks will be developed in future issues of the Annual Economic and Fiscal Update as Palau builds capacity in the execution of the law:

1. ***Macroeconomic volatility***.

2. ***Financial sector crisis***.
3. ***Change in debt interest rates***.
4. ***Demographic changes***.
5. ***Natural disasters***.
6. ***Government guarantees***.
7. ***Government litigation and lawsuits***.
8. ***Public private partnerships and/or private financial initiatives***.
9. ***Environmental degradation***.
10. ***Local government and/or devolved administrations***.
11. ***State owned enterprises***.

Part A Economic and Fiscal Review - FY2021: Foundation for Projections in the Update

1 Recent Economic and Fiscal Performance and the Impact of COVID-19

i Palau's response to COVID-19

Visitors to Palau effectively dried up after April 2020: In the early months of 2020, the onset of the COVID-19 global pandemic ravaged the global economy with unprecedented reductions in GDP and rapidly rising unemployment. To reduce the spread of the virus, global travel restrictions were implemented which led to a collapse of international travel and tourism. In response to the pandemic Palau effectively closed its borders at the beginning of April and established a 14-day quarantine period for limited approved arrivals. Those arrivals included limited charter flights arranged to repatriate stranded Palauan residents living abroad, medical referrals and essential workers. Visitor arrivals to Palau effectively ended in April 2020.

After a sizeable outbreak of COVID-19 in February and March 2022 cases have declined sharply, although more recently cases numbers have risen. At the start of 2021 Palau was able to participate in the US operation "*warp speed*" and commence vaccinating its population. By mid-year Palau had vaccinated an exceptionally high proportion of the population according to the Ministry of Health, greater than in any other US state, territory, or FAS. In the second half of the year boosters became available although the uptake of boosters was lower than the initial doses. In July Palau loosened its travel requirements allowing travelers to enter provided they were fully vaccinated, tested negative and underwent a period of restricted movement after entry. Palau remained free of COVID-19 until December when a first case of community transmission was reported. This rapidly built into a substantial outbreak maxing out with 371 daily positive cases reported on January 28th or 2.5% of the population. Thereafter, the number of daily cases declined sharply, although more recently cases numbers have risen and are currently averaging 20 a day[1]. In total 4,936 cases have tested positive or 27% of the population, with 6 fatalities. With high rates of vaccination and case incidence, the population has achieved a significant degree of immunity against the existing COVID-19 variants.

ii Recent Economic Performance

Visitor numbers dropped to 41,674 in FY20 and virtually disappeared in FY21. Figure 1 indicates the trends in visitor arrivals and GDP since FY10. The number of visitors rose rapidly in the FY10-FY15 period from 81,000 to 169,000, largely reflective of expansion of the low-end Chinese market. From FY15 through FY19 visitor numbers dropped to 90,000 as both the Chinese market and Palau's more traditional markets contracted. FY20 was set to be a better year with 120,000 visitors anticipated, but with the advent of the COVID-19 global pandemic that number dropped to 41,674 in FY20 and in FY21 recorded a level of 3,412 for the fiscal year.

Palau's economic growth has been modest and has displayed considerable volatility. Palau's economic performance during the pre-COVID period FY00-FY19, has been modest with economic growth trending at 0.5% during the period[2], see Figure 2. Palau's low average growth during the period reflects high volatility between periods of strong growth in construction and

[1] Ministry of Health, Palau, 5/22/2022, http://www.palauhealth.org/

[2] Trends estimated using log-linear regression.

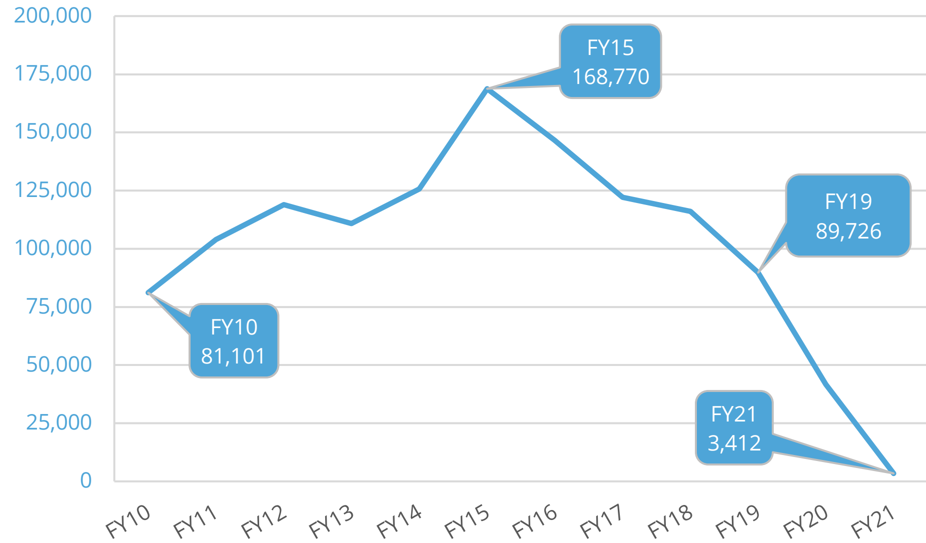


Figure 1 Visitor arrivals

the tourist industry, against periods of substantial contraction. The main drivers of growth have been tourism, and the construction industry. During the initial part of the 2000s through FY05 the economy grew by an average 3.5% 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 2.8% during FY05-FY10. From this point going forward Palau underwent a tourism expansion phase growing by an annual average of 3.9%. But this in turn came to an end in FY15 and the economy once again contracted by 1.8% through FY19 as visitor arrivals contracted to a level only 6% above the FY05 level.

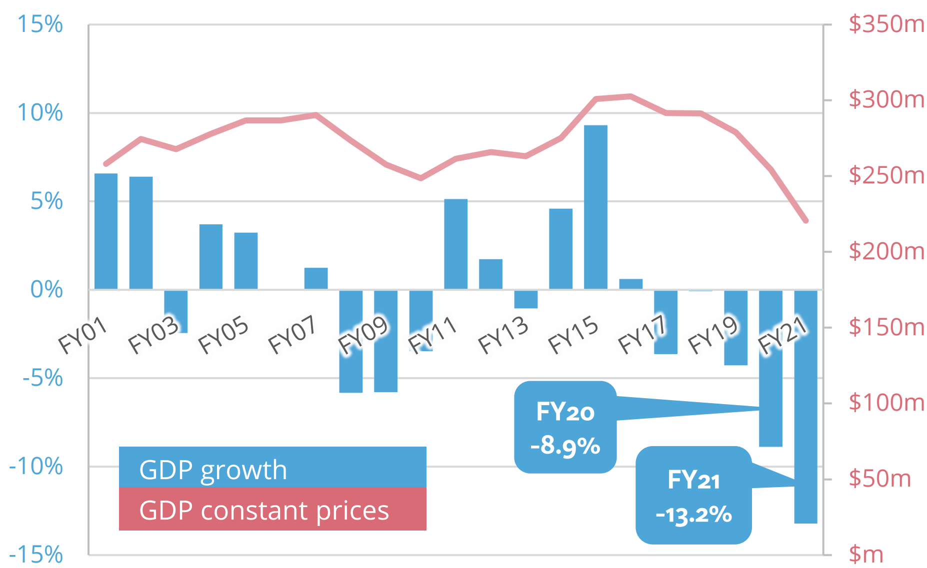


Figure 2 Palau real GDP annual growth, FY15 prices, percent

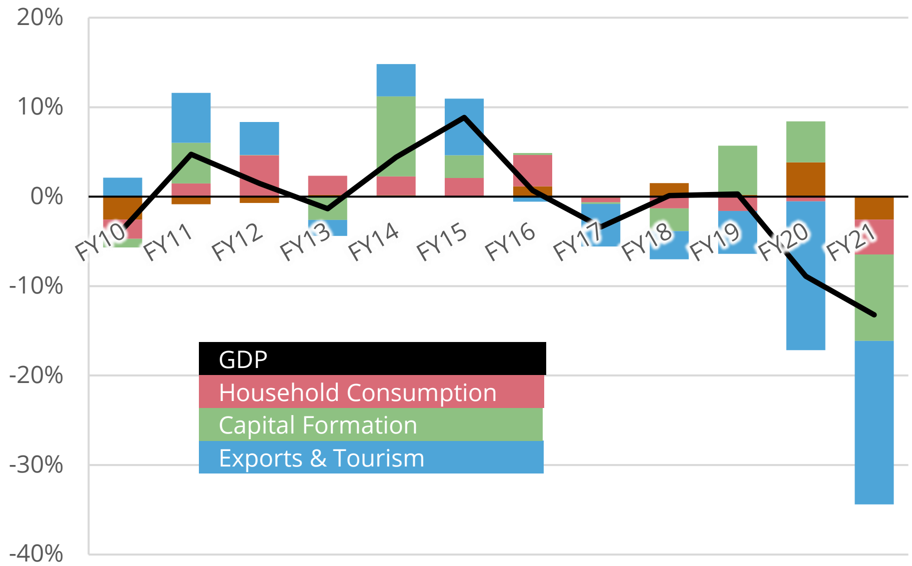


Figure 3 GDE, contribution to growth

Palau's economy is projected to decline by 21% in FY21 compared with pre-pandemic levels of FY19. 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. GDP is estimated to have contracted by 9.1 percent in FY20 and to have fallen further by an additional 13.3 percent in FY21 as the full force of the collapse in the tourism economy was felt. The drop in FY21 reflects the virtual disappearance of visitors throughout the entire fiscal year, a reduction in the level of construction activity, but includes the positive impact of the mitigation programs: the CROSS and CARES Acts provisions (described below), see Figure 3.

Private sector experienced most of the impact of the pandemic and is projected to have fallen by 39%. Figure 4 indicates the impact of the COVID-19 pandemic on the private sector. While the public sector is projected to have remain unchanged—thanks to donor financing to maintain basic services—the brunt of the COVID-19 pandemic impact fell upon the private sector. In FY20, a large reduction of 21 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 23 percent occurred, reflecting the full-year impact of the reduction in tourism. Overall, a massive loss in output of 39 percent hit the private sector.

iii Gross National Income per Capita

GNI is projected to decline to $13,785 in FY21 reflecting the impact of the COVID-19 pandemic but still remaining within the World Bank's grouping of high-income economies. The population of Palau consists of Palauans and a large number of foreign workers, mostly Filipinos. Since 1986, the Palauan component of the population has grown by 0.2%, after allowing for external migration, reaching 12,890 in FY15. The number of foreign residents has grown from 1,550 to 4,771 over the same period, reflecting the increased need for tourism-industry workers. GDP per capita has risen by 0.8% per annum since FY00. Gross national income per capita attained a level of $16,093 in FY19, placing Palau in the World Bank's high-income group by exceeding the FY19 threshold of $12,055. In FY21 GNI per capita is projected to have fallen to $13,785 reflecting the

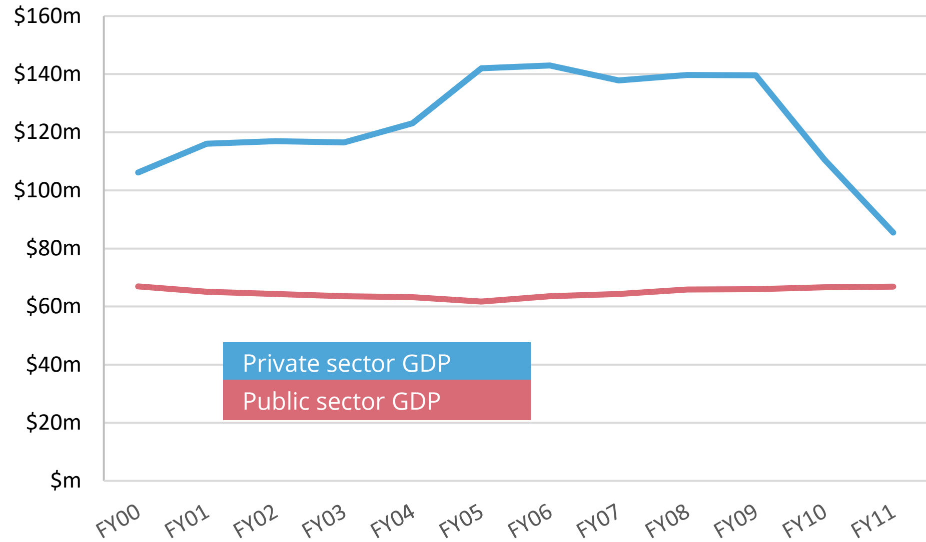


Figure 4 Private and public sector GDP, constant prices, FY15

impact of the pandemic but to have remained above the World Bank FY21 threshold of $12,535 by 10%. This level of GNI per capita has important implications for the eligibility of Palau for assistance from both multilateral and bilateral donors.

iv Employment

Early projections of job losses turned out to be less dire than original estimates with final figures indicating 1,245 jobs were lost compared with FY19. The labor market in Palau was comprised in FY19 of 5,535 Palauan workers and a larger number, 5,883, of foreign workers. In normal times the Palauan segment is close to full employment with excess demand supplied by foreign workers. During the FY00-FY19 period the Palauan segment had grown by an annual average of 0.3 percent with the number of foreign workers fluctuating with the demands of the economy, see Figure 5. Initial projections of the impact of the pandemic on employment suggested that a total job loss of up to 3,100 could be anticipated or 27 percent of the labor force. However, final employment data for FY21 indicates that 1,245 jobs were lost or 11% of the FY19 level. This unexpected result requires further inspection.

The impact of job loss has been mitigated by the private sector retaining workers in many cases on reduced hours to support recovery. Data on employment for the private sector indicates a loss of 1,104 jobs or a 17 percent decline of private sector employment since FY19. However, the Social Security records on which these figures are based do not account for a reduction in working hours or reduced pay rates that tourism operators have used to offset lost revenues during the pandemic. On a full-time equivalent basis, the loss of private sector jobs would have been considerably higher than the figures imply. The resulting impact of the COVID-19 pandemic on employment thus turned out to be less dire than anticipated due to employers retaining workers on reduced hours to enable recovery and the impact of mitigation programs to offset the impact.

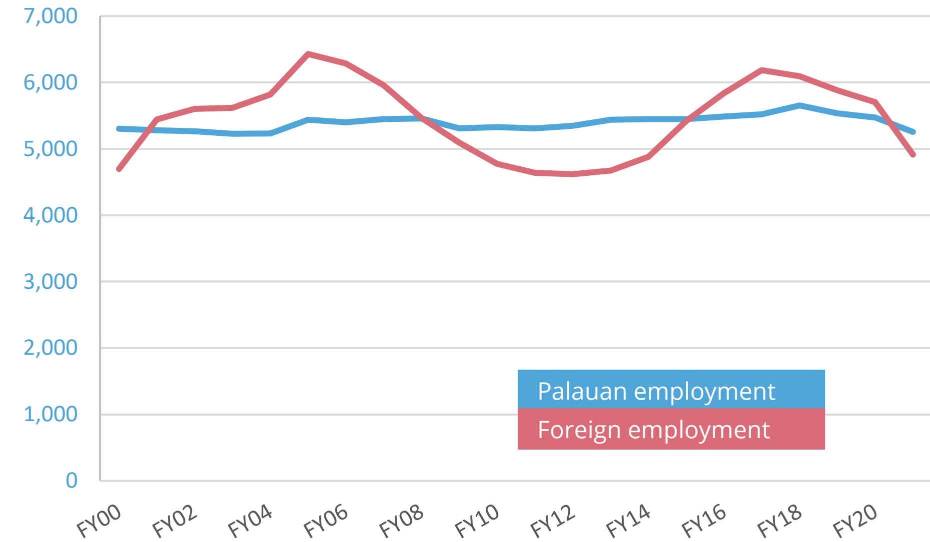


Figure 5 Employment by Palauan and foreign workers

v *INFLATION AND WAGES*

Inflation in Palau has been historically low, but prices are rising rapidly reflecting increasing oil and food prices. Trend inflation in Palau has averaged 2.8 percent since FY00 and has generally been moderate. Inflation rose rapidly in FY08 reflecting the global financial crisis, rising fuel and food prices, see Figure 6. After FY15 inflation was low averaging 0.5 percent through FY21. As of the end of FY21 inflation recorded 0.5%, but the annual figure masks a set of factors. While food prices recorded a 1.2% increase compared with a year earlier, the impact of increasing fuel prices after the depressed levels at the start of the pandemic was exerting upward pressure. The transport component in the CPI recorded an average increase of 18% in the 2nd and 3rd quarter of 2021 but was offset by a 13% reduction in electricity prices during the

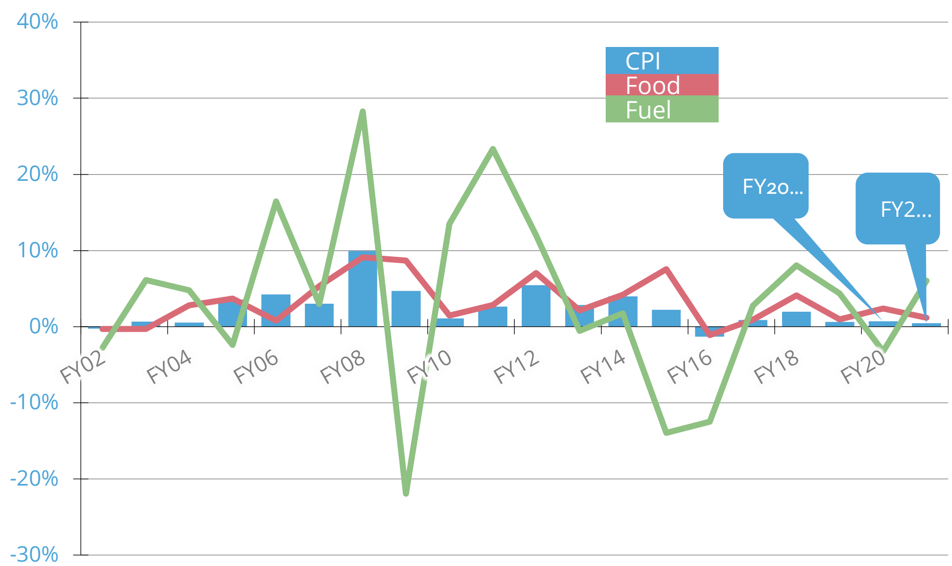


Figure 6 Consumer price index

1st and 2nd quarters. Electricity prices are based on a highly lagged formula and the fall in prices reflected fuel prices prevailing several quarters earlier. In FY22, the increase in inflation being experienced globally was felt in Palau and the CPI recorded an inflation rate of 11.9% during the 1st quarter of 2022 (year-on-year). The impact of rising fuel prices was now felt not only at the pump but was also filtering its way through the PPUC tariff structure. Further, food prices were also peaking and recorded an average 13% increase in the last quarter of 2021 and 1st quarter of 2022. While some of the price increase reflect short-run effects following the recovery out of the pandemic, the more recent hikes due to the Ukraine war will be longer lasting and permanent as markets readjust from reliance on energy from Russia and grain shortages remain disrupted.

Real wages have declined in both private and public sectors with a considerable differential between the two. Nominal wages in the public and private sectors in Palau have grown by 2.4 and 2.3%, respectively, since FY00 with public sector wages being 85% above those in the private sector, see Figure 7. Real wages declined marginally in the public sector by -0.3% per annum and by an average of -0.4% per annum in the private sector. In the near term the impact of inflation on real wages in Palau can expected to be significant as the large imbalances between demand and supply work their way through the global economy. Citizen wages are 55% above non-citizen wages with a majority of Palauan workers in the public sector and a majority of non-Palauans in the private sector.

vi THE FISCAL OUTTURN

Palau has maintained a prudent fiscal policy while running surpluses during the tourism boom years. Between FY05 and FY13 Palau maintained fiscal balance on average with expenditures matching the revenue envelope, see Figure 8. During the global financial crisis in FY07 and FY08 fiscal balance turned negative, but the deteriorating position was largely contained. After the recovery in FY14 and reflecting the tourism boom years through FY18, the government recorded surpluses in each year, averaging 4.7 percent of GDP. By period end FY18, government deposits had risen to $43 million, up from a level of $9 million five years earlier. In FY19 as the number of visitor arrivals fell to a level not seen since FY10, and the fiscal position tightened, the

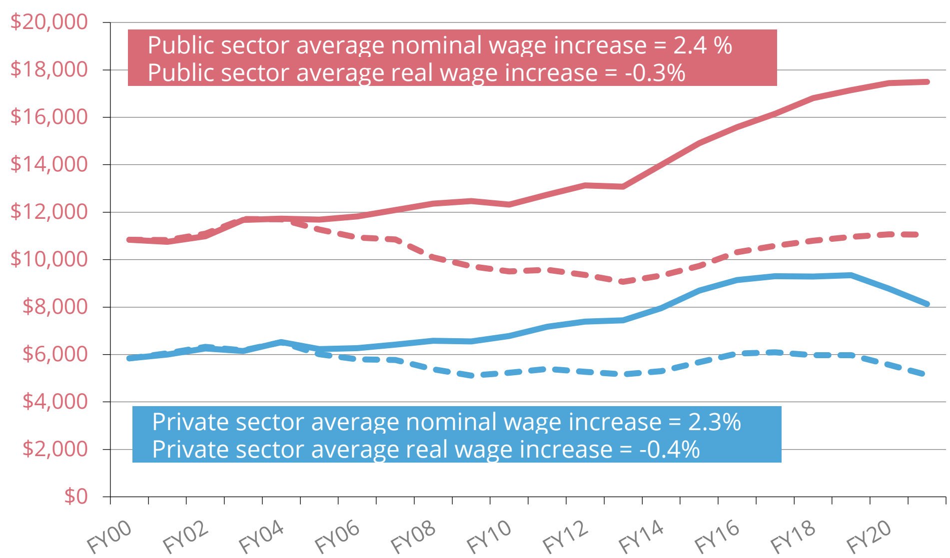


Figure 7 Nominal and real wages, FY15 prices

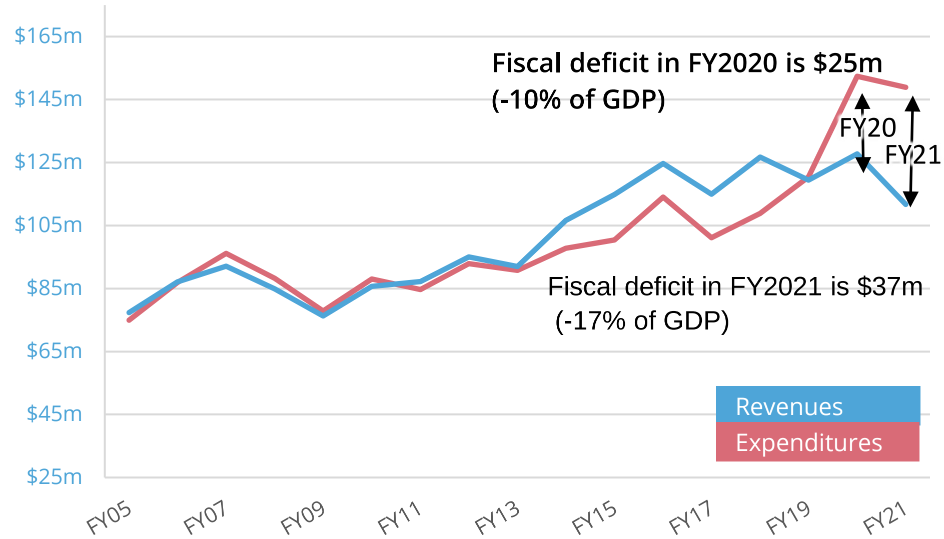


Figure 8 Government revenues and expenditures

government ran a small deficit of -0.4 of GDP and cash deposits fell to $31 million. However, despite the reduction in reserves, fiscal prudence during the boom years had established a significant cushion which would come to serve the nation well during the onslaught of COVID-19.

Total financing needs of 23% of GDP have been required to support the fiscal deficit during the COVID-19 crisis during FY20 and FY21. With the impact of COVID-19 the fiscal position deteriorated rapidly. From a balanced position in FY19 a deficit of $25 million or 11% of GDP was incurred in FY20, which rose to $37 million or 17% of GDP in FY21. Not only did tax revenues decline reflecting the impact of the loss of the visitor industry but also Palau embarked on a series of mitigation programs requiring additional expenditures under the CROSS Act. Total financing needs during this period thus amounted to $62 million or 23% of GDP to support Palau through the crisis.

Available financing was sufficient to keep the government open through the end of FY21. To finance the deficit Palau requested funding from the ADB to support the nation through the crisis. A series of loans were initiated: (i) a $15 million facility under the DRP (Disaster Resilience Program), (ii) $20 million under the CPRO (COVID-19 Pandemic Relief Option, and (iii) a further $55 million Policy Based Loan (PBL) comprised of two subprograms amounting to $25 million and $30 million each. The conditions for release of funds under Subprogram 1 were met early 2021, with anticipation of completion of the second set of conditions in time for release of funds by the end of FY22. The availability of funding from the DRP, CPRO and subprogram 1 of the PBL, $60 million, coupled with the Palau's own reserves have been sufficient to keep the government operational and maintain financial stability during the COVID crisis.

2 Mitigation: CROSS, CARES, and impact on household incomes

This section reviews the mitigation programs enacted by Palau through the CROSS Act and benefits that were available to the citizens of Palau through the U.S. CARES Act. Detailed analysis of the different programs is undertaken coupled with an impact study of the combined support on household incomes.

i THE CROSS ACT

On April 27, 2020, the President of Palau signed into law the Coronavirus One Stop Shop Relief Act known as the CROSS Act. A total of $20 million was appropriated for a nine-month period through the end of January 2021. Unused funds available at the end of this period enabled continuation of the program through the end of FY21 and a further extension under the FY22 budget. The law provided a variety of programs to mitigate the impact of the COVID-19 global pandemic:

1. ***Unemployment benefits***: Under the original provisions qualified individuals in priority affected sectors were entitled to receive $100: (i) per week, if they are unemployed and generating no income; (ii) per fortnight, if their monthly working hours and earnings have been reduced by at least 50%; or (iii) per month, if monthly work hours and earnings are cut by more than 25% but less than 50%. The program was originally available to both Palauan and foreign nationals. The original program was designed to support 1,600 persons at a cost of $6.9 million. In March of 2021 the program was redesigned, with unemployed worders returning to their employers with government funding a maximum of 20 hours per week at the minimum wage.
2. ***Temporary jobs program***: Those unemployed because of the pandemic were also eligible to apply for work in the temporary jobs program at the minimum wage of $3.50 an hour. Non-resident workers, particularly those in the tourism sector, were able to apply for transfer of employment visas to the temporary jobs, with an understanding that their original employers would either re-hire them once their businesses re-opened or would arrange for their repatriation when outbound travel became possible. The program budgeted for the creation of 700 jobs at a cost of $4.3 million. In March of 2021 the program was closed to non-Palauans, who were transferred to the unemployment benefit scheme.
3. ***Private sector relief***: Loans administered by the National Development Bank of Palau were made available to an estimated 112 businesses in affected industries. The loans were designed to cover businesses' fixed costs and finance of improvements in tourism facilities. Loans were provided with 10-year terms, with no payment obligations during the first two years; annual interest payments of 2% to start by the third year; and principal repayments due from the fourth year until maturity. Priority funding was for loans that covered businesses' fixed costs, capped at $30,000 every 3 months per employer. The CROSS act budgeted $8 million for this component.
4. **Lifeline utility services**: This program enabled a lifeline electric, water, and sewer subsidy program for low- or fixed-income households to include those affected by the COVID-19 global pandemic. PPUC's lifeline subsidy covers 150 kilowatt hours of electricity and 5,000 gallons each of water supply and wastewater services, per household. A sum of $0.8 million was budgeted for this program.

The structure of unemployment benefits was improved in March of 2021 with the program switching to a wage subsidy for employers. Table 1 indicates the number and benefits received under the CROSS Act unemployment benefit program from the 3rd quarter in 2020 after the program had become regularized through the 3rd quarter of 2021. At the start of the program both Palauans and foreign workers were included in the program, but after Palau became

Table 1 Analysis of CROSS unemployment benefits, by nationality and gender

No of Recipients

		Q3-20	Q4-20	Q1-21	Q2-21	Q3-22
Nationality	Gender					
Palauan	F	79	31	19	18	22
	M	98	40	22	14	17
Foreign	F	706	638	530	571	562
	M	932	909	712	675	687
Unidentified		56	48	40	118	43
Total		**1,871**	**1,665**	**1,323**	**1,396**	**1,331**

Amount Paid ($'000)

		Q3-20	Q4-20	Q1-21	Q2-21	Q3-22
Nationality	Gender					
Palauan	F	53	18	12	13	15
	M	65	25	13	11	13
Foreign	F	472	406	363	456	434
	M	628	571	483	548	535
Unidentified		69	39	30	56	32
Total		**1,288**	**1,059**	**902**	**1,084**	**1,030**

Average payment, $

		Q3-20	Q4-20	Q1-21	Q2-21	Q3-22
Nationality	Gender					
Palauan	F	225	197	215	242	236
	M	222	207	204	267	256
Foreign	F	223	212	228	266	258
	M	225	210	226	271	260
Unidentified		411	271	255	158	246
Average		**230**	**212**	**227**	**259**	**258**

eligible for benefits under the U.S. CARES act, most Palauans were transferred to CARES funding. The numbers thus fell from the start of the program to an average of 1,300 by the end of FY21. While the program allowed for a maximum benefit of $400 per month, after taking into account those persons on reduced benefits, the average current benefit through the 1st quarter of 2021 was $220. In March of 2021 the program changed into a wage subsidy of up to 20 hours of work per week at the minimum wage. The average monthly benefit thus rose to $258 a month close to the maximum of $280. The proportion of females in the program averaged 45 percent in the final quarter of FY21 with just 3 percent of Palauans participating.

Temporary jobs program has unintended consequence of providing 80 percent of jobs to Palauans. Table 2 describes the temporary jobs program originally intended to fund 700 dislocated foreign workers. After a slow start the program gradually gained momentum, and by the last quarter of 2021 had achieved its objective, employing 689 people. However, while the program was initially intended to provide jobs for those made unemployed by the pandemic and not eligible for the U.S. CARES act, this was not deployed until several months into the program. As a result, over 507 Palauans or 74 percent of the total jobs provided, were placed under the scheme during the 4th quarter of 2020. Returning Palauan students and graduates from the Community College made up a significant number and were placed despite not having been laid

Table 2 Analysis of the PVA temporary jobs program, by nationality and gender

No of Recipients

	Q2-20	Q3-20	Q4-20	Q1-21	Q2-21	Q3-21
Palauan	22	283	507	459	396	369
Philippines	14	79	124	87	2	1
Bangladesh	1	9	15	11	0	0
Female	25	201	355	305	202	190
Age<26	20	192	307	266	203	191
Total	**44**	**404**	**689**	**589**	**403**	**376**

Note Q2-20 is for May and June only

Amount Paid ($'000)

	Q2-20	Q3-20	Q4-20	Q1-21	Q2-21	Q3-21
Palauan	9	400	880	636	701	575
Philippines	6	106	214	103	3	2
Bangladesh	0	14	27	14	0	0
Female	10	281	610	412	361	299
Age<26	8	268	519	360	355	294
Total	**18**	**561**	**1,188**	**790**	**713**	**585**

Average monthly payment, $

	Q2-20	Q3-20	Q4-20	Q1-21	Q2-21	Q3-21
Palauan	212	471	579	462	590	519
Philippines	219	447	576	394	627	551
Bangladesh	84	524	606	410		
Female	207	465	573	450	594	523
Age<26	199	466	563	451	584	515
Total	**209**	**463**	**575**	**447**	**590**	**519**

off as a result of the pandemic. This unintended consequence made a favorable contribution to the broader economic impact of the program. During March 2021 the nature of the program was changed and only Palauans were eligible to patriciate with non-Palauans being placed in the CROSS Act unemployment program. By the last quarter of FY21 the numbers had fallen to 376 with the scheme being almost entirely comprised of Palauans. Female participation has been 50 percent and over 50 percent of the total placed was employment of those under 26 years of age.

Funds disbursed to support the private sector of $2 million were significantly below target. During FY20 the NDBP received $1.5 million and a further $0.5 million was approved in FY21, but the NDBP is waiting direction on the purpose of the second tranche. The disbursement of funds to support the private sector through the National Development Bank of Palau has not been widely subscribed. While the scheme was not designed for large establishments, the impact of the pandemic and uncertainties of its duration resulted in significant apprehension on the part of small and medium sized enterprises to avail themselves of loan funding that might lead to their insolvency. By the end of 2021 only 40 loan applications had been approved. Once recovery becomes more evident, the need for funding and confidence concerning debt service capacity will likely strengthen and demand for finance may increase.

The Lifeline utility facility has not been widely adopted. The application for funding for the utility program as a result of the pandemic has not been widely taken up by households with only 58 applications received by the end of February 2021. Resulting drawdowns from the $0.8 million authorized for the program has been minor.

ii The U.S. CARES Act

Under the U.S. CARES Act 2020, the citizens of the Freely Associated States were eligible for certain unemployment benefits under two facilities:

1. ***The Pandemic Unemployment Assistant (PUA) program***. The PUA program provides a temporary benefit to individuals whose employment or self-employment has been interrupted or was lost as a direct result of the COVID-19 Pandemic. PUA provided $397 per week for up to 39 weeks through December 31, 2020 of unemployment assistance or benefits. These benefits were extended for a further period until March 14, 2021, when the Consolidated Appropriations Act became law and again through Sept. 6, 2021, adding a further 29 weeks after the American Rescue Plan Act became law. In total the PUA covered a period of 79 weeks
2. ***The Federal Pandemic Unemployment Compensation*** (FPUC) program. The FPUC program provided an additional number of benefits to qualified individuals receiving assistance under the Pandemic Unemployment Assistance. Under the FPUC, individuals were eligible for $600 per week for periods beginning on or after April 1, 2020 through July 31. Under the Consolidated Appropriations Act and the American Rescue Plan Act, the FPUC was extended from January 1, 2021, at a reduced rate, allowing unemployed individuals to receive an additional $300 per week also though Sept. 6, 2021.

U.S. CARES Act provides sizeable level of funding for Palau. Under the original CARES act the U.S. indicated that $14.9 million would be available to Palau under the program. The program was restricted to Palauan citizens and citizens of the other two Freely Associated States, as well as citizens of the U.S. Table 3 provides details of the program, but information is only partial. While irregularity of payments and uneven periodicity of those payments has made analysis difficult, issues at the WIOA office have compounded matters. The program has largely benefited Palauan citizens and female participation is close to that of males. The average payments received under the program were twice that of the average Palauan wage for the same period.

Household incomes rose in FY20 despite the anticipation of a significant loss but fell in FY21 reflecting the full impact of the pandemic. The impact of the COVID-19 global pandemic on household incomes is indicated in Figure 9, showing that real household incomes rose by 4.3% in FY20 despite the anticipation of a significant loss, but were to fall by 2.1% in FY21 reflecting the full impact of the pandemic. Simulations indicate that without the CARES and CROSS programs household incomes would have fallen by 5.2% in FY21 and a further 3.7% in FY21. For the two years the simulations indicate that household incomes were 10.1% and 12.0% above what they would otherwise have been, respectively. This result attests to the highly successful and timely beneficial impact of the combined mitigation efforts.

iii Repatriation

Significant numbers of foreign nationals depart Palau since the start of the pandemic. Repatriation of foreign nationals reached 1,074 workers returning home (including end of

Table 3 Analysis of the US CARES benefits combined PUA and FPUC by nationality and gender

	Q2-20	Q3-20	Q4-20	Q1-21	Q2-21	Q3-21
No of Recipients						
Palauan		379				
Non-Palauan		36				
Female		195				
Male		221				
Female Palauan		183				
Male Palauan		196				
Total		416				
						231
Amount Paid ($ million)						
Palauan		9.810				
Non-Palauan		1.015				
Female		4.257				
Male		6.569				
Female Palauan		3.988				
Male Palauan		5.822				
Total		10.826				6.375
Average payment, $						
Palauan		8,621				
Non-Palauan		9,316				
Female		7,276				
Male		9,923				
Female Palauan		7,251				
Male Palauan		9,902				
Total		8,681				9,200

contract work permit holders) compared with direct foreign workers in the tourism industry of 1,579. At the start of the COVID-19 global pandemic, it was debated whether there would need to be widespread repatriation of foreign workers. Repatriation of foreign workers is the responsibility of employers and not the government. Most employers preferred to keep their workforce ready to restart the industry once the recovery took hold, rather than bear the cost of repatriation and subsequent recruitment of replacement employees at a later stage. To save cost, remaining foreign workers were in many cases placed on part-time work and coupled with the mitigation programs sufficient safety nets were put in place. However, some foreign workers were repatriated as flights became available, and Table 4 indicates numbers by gender and nationality by month.

Mitigation programs including the CROSS Act and U.S. CARES Act proved highly effective with the CROSS Act receiving a very favorable international reaction. At the start of the pandemic as the realization of the rapid collapse of Palau's tourism industry became apparent the outlook was dire with the prospect of a large pool of unemployed labor and rising poverty. Palau reacted quickly with the passage of the CROSS Act by the end of April and the first benefits paid in May. The combination of the use of Palau's internal savings, donor support through the Asian

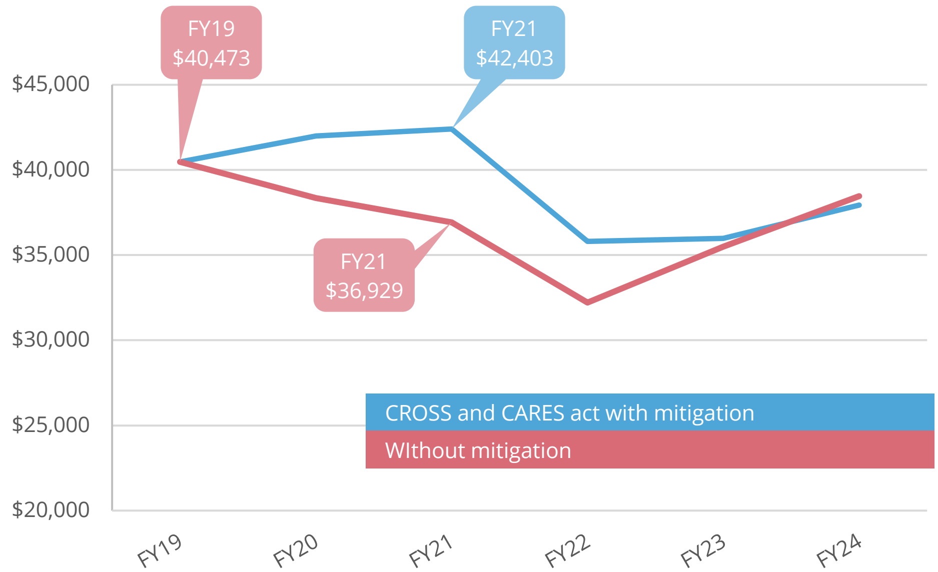


Figure 9 Household impact with and without CROSS and CARES Acts mitigation

Development Bank, and eligibility under the U.S. CARES Act, enabled Palau to maintain momentum in the domestic economy, actually increase household incomes in FY20, avoid widespread poverty, and suppress any threat to the social fabric. Palau's performance to support not only its own citizens but also foreign workers was widely recognized by the international community and has generated good will and a favorable reputation.

3 *Impact of the Pandemic on the FY20 and FY21 budgets*

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

Table 4 Departures of Non-Palauan residents (workers, dependents, and other non-visitors)

	Q2-20	Q3-20	Q4-20	Q1-21	Q2-21	Q3-21	TOTAL
Gender							
Female	49	96	81	52	80	143	501
Male	51	210	148	93	183	237	922
Total	100	306	229	145	263	380	1,423
Work permit	56	226	178	115	198	301	1,074
Dependent or other	44	80	51	30	65	79	349
Nationality							
Philippines	3	153	166	94	26	184	626
Bangladesh						36	36
China	2	82		2	157	42	285
United States of America	15	14	9	10	23	28	99
Japan	41	12	13	7	8	21	102
Korea, Republic of	29		2	3	5	5	44
Taiwan, Republic of China	2	16	12	9	20	17	76
Other	8	29	27	20	24	47	155

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. Original projections of the impact of the pandemic made in July 2020 indicated a reduction in GDP of 13.8 percent. This projection turned out to be more adverse than the 9.1 percent current provisional figure for the FY20 outturn. For FY21 the original July 2020 estimate projected 13.2%, which was close to the current provisional figure of 13.3%. While the tourism economy had largely disappeared by April 2020 the impact on the non-tourism private sector was also substantial, which fell by 9% and 6% in the two years, respectively. While the result for the non-tourism private sector was unfavorable the mitigation programs helped significantly reduce a more adverse result that would have occurred in their absence.

The second objective to mitigate the impact legislated through the CROSS act was designed to provide funds in the four areas discussed above: (i) unemployment benefits, (ii) a temporary jobs program, (iii) support to the private sector through the NDBP, and (iv) a utility lifeline. The original legislation provided $20 million of resources through the end of January 2021. By the end of FY20, only $5.1 million or 25 percent of the resource needs had been utilized. In part, the savings were due to the eligibility of Palau citizens for the benefits under the U.S. CARES act, which reduced domestic funding requirements. Further, the individual programs took time to build up momentum. The CROSS Act was renewed through the end of FY21 with the savings under the original program sufficient to meet needs. At the end of FY21 the US CARES Act expired, and former Palauan beneficiaries were transferred to the CROSS program albeit with reduced benefits. The fiscal savings enabled the CROSS Act to be further extended into FY22 and the OEK provided an additional $1m of funding in March of 2022[3]. The mitigation programs are generally considered to have been very successful in supporting the household incomes at a time of considerable adversity for Palau.[4]

i Revenue Effort

Revenue effort was strong in FY20 but by FY21 had fallen by 5% compared with FY19 before the pandemic. However, the composition of revenue changed significantly with reduced tax effort being offset by increases in grants, see Table 5. The impact on tax revenues largely reflected the impact of the pandemic on the economy and fell by 21% FY21 compared with FY19. Wage taxes fell by 8% reflecting the lay-off of tourism related workers and reduced working hours. However, overall wage tax collections held surprisingly firm reflecting the composition of employment and that high wage earners are largely employed in the public sector which was unaffected by the pandemic. Gross receipts taxes fell by a large 18% reflecting the importance of tourism activities and the hotel room occupancy tax fell from $3.6 million in FY19 to $0.5 million in FY21. Taxes on international trade or import taxes rose by 11% over the two years reflecting greater spending on infrastructure and helped maintain the revenue base. Other taxes largely relating to departure fees paid by travelers entering Palau (PPEF - Pristine Paradise Environmental Fee) fell

3 As part of the response to COVID-19 community transmission in January 2022, the government also allocated a further $200,000 to provide a one-time benefit to affected employees.

4 A recent Project Completion Report of the ADB COVID-19 Pandemic Relief Option (CPRO) rated the CPRO has both *efficient* and *highly effective*.

Table 5 Revenues of the national government (GFS basis), $'million

	FY17	FY18	FY19	FY20	FY21
Revenue	115.0	126.7	119.4	127.8	112.9
Tax revenue	56.9	60.5	51.8	46.8	41.0
Income tax - payable by individuals (wages tax)	10.9	11.0	10.9	11.2	10.0
Taxes on payroll & work force (foreign labor permits)	1.5	1.4	1.4	1.4	0.8
Taxes on goods and services	21.1	21.4	21.5	16.4	14.2
Turnover taxes on goods and services (BGRT)	14.0	14.5	14.1	11.8	11.5
Taxes on specific services (hotel room tax)	5.0	4.5	3.6	2.4	0.5
Licenses	2.2	2.4	3.8	2.2	2.2
Taxes on international trade and transactions	16.0	15.7	13.5	15.8	15.0
Other taxes	7.4	11.0	4.5	2.0	0.9
Other taxes: payable by businesses	0.8	1.1	0.7	0.3	0.4
Other taxes: departure taxes	6.6	9.9	3.7	1.7	0.5
Grants	37.3	49.4	50.3	65.0	58.5
From foreign governments	37.3	49.4	50.3	65.0	58.5
Foreign governments - current	31.0	43.7	29.7	47.2	47.8
Compact	13.1	24.6	0.0	0.0	0.0
Federal Programs and other US	9.7	9.5	9.6	27.2	25.2
Taiwan	3.1	4.6	5.1	5.0	7.6
Compact - Trust Fund	5.0	5.0	15.0	15.0	15.0
Foreign governments - capital	6.3	5.6	20.6	17.8	10.7
US Government	1.2	0.4	10.9	6.4	4.9
Other governments	5.1	5.3	9.8	11.4	5.9
Other revenue	20.7	16.9	17.3	15.9	13.3
Property income	11.7	9.3	9.9	6.7	6.4
Interest and dividends	1.0	0.4	0.8	0.2	0.0
Post office and airport	1.4	0.5	-0.4	-1.6	-1.6
Royalties fishing fees	9.3	8.5	9.5	8.1	8.0
Sales of goods and services	7.7	5.7	5.3	3.9	3.9
Miscellaneous income	1.3	1.8	2.1	5.4	3.0

from $3.7 million to $0.5 million. Tax effort thus remained largely as anticipated given the impact on the economy of COVID-19, and compliance remained strong despite pressures to provide tax breaks to the private sector.

Large funding increases flowed in grants from the U.S. for health purposes and under the CARES Act. Offsetting the reductions in tax revenues has been a large increase in grants. The annual flows recorded for Compact grants ceased in FY19 as agreed under the Compact Review Agreement (CRA) of 2018. On the flip side annual drawdowns from the Compact Trust Fund increased from $5 million to $15 million. The most significant increase in grants was recorded under federal programs and includes revenues under the U.S. CARES act for other health related purposes. From a level of $9.6 million in FY19 federal programs rose to $27.2 million in FY20 and $25.2 million in FY21. There was also a significant increase in capital funding from the U.S. under the Compact Review Agreement during FY19 through FY21 including the Koror-Airai road repavement, and the Angaur dock, second fiber optic cable amongst others. From a level of $0.4 million in FY18, capital grants rose to $11 million in FY19 falling in FY21 to $4.9 million. Increases in funds were also received from Taiwan in FY19 and FY20 for the national Gym rehabilitation. The remaining significant element under "other revenues" is the receipt of fishing fees, which was slightly down in FY20 and FY21, but now represents an important source of non-tourism related funding. Under the marine sanctuary, commercial fishing has been reduced but Palau remains eligible as a PNA member to sell its allocation of fishing days under the VDS scheme.

Revenue diversification has supported fiscal stability during COVID-19 and will be further enhanced with the introduction of the new reformed tax regime. Drawing out lessons from the structure and performance of Palau's revenue base, several conclusions can be drawn. Firstly, tax effort is not, as in many countries, the overriding element of Palau's revenue base. In FY19, before the onset of the COVID-19, taxes represented 49 percent of total revenues. In FY21, taxes fell to 41 percent, as non-tax revenues provided a cushion against adverse shock of the pandemic. Secondly, the core elements of Palau's existing tax regime date to Trust Territory days. It is inefficient, inelastic, and provided little scope for resource mobilization. As part of Palau's recent reform initiatives and supported under the ADB's Policy Based Loan, Palau passed into law a comprehensive tax reform bill during August 2021. The key features of the new regime, to be implemented by the start of 2023, include the Palau Goods and Service Tax (a valued added tax) and a Business Profits Tax. The new system will introduce a modern and efficient regime that supports fiscal stability during the economic cycle. Thirdly, grants are a large proportion of revenues and likely to remain so, assuming the ongoing negotiations with the U.S. for Compact funding renewal are successfully concluded prior to the end of FY24. Relations with Taiwan have also played an important role to support Palau's funding needs. Lastly, fishing fees have grown to represent a significant source of funds without which the tourism downturn in FY16-FY19 would have required adjustment. This is an important source of revenues and Palau will look to maximize its yield from the VDS.

ii Expenditure Performance

Expenses grew by 25 percent in FY21 compared with FY19. In response to the COVID-19 global pandemic, it would be expected that expenses would increase as greater outlays were required to fund the various mitigation efforts; however, while this was certainly true and expenses were 31% and 27% higher in FY20 and FY21 compared with FY19, respectively, large increases also occurred in subsidies to SOEs, transfers to state governments, the social insurance and pension sector, and funding for housing, see Table 6.

Payroll expense grew modestly by 1.9 percent in FY21 compared with FY19, although introduction of a new financial management system makes interpretation problematic. Payroll represented 44 percent of expenses in FY19 before the pandemic in a normal year, but payroll growth was modest between FY19 and FY21 growing by 1.9%. Figure 10 indicates recent trends in equivalent man-years[5] and average hourly pay rates. While the number of equivalent man-years has grown modestly at 0.6 percent between FY10 and FY19 before the pandemic, per annum average pay rates rose by 3.5 percent and at a greater rate than the cost of living which

[5] Total hours worked in a year divided by 2,080 hours (52 weeks times 40 hours).

Table 6 Expense of the national government (GFS basis), $'million

	FY17	FY18	FY19	FY20	FY21
		-	-	-	-
Expense	-92.8	102.3	103.6	135.8	131.2
Compensation of Employees	-42.9	-44.6	-45.5	-47.4	-46.4
Use of goods and services	-25.1	-26.6	-27.1	-28.1	-26.6
Foodstuffs	-1.3	-1.5	-1.4	-1.6	-1.4
Supplies and materials	-3.6	-3.3	-3.7	-4.5	-4.8
Medical supplies	-2.1	-3.2	-3.2	-2.9	-3.5
Medical referrals	-2.7	-1.8	-0.2	-0.1	-0.1
Petroleum products	-1.0	-1.1	-1.1	-1.2	-1.2
Utilities	-2.7	-3.0	-3.1	-3.3	-2.7
Transportation	-3.2	-3.9	-3.9	-2.2	-0.5
Communications	-1.4	-1.5	-1.2	-1.4	-1.0
Financial services	-0.1	-0.1	-0.1	-0.6	-0.2
Rentals	-1.3	-1.3	-1.2	-1.9	-1.6
Professional and contractual services	-3.5	-4.0	-5.1	-5.7	-5.9
Other costs	-2.1	-1.9	-2.9	-2.6	-3.7
Interest Payments	-0.5	-0.4	-0.6	-0.8	-0.7
Subsidies	0.0	0.0	-0.5	-3.9	0.0
Grants	-13.5	-17.2	-17.5	-22.7	-23.5
Government agencies	-6.4	-9.6	-5.7	-5.4	-5.3
State Government	-7.1	-7.6	-8.1	-9.9	-9.1
Social Security Funds	0.0	0.0	-3.7	-7.4	-9.1
Social Security	0.0	0.0	-2.1	-2.8	-6.7
Civil Service Pension Fund	0.0	0.0	-1.6	-4.6	-2.4
Social benefits	-0.1	-0.1	-0.1	-18.2	-22.4
Other expense	-10.8	-13.4	-12.3	-14.8	-11.5
transfers	-5.1	-5.8	-6.0	-13.7	-10.9
Current	-5.1	-5.8	-6.0	-5.2	-5.2
Non profits	-2.1	-2.6	-4.4	-2.9	-2.2
Households	-2.9	-3.2	-1.6	-2.3	-2.9
Capital (NDBP & PHA)	0.0	0.0	0.0	-8.5	-5.8
Miscellaneous	-5.7	-7.6	-6.3	-1.1	-0.6

grew by 2.1 percent. That said, in FY21 man-years fell by 5.3 percent while pay rates were 1.5 percent above their FY19 levels and rates. This suggests that a tight rein was held over overtime and additional hours, but while wage rates were frozen, normal wage drift inherent in the civil service pay scales led to a small increase. That said general ledger estimates of compensation of employees indicates wage costs rose by 1.9% compared with a figure of -3.9 from the payroll system. In FY20, the Financial Management Information system formerly based on DILOG software was replaced by the new Tyler-Munis system six months into the fiscal period. There are thus possible discontinuities arising from the changeover and differences in classification of items of expense.

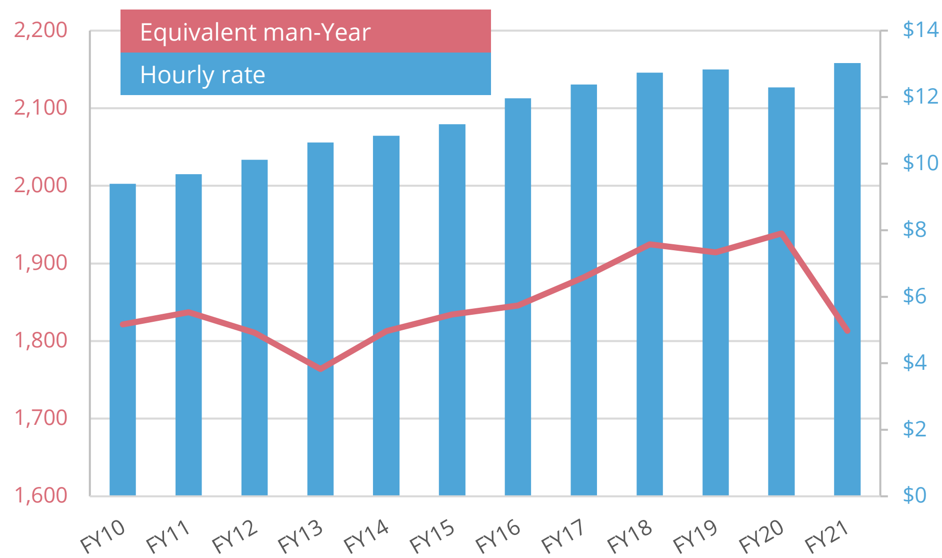


Figure 10 Public sector payroll: hourly rates (US$), and equivalent man-years

Use of Goods and Services fell by 1.8% in FY21 compared with FY19. The second most important item of expense is outlays on goods and services, which represented 26% of expense in FY19, and fell by 1.8% in FY21 compared with FY19. Most items were generally in line with FY19 figures with some exceptions. Purchases of material and supplies increased as did medical supplies reflecting health needs. Outlays on utilities and travel declined due to falling fuel prices during this period and pandemic-related travel restrictions. Increases in expense also occurred in outlays on professional and contractual services. As in the case of payroll, use of goods and service was tightly controlled during the pandemic. The two items representing 70% of government expense grew by a very modest 0.5% during the pandemic.

Subsidies to SOEs grew rapidly in FY22 and pose significant fiscal risk. Subsidies to the SOE sector were zero for many years until FY19 when they recorded $0.5 million and rose to $3.5 million in FY20 (zero in FY21). The failure to charge full cost-recovery and a pricing structure that only recovered cash expense meant funds were not set aside for capital replacement or maintenance and a variety of critical functions. The financial position of PPUC has thus been largely insolvent. In FY21 the ADB approved a power sector policy-based loan for PPUC requiring a variety of reforms including the adoption of full cost recovery. A new electricity tariff has been implemented and prices have risen considerably reflecting the full cost of production. However, as fuel prices started to rise rapidly in late 2021 with recovery in the global economy and the Ukraine war, a series of subsidies were granted to PPUC, $3.55 million in the FY22 budget and a further $1.5 million in early 2022. The subsidies are inefficient in that they apply to all consumers in both the private and public sectors and fail to target disadvantages consumers. They are further unsustainable given the outlook for sustained high international fuel prices for some time to come. A second phase of the PPUC loan program also includes the adoption of reforms in the water and wastewater operations of PPUC including a full cost recovery tariff, which currently runs at about 50% of the full economic cost. PPUC operations in both power production and water and wastewater thus pose significant fiscal risk.

Grants and transfers to government entities rose rapidly large between FY19 and FY21, with large increases to state governments, social insurance and pensions funds. Grants and transfers to government entities includes three major categories: government agencies, state governments and national insurance. Transfers to government agencies including the Community College have generally been stable and fell during the pandemic years. However, transfers to state governments have grown significantly over recent few years, from $4.8 million in FY10 to $9.1 million in FY21. It has been proposed in the Fiscal Strategy that a rules-based approach be introduced to ensure that grants to local government stay on a sustainable path. A major item of increase in cost has been transfers to the Social Security Administration and the Civil Service Pension Plan. Both entities have been under significant financial distress due to payment of legislated benefits at increased levels without parallel increases in contributions. As part of the ADB policy-based loan to support Palau during the pandemic reforms to the Social Security system have been drafted in law and transmitted to the OEK. If adopted these reforms, including changes in both contributions and benefits will enable the SS to operate on a financially sustainable basis in the foreseeable future. The financial position of the CSPP is, however, particularly dire and without government support is projected to collapse in the near-term. Reforms of the CSPP are programmed to follow those currently under consideration for Social Security.

Social benefits payments through the CROSS and CARES acts recorded $18 million and $22 million in FY20 or 8% and 10% of GDP, respectively. Payments to households under the CROSS and CARES acts are recorded under Social Benefits and on a fiscal year basis are estimated to have been $18.2 million and $22.4 million in FY20 and FY21, respectively. The rapid disbursement of funds under both programs provided significant support to Palauan and foreign workers and must be considered a notable success[6]. It is of course anticipated that upon economic recovery these benefits will decline and then terminate.

FY20 saw major capital transfers to the NDBP and PHA. The final item of government expense is categorized as “other”; this comprises current transfers to non-profits and households, capital transfers, and miscellaneous expense. While transfers to non-profits and households have remained stable there has been large capital transfers to the National Development Bank of Palau and the Palau Housing Authority. While $1.5 million was provided to the NDBP under the CROSS act for private sector loans, most of the funds were provided through a loan from Taiwan of $15 million under the Housing Development and Loan Program (HLDP). In FY20 $7 million of the loan was drawn down by NDBP and PHA with the remainder due for transfer in FY21. The $15 million borrowed from Taiwan was originally to be on-lent, but was subsequently converted into capital transfers, thus effectively increasing the net liabilities of the national government.

Transfers to SOEs, social insurance and pension funds pose the greatest risk to fiscal stability. The overall level of government expense in FY20 and FY21 saw a significant increase over prior years. However, once adjustment is made for the impact of the pandemic due to the CROSS and CARES Act, and the HLDP, government expense recorded a structurally adjusted level of $109 million in FY20 and $103 million in FY21. This represented a 5.5% increase in FY20 and a

[6] See Chapter 2 for a detailed discussion of the disbursement of the funds.

reduction of 5.6% in FY21 as core expenses fell below pre-pandemic levels. The major areas of fiscal concern are:

- Growing subsidies to the SOE sector,
- Increases in transfers to state governments,
- Need to implement the recent proposed reforms to Social Security, and
- Imminent collapse of the CSPP.

iii CAPITAL EXPENSE AND FINANCING

Infrastructure projects grew significantly in FY20 and FY21. Capital expense in fixed assets and infrastructure funded through grants from the U.S. under the Compact Review Agreement and Taiwan saw a large increase in FY20 growing from $10.5 million in FY19 to $16.6 million in FY20 and a further increase to $18.5 million in FY21. After a period of low investment in public infrastructure in FY17 and FY18, this increase could not have come at a better time to support the struggling economy as the impact of the COVID-19 global pandemic hit, see Table 8.

Palau borrowed a record $50 million in FY20 and a further $35 million in FY21. On the finance account the major component was the large external borrowing of $50 million in FY20 including $15 million from the ADB under the Disaster Resilience Program (DRP), $20 million from the ADB under the COVID-19 Pandemic Relief Option (CPRO), and $15 million under the Housing Development and Loan Program (HLDP) sourced from Taiwan. In FY21 there was further borrowing from the ADB under a Policy Based Loan (PBL) of $25 million under the Recovery through Improved Systems and Expenditure Support (RISES) program to maintain government operations during COVID-19, $5 million from ADB under a PBL to support a PPUC reform program, and a further $5 million from Taiwan for on-lending to the NDBP for support to women, youth entrepreneurship and SMEs.

Table 7 Capital and Finance of the national government (GFS basis), $'million

	FY17	FY18	FY19	FY20	FY21
Non-financial assets	-8.4	-6.6	-16.9	-16.6	-18.5
Fixed assets	-8.4	-6.6	-10.5	-16.6	-18.5
Non-prdouced assets (land)	0.0	0.0	-6.3	0.0	0.0
Fiscal Decifit/Surplus	13.8	17.8	-1.0	-24.6	-36.7
Financial assets	-18.4	-29.3	-3.3	-27.9	11.1
Domestic	-21.7	-32.1	1.4	-24.5	12.0
Deposits	-10.8	-13.2	5.6	-21.2	21.1
Accounts receivable	-10.9	-18.9	-4.2	-3.3	-9.1
Foreign	3.3	2.8	-4.7	-3.4	-0.8
Financial liabilities	4.6	11.4	4.4	52.6	25.6
Domestic (accounts payable)	-5.1	1.8	0.9	-0.4	-2.7
Foreign (loans)	9.8	9.6	3.5	52.9	28.3

Fiscal deficit recorded a level of $25 million or 10 percent of GDP in FY20 and reached a record $37 million deficit or 17% of GDP by the end of FY21. The original deficits projected for FY20 of $32 million and $50 million for FY21 during the early stages of the pandemic, July 2020, were significantly higher than eventuated. It had been anticipated that the resources programmed through the CROSS Act for the mitigation programs would be drawn on rapidly and exhausted by the end of January 2021. However, the rate of drawdown of CROSS Act funding was considerably below the original estimates, and the appropriated $20 million was sufficient to maintain the program through the end of 2021. However, the lower level of use of CROSS Act funds and thus reduced fiscal deficit was offset by increases in state government, SOE, Social Security and CSPP pension needs. A significant level of the overall deficit was thus due to structural non-COVID related forces that existed before the pandemic.

Cash-flow has remained strong during the pandemic, but further deficit financing will be required for FY23. By the end of the FY20, cash balances had risen to over $65 million, an increase of nearly $30 million on FY19, and by the end of FY21 were still at health levels of $45 million after receipt of the $25 million ADB PBL. By the end of March 2022 balances had fallen to $30 million, a level that can maintain government operations through the end of the fiscal period but indicates the need for processing sub program 2 of the RISES PBL before the start of FY23.

Part B The Economic and Fiscal Forecasts

1 Economic and fiscal forecasts of the Economy over the medium-term and beyond

Analysis to this point has provided a detailed discussion of the performance of the economy and fiscal outturn for FY20 and FY21. In the first section of Part B of the *Update* the discussion starts with a baseline projection or scenario based on existing policy as the economy recovers from FY22 and onwards through FY30. The focus of the analysis is to provide a conservative but realistic projection of the economy, fiscal outturn, together with financing needs. Special attention is devoted to external debt sustainability. The second section in Part B provides an analysis as mandated in law of the impact of economic and fiscal policy changes under consideration, and also considers the sensitivity of the economic and fiscal forecasts to changes in economic conditions.

i ASSUMPTIONS OF THE PROJECTIONS

The level of visitors to Palau is projected to remain close to zero in FY22 as most of Palau's tourism generating nations remain closed to international travel. By the middle of 2021 Paau had reached a high degree of vaccination of its population and reopened its boarder subject to certain restrictions; a COVID-19 negative test, a vaccination certificate and 4-day restricted movement period. A modicum of visitors arrived in Palau during the remaining months of the fiscal period, and by year end 3,412 arrivals had been recorded. However, while Palau had attained a state of preparedness for revival of the tourism industry, the major generating nations remained firmly closed. At the start of 2022 Palau recorded its first case of community spread of COVID-19 and subsequent rapid spread of the virus but without serious health implications given the high level of immunity against severe illness afforded by the vaccination programs. By the start of May there had been no change in openness to travel of Palau's tourism generating nations and the outlook remained bleak with the *Update* forecasting only 6,872 by the end of FY22.

Full recovery of the tourism industry is not projected until FY25. Going forward the *Update* has taken the view that through FY23, most of Palau's tourism originating nations will generate a return of visitors to Palau at 50% of their pre COVID levels except for China, which is presumed to remain committed to its zero COVID policy. These assumptions generate a level of 41,000 visitors to Palau in FY23, see Table 9. For FY24 continuation of recovery has been assumed with a change in China's zero COVID policy as it becomes increasingly untenable. For fiscal period FY24, 83,500 visitors have been projected, but still below the FY19 level, which was itself well below trend. Eventual recovery is projected for FY25 with the number of visitors returning to 111,000, a level not far below the FY18 level, and a year in which visitor capacity utilization rates were closer to normal. These projections are consistent with industry forecasts for the region. The Economic Intelligence Unit reports: "*Asia's tourism market is not expected to recover to its pre-Covid levels before 2024, due to the lack of Chinese tourists and ongoing travel restrictions*".

A cautious approach has been adopted to recovery and return to normal operating levels in the industry. Going forward through FY30 more normal forces are presumed to assert their influence on the tourism industry. Room occupancy levels are presumed to return gradually to 50% by the end of FY30, the average level during the FY10-FY18 period. Figure 11 indicates the

Table 9 Projected visitor arrivals by country of origin

	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25
Japan	24,437	19,637	10,647	191	382	12,500	25,000	30,000
South Korea	12,872	11,569	6,227	26	52	10,000	15,000	20,000
Taiwan	11,354	14,065	6,269	732	1,464	7,500	15,000	20,000
Chian adjusted	50,211	28,504	9,761	18	36	0	12,500	25,000
USA	8,426	7,832	4,011	2,087	4,174	6,000	8,000	8,000
Europe	4,486	3,786	2,541	108	216	3,000	4,000	4,000
Other	4,211	4,333	2,218	274	548	2,000	4,000	4,000
Total	115,997	89,726	41,674	3,436	6,874	41,000	83,500	111,000

path visitor arrivals are projected to take through FY30 and attain a value of 158,000, a level below the peak attained in FY15 of 169,000, 15 years earlier. Earlier projections had assumed that recovery would be well underway by mid-2022 and in fact not out of line with the experience in the South Pacific. However, the return to normal in the East Asian region has been below expectations and experience has taught that caution and a conservative approach to recovery is warranted.

Construction demand is projected to contract in FY22 by 20% but remain above pre-COVID levels. Construction has traditionally had a large impact on the economy and the assumptions about major projects have a significant impact on the projections. In FY19 construction activity rose rapidly by 48% and remained close to that level through FY20 and FY21. This had an important impact in supporting the economy during COVID-19. In FY22 construction is projected to fall by 20% as the pipeline of projects nears completion reverting to the prevailing levels before FY19. The remaining on-going projects include finalization of the airport Joint Venture, remaining elements of the Koror-Airai Sanitation Project (KASP), and the Surangel Superstore shopping mall in Airai. The One-Stop Shop building in Koror has now finally started and is the

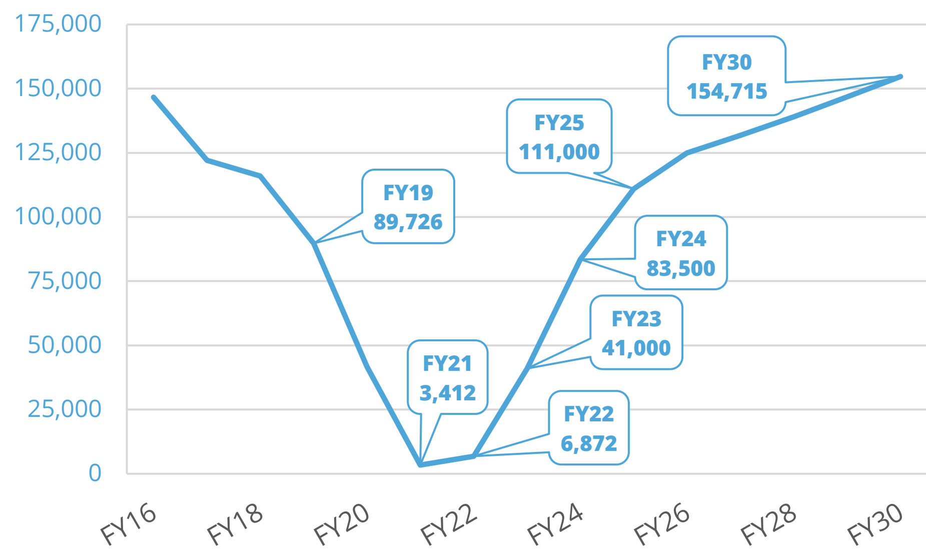


Figure 11 Visitor arrival projections: FY22-FY30

only major project currently underway. Other major investments yet to break ground include a new power purchase agreement for the supply of electricity to PPUC, the second fiber optic connection to the internet, the ADB supported Koror–Babeldaob Resilient Urban Development Strategy (KBRUDSAP) and continued installation of the U.S. radar surveillance system. While all these projects will have significant impact on the economy, the timing of implementation is uncertain and they have not been included in the projections.

The outcome of the negotiations for the renewal of the Compact is presumed to be favorable. With the appointment of a special US envoy negotiations between Palau and the US are set to ramp up with the US intention to complete the negotiations before end of 2022. Reflecting current sentiment in the US and relations between the two nations, it is anticipated that the Compact will be renewed for a further period of 20 years. The outcome of the negotiations is uncertain but, in the *Update*, it has been assumed that an annual stream of budgetary support equivalent to the permitted $15 million drawdown from the COFA Trust Fund full indexed for inflation will commence at the start of FY25. This will be supported with an annual flow of resources for capital investment equivalent to 30% of the current grant levels. The impact of these assumptions falls in the final year of the projections required in the Fiscal Responsibility Act but is useful in analyzing the longer-term economic outlook.

Fiscal policy stance assumed to remain in line with the FY22 budget and to remain in place through FY23 until recovery is established. The projections assume the provisions of the FY22 budget remain in force and the 10% reduction in appropriations, estimated to be $5.2 million, is maintained. Given the weak fiscal outlook, it is assumed that no increase in departmental budgets is allowed in FY23, but that in FY24 the 10% reduction is restored. In FY25 it is assumed as the recovery gets well under way, there is full restoration for the erosion of expenditures due to inflation since FY19 including the recent spike. It is assumed that the government continues to finance the CROSS program at the revised rates (March 2021) for both the PVA temporary jobs program and unemployment benefits for foreign workers. Expenses on these programs are assumed to decrease in relation to the speed of recovery. In FY22 this is estimated to be $5.5 million, reflecting the state of the economy before recovery, and in FY23 to fall to $3 million as recovery gets underway. By FY24 it is assumed these programs are finally terminated. The U.S. CARES benefits were terminated at the end of FY21 and is no longer reflected in the fiscal profile.

Tax reform is assumed to be implemented in 2023. A major policy initiative of the government has been the passage of the tax reform legislation in September of 2021. The major components of the tax reform are:

- The introduction of Palau Goods and Services Tax (PGST): 10%.
- The introduction of Business Profits Tax (BPT): 12%.
- Revisions to the wages tax reducing the rate for incomes falling between $8,000 - $40,000 to 10%, and the provisions of a tax refund to Palauans with incomes below $15,000 at the end of the calendar year.
- Conversion of specific import taxes into excises applicable to both imports and domestic products.
- Abolition of general import duty rate and Business Gross Receipts Tax of PGST registered taxpayers.

Implementation of the tax reform initiative is planned for the start of 2023 and has been programmed into MTEF-mod and the *Update* accordingly.

ii ECONOMIC AND FISCAL OUTLOOK

a OUTLOOK FOR THE ECONOMY

In FY22 the economy is projected to contract further by 3.6%. Earlier estimates of the recovery had presumed that by the end of FY22 the recovery would be well underway to regaining some of the lost ground. However, current estimates suggest the economy will contract further in FY22 by 3.6%, see Figure 12. As already outlined visitor arrivals are not expected to show any signs of growth until FY23. Further the economy will no longer benefit from the US CARES unemployment benefits, which had a strong stimulative impact in FY20-FY21. Lastly, the construction industry is expected to contract to prior levels before FY19 as projects in in the pipeline are completed. After the two-year reduction in GDP of 21% between FY19-FY21, the economy is now projected to fall by 24%.

The economy is now projected to start a slow recovery in FY23 and achieve full recovery by FY25. In FY23 it is assumed that the process of a slow and gradual recovery commences and visitors to Palau achieve a level of 41,000 (36 percent of the projected level for FY20 before the pandemic). While construction levels are not expected to expand in FY23, the economy is projected to grow by 13.6%, albeit from a low base. However, this level of economic activity remains 18% and well below the level prevailing in FY18, a healthy year of economic activity. The tourism recovery is expected to proceed in FY24 and to be completed by FY25 with a level of 111,000 visitors projected and GDP to attain a value slightly higher than the FY18 level, seven years earlier.

After recovery from COVID-19 has been attained, the tourism economy is projected to return to normal levels of occupancy and profitability by FY30. While recovery from COVID-19 is assumed to have been achieved by FY25, the level of capacity utilization remains well below normal profitability levels. Based on the level of rooms in existence before the pandemic and assuming completion of plant under construction and no major closures, the level of visitors projected represents close to 40% of rooms available. The existence of significant capacity under-

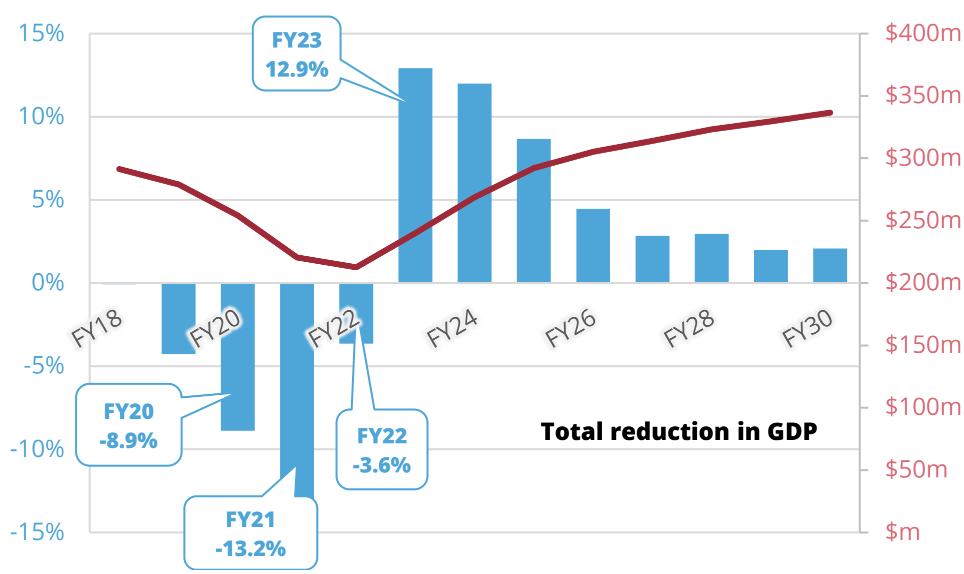


Figure 12 GDP level and growth: FY18-FY30

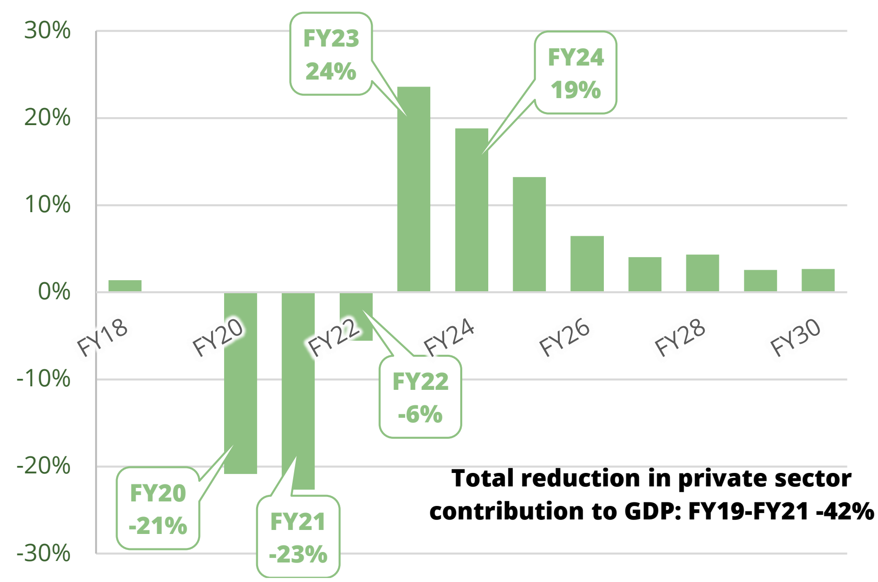


Figure 13 Private sector GDP: FY18-FY30

utilization suggests that operators will have significant scope for further expansion and the projections assume occupancy rates will rise to 50% by FY30. Coupled with modest further expansion in plant of 10% or an additional 220 rooms, total visitor arrivals of 155,000 are projected by the end of the decade; a level still below that attained at the height of the tourism boom in FY15. After recouping the lost ground due to COVID-19, the economy is projected to grow by 3% per annum between FY25 and FY30 as capacity utilization and profitability levels return to normal.

Private sector contracted by a massive 43% FY19-FY22 but is projected to regain the loss ground during the recovery by FY25. Figure 13 indicates the impact of the pandemic on the private sector. While the public sector is projected to remain largely unchanged—due to donor financing to maintain basic services—the brunt of the COVID-19 impact was felt by the private sector. In FY20, a large reduction of 21% was experienced and a further contraction of 23% was experienced in FY22. It had initially been hoped that the recovery would get underway in FY22, but this has provided unrealistic and a further private sector reduction of 6% is forecast. Overall, the total contraction in private sector output, primarily in the tourism economy, of 43% was experienced, but the projections suggest that the loss ground will be regained by FY25.

b EMPLOYMENT AND IMPACT ON HOUSEHOLD INCOMES

Demand for labor is anticipated to return with the recovery and expand in the 2nd half of the 2020s with favorable tourism growth and Compact renewal. The impact of the pandemic turned out to be less sever than originally projected, but over 1,244 employees are estimated to have lost their jobs. The labor market in Palau is comprised of two segments: the Palauan and foreign worker components. The Palauan segment has been observed to be largely fully employed with the excess demand fulfilled by foreign workers. With majority of the Palauan segment in the public sector, the impact of the pandemic was less severe than for the labor market as a whole. The projections anticipate the Palauan segment will recovery and return to full employment by FY24 and then due to the full employment constraint will cease to grow unless strong incentives are provided to induce former migrants to return, see Figure 14. In the case of foreign workers

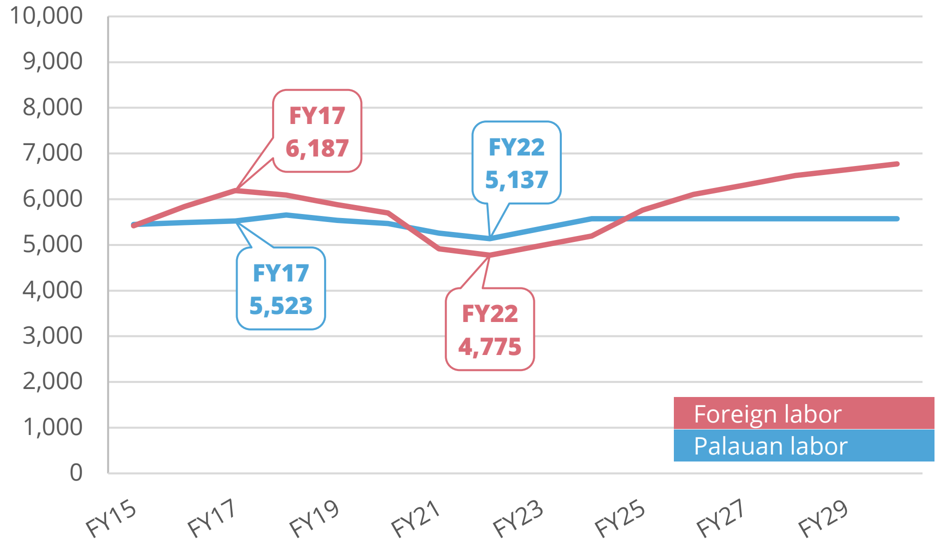


Figure 14 Employment of Palauans and foreign workers, FY15-FY30

demand for labor is not anticipated to return to former levels until the 2nd half of the 2020s. The growth and sustained recovery in the tourism sector, plus assumption of a favorable renewal of the Compact and an invigorated infrastructure program, generate strong growth for foreign labor above the former peak attained in FY17.

Household incomes are projected to contract significantly in FY22 with the loss of the CARES Act unemployment provisions but to slowly improve through FY25. In the case of household incomes, the domestic CROSS Act provisions and US CARES Act led to increased real household incomes and supported the economy during the 1st two years of the pandemic in FY20 and FY21. However, with the termination of the CARES Act unemployment provisions and further contraction in the economy in FY22, household incomes are projected to decline sharply by 20%. The decline in real household incomes also has in turn a significant negative impact both on demand and on the economy. From the low base in FY22 household incomes are projected to slowly recover with the re-emergence of tourism activity, see Figure 15.

C FISCAL IMPACT

The accumulated fiscal deficit resulting from COVID-19 is likely to reach $94 million and 39 percent of GDP. The fiscal outturn is shown in Figure 16. In FY20 a fiscal deficit of $25 million—10 percent of GDP—was attained and in FY21 the gap widened, and Palau ran a deficit $37 million, or 17 percent of GDP. With the delayed recovery now not assumed until FY25 a significant deficit of $21 million, 10 percent of GDP, is projected for FY22, which is only bought under control in FY24 and then after continuation of the budget appropriation cuts and austerity measures introduced in FY22. In total, an accumulated deficit of $97 million or 41 percent of GDP is likely to result during the FY20-FY23 period.

The event driven component of Palau's fiscal deficit due to payment of pandemic related health costs and mitigation programs is estimated to be $27 million during FY20-FY23. Analysis of the fiscal deficit can be decomposed in three major parts: (i) *event driven* costs of the health response and mitigation efforts, (ii) the *cyclical impact* of the loss of the tourism industry on

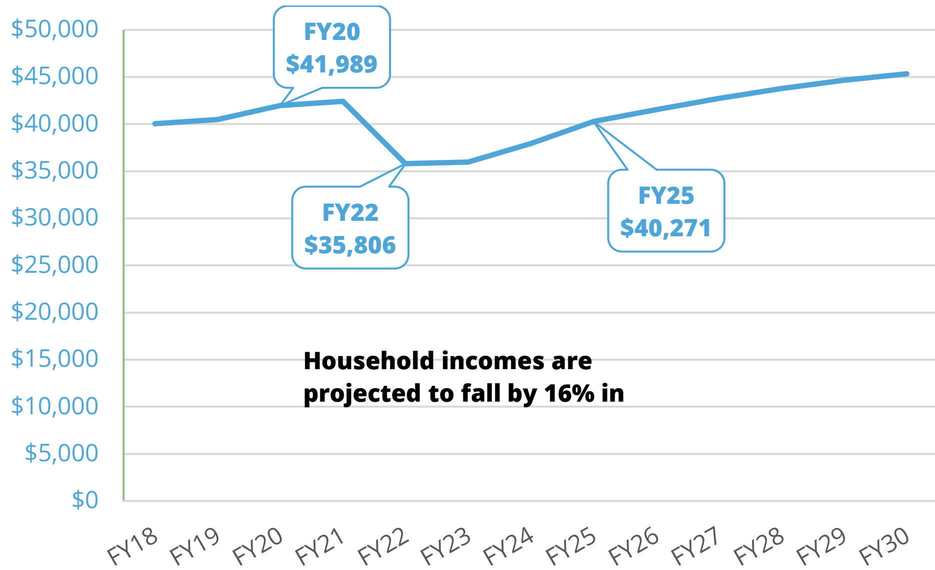


Figure 15 Household incomes, FY19-FY30, FY15 prices

government revenues, and (iii) an emerging *structural deficit*. Of a total projected deficit of $97 million over the four fiscal periods, FY20-FY23, the cost of implementing the CROSS Act is projected to be $27 million through the end of FY23. Additional costs of medical supplies and drugs were smaller than expected, while medical referral costs fell sharply reflecting travel restrictions. The size of the event driven part of the fiscal deficit item (i) above is thus largely limited to the implementation of the CROSS program.

The cyclical part of the deficit due tax and revenue shortfalls is estimated to be $31 million during FY20-FY23. Notably, the unprecedented size of the fiscal deficit is mitigated by the structure of Palau's fiscal account. About half of revenues are non-tax revenues representing

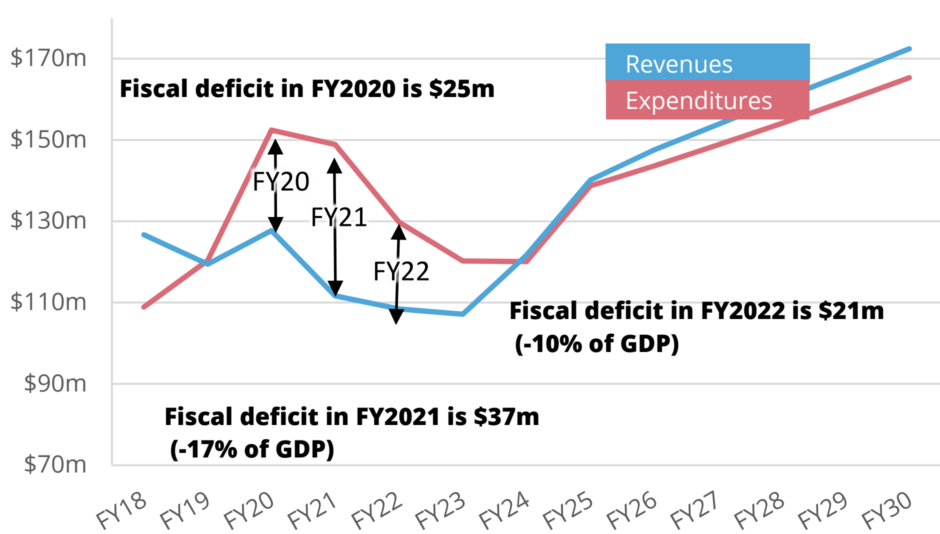


Figure 16 Government revenues and expenditures, FY19-FY30

grants, drawdowns from the COFA trust fund, fishing fees, and other fees and charges. These were all largely unaffected by the pandemic. The principal components of the tax revenues are the payroll tax, gross revenues tax, hotel room tax, PPEF, and import taxes. Total tax revenue fell by $5 million in FY20—about half of the original projections—and further losses of $11 million and $13 million are projected for FY21 and FY22 compared with FY19, respectively. Over the four-year FY20-FY23 period, tax revenues are projected to fall by $34 million; this represents the size of the *cyclical deficit*.

Palau's structural deficit is estimated to have grown to $36 million during the pandemic years, FY20-FY23. The major area of fiscal weakness has been in subsidies to SOEs and transfers to the Social Security and Civil Service Pension Plan. In the case of SOEs subsidies for power production have until recently been small and well managed. However, the continuing pandemic induced recession in Palau and recent surge in international oil prices due to recovery from the pandemic elsewhere and the war in Ukraine, have led to large unsuitable subsidy payments to PPUC for power production. International conditions in the global energy market, as many democracies transition away from use of Russian oil, are unlikely to change in the near-term, and Palau needs to adapt. In the case of water and wastewater Palau has yet to implement a full cost recovery tariff and sales are twice the cost of production. In the case of Social Security, and after a participatory workshop in November 2021, reforms have been drafted and are awaiting consideration by the OEK. However, until such time as action is taken, Palau will need to continue payment of unfunded supplemental benefits. In the case of CSPP, a similar program of reforms is underway, but adjustments will need to be more far reaching and deeper than SS, if the CSPP is to become financially sustainable and able to live on its own without government infusion of cash. Adding together the cost of subsidies and transfers to government SOEs and agencies, the third element of the deficit due to structural weaknesses is estimated to be $36 million.

d FINANCING

National government cash reserves, combined with resources from sub-Program 2 of the ADB Policy Based Loan (PBL), are projected to provide sufficient financing to support government operations until full recovery has been achieved in FY25. In Figure 16 above the figure indicates that in FY24 revenues match expenditures and fiscal balance is restored. However, the fiscal balance does not account for financing items such as debt repayment and thus does not provide a full picture of government's cash flow position. Figure 17 indicates the level of government cash balances at the end of each fiscal year and the inflow of borrowed funds from the ADB for deficit financing. The figure indicates that during the FY20-FY22 period the government is projected to borrow $90 million comprised of three loans from the ADB: (i) The $15 million facility under the DRP (Disaster Resilience Program) in FY20 (ii) $20 million under the CPRO (COVID-19 Pandemic Relief Option) in FY20, (iii) $25 million in FY21 under the ADB subprogram-1 of the RISES (Recovery through Improved Systems and Expenditure Support Program) and a further $30 million under subprogram-2. Figure 17 indicates that after allowing for debt repayment and after fiscal balance is restored in FY24, Palau is projected to hold cash reserves of $22 million. However, while fiscal balance has been restored, financing is still required due to debt repayment obligations and the cash position is deteriorating. Should the Palau economy follow the track outlined in the *Outlook,* this implies a fiscal correction may be required subsequent to the full recovery projected for FY25.

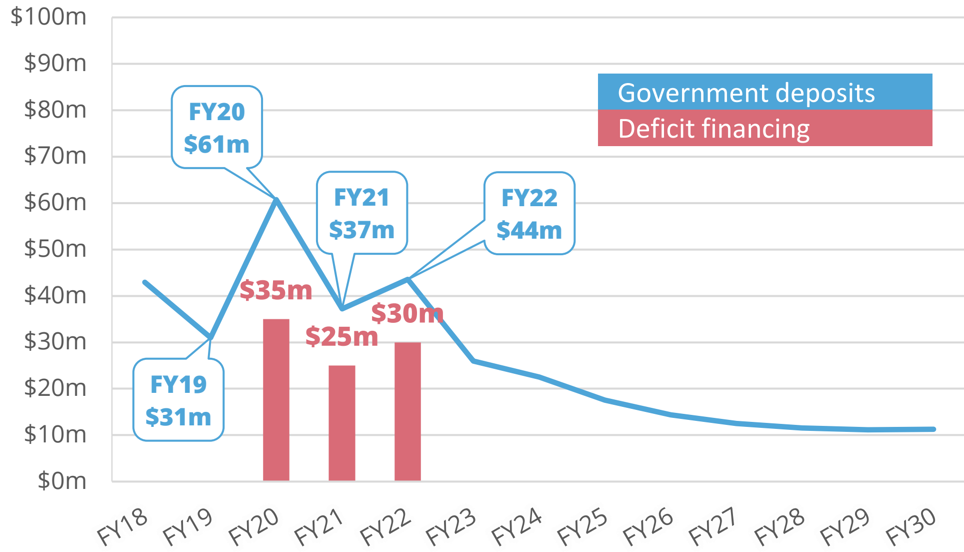


Figure 17 Government deposits, FY19-FY30

e EXTERNAL DEBT

External debt/GDP ratio is projected to rise rapidly to 93% of GDP to finance the impact of the COVID-19 global pandemic, but then decline sharply to 56% in FY25 as the economy recovers. As a result of the COVID-19 global pandemic the need for external borrowing has risen rapidly sharply, see Figure 18. External debt rose from a level of 33 percent to GDP in FY19 to 56 percent in FY20, to 78% by the end of FY21 and even higher to 93 percent in FY22. While the rise in the debt/GDP ratio is projected to reach record levels, much of the increase is due to the decline in the denominator, GDP. After peaking in FY22, the ratio declines rapidly to 56 percent by FY25 as the economy recovers. From this point forward debt/GDP is projected to fall steadily to 36% of GDP by FY30 on the assumption that Palau incurs no further external debt. While much of the

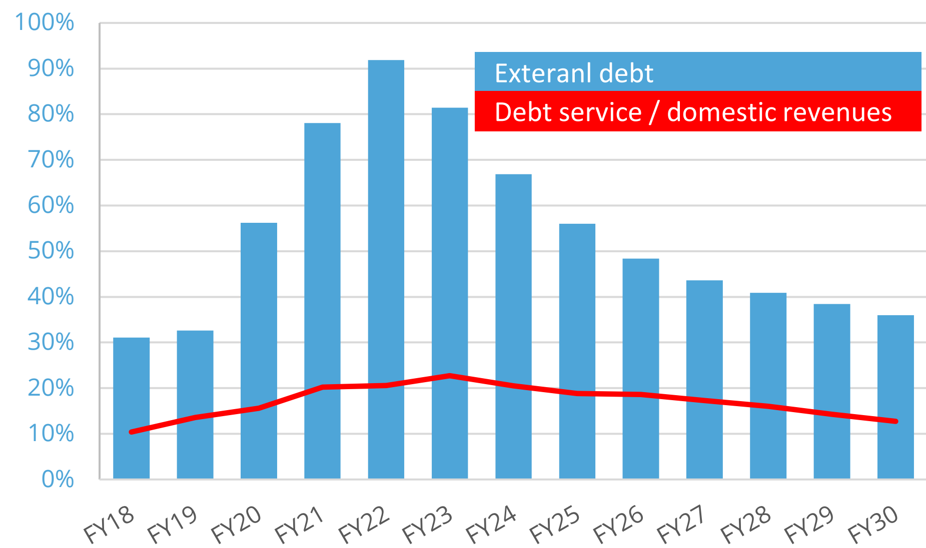


Figure 18 External debt % GDP, and debt service % government revenues

rise in external debt, $90 million, is due to COVID-19, Palau has also borrowed or is committed to borrow for other purposes: the Taiwan HLDP loan of $15 million, an additional ADB PBL for PPUC of $10 million, and $15.4 million for the second internet fiber project. In all, recent additional non-COVID borrowing totals over $40 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 23% in FY23 and then is projected to drop back to 13 percent by the end of FY30. Removing the SOE component from legacy borrowing, national government debt service is projected to max out at 14% of general fund revenues in FY23 and to decline thereafter. 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 the concessional nature of the debt, pose a high risk of debt stress. Rather, it will require careful monitoring including stress tests, especially after the period of low interest rates appears to be coming to an end with the recent hikes in the US by the US Federal Reserve reflecting mounting fears of sustained inflationary pressure.

2 Impact of policy changes under consideration by the government and sensitivity of the projections to variation in assumptions

i The Impact of an Increase in the Minimum Wage

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

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

Assumptions: wage bill is estimated to rise by 17%: Based on the assumed increase in minimum wages being applied to all wage earners, it is estimated that the total wage bill for the economy will rise by 17%, see Figure 19. This wage increase in turn will increase the prices of items consumed in Palau and the cost of tourism. In the case of consumers, the model projects that consumer prices will rise by 6.1%, and in the case of tourism the price impact is estimated to be larger at 11%. The difference between these projections reflects the use of labor in production and the import intensity of household and tourist expenditures. Clearly, the greater the use of labor, the greater will be impact on inflation. The model further assumes that producers pass on the cost of inflation[7], which amplifies the impact of wage inflation on prices. The model also draws on an investigation of the impact of price increases on tourism demand in the south

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

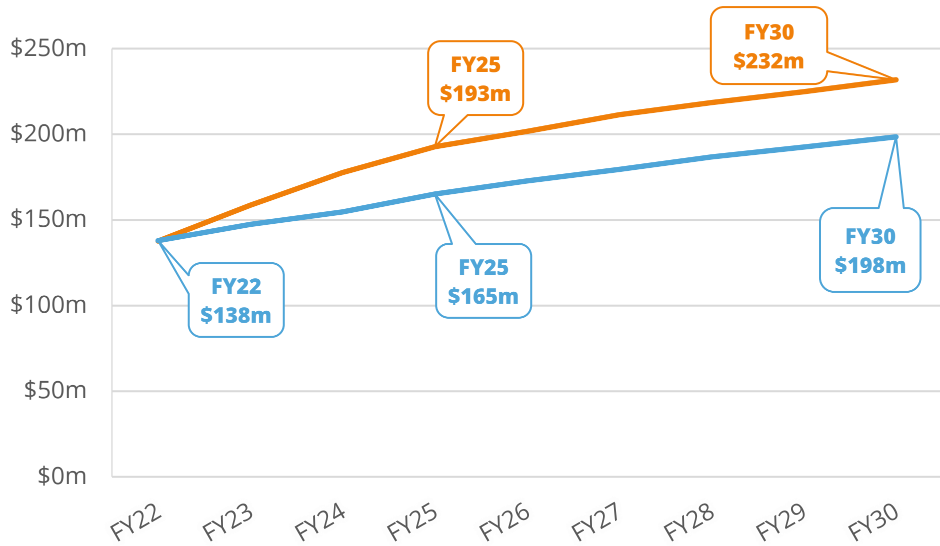


Figure 19 Total Wage bill before and after minimum wage increase: FY22-FY30

Pacific nations of Fiji, Cook Islands, Samoa, Tonga and Vanuatu[8]. The study estimates that for every 1% increase in prices visitor arrivals will fall 0.61%. This *price elasticity of demand* is used in the current impact estimates, although the tourist markets for Palau are different to those in the South Pacific.

GDP is projected to fall by 1.5% and visitor arrivals by 6.6% due to the increase in minimum wages. Real household incomes are projected to rise by 5.9% by FY30. Figure 20 indicates the

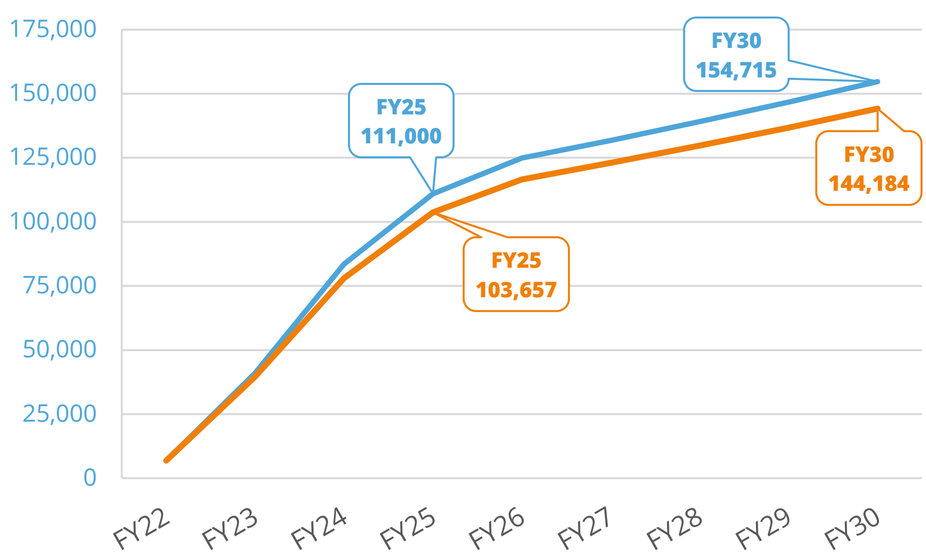


Figure 20 Visitor arrival projections with and without minimum wage increase: FY22-FY30

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

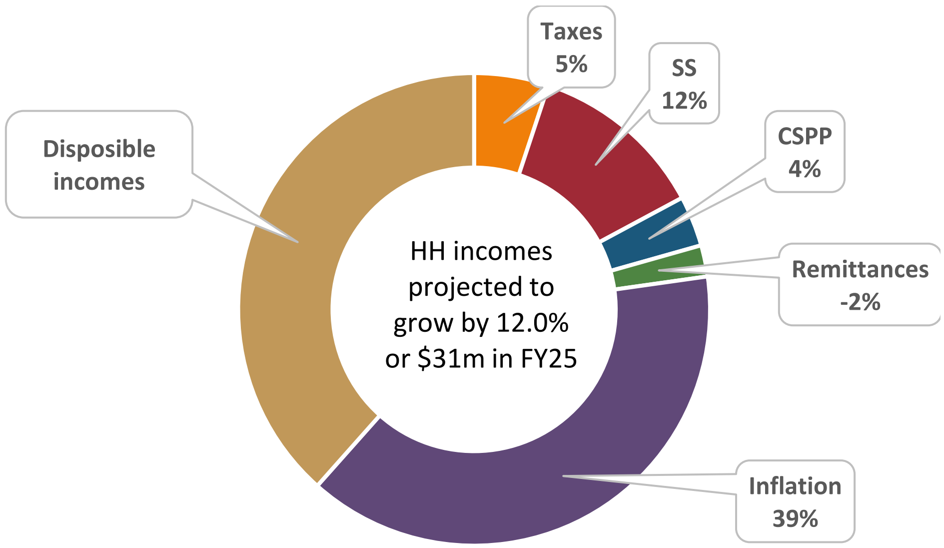


Figure 21 Allocation of benefit of minimum wage increase, FY30

impact on visitor arrivals and suggest that by FY25 visitor arrivals will be 6.6% lower and 7,343 less than in the base case without the minimum wage. The impact of the reduction in visitors plus other macroeconomic affects, including additional demand due to higher wages but offset by the impact of inflation, suggest the economy is likely to be 1.5% lower after the minimum wage increase. While nominal wages are projected to rise by 17% in FY25, this is offset by a series of increases in taxes, social contributions, reductions in overseas remittances of foreign workers and inflation. Figure 21 indicate the share of the increase in minimum wages arising from these categories: 21% of the benefit is paid on taxes and social costs, -2% on remittances, and a large 39% is eroded by inflation. Due to the projected contraction in the economy under the minimum wage scenario the demand for foreign workers falls and more than offsets the increase in outward remittances due to higher wages. After deduction of these costs wage earners are left with an increase of 38% in disposable income out of the original increase in the minimum wage.

Impact on fiscal position is large but offset by growth in taxes. The impact of the minimum wage increase on the fiscal deficit is shown in Figure 22. The impact of the payment of higher payroll costs is clearly negative as expenses rise although they are offset by increase in tax collections. Of the increase in government's wage bill of $7.8 million in FY25, tax collections (wage taxes and PGST) will have covered $3.5 million of the increase. It may be noted that application of the minimum wage increase solely to the national government will leave the increase in payroll cost untouched but will be only offset by increased wage tax collections of civil servants, estimated to be $0.7 million. Application on the minimum wage only to civil servants would thus be far more costly. By FY25 the fiscal position is projected to have deteriorated by $4.1 million and the total accumulated deficit to have risen by $6.1 million.

The Social Security system and Civil Service Pension Plan are significant beneficiaries of an increase in the minimum wage. Of special note is the impact of the minimum wage on the Social Security system and Civil Service Pension Plan. In FY25 contributions to the SS are projected to rise by $3.9 million or 16.8%, and over the period FY23-FY25 to have accumulated by $8.8

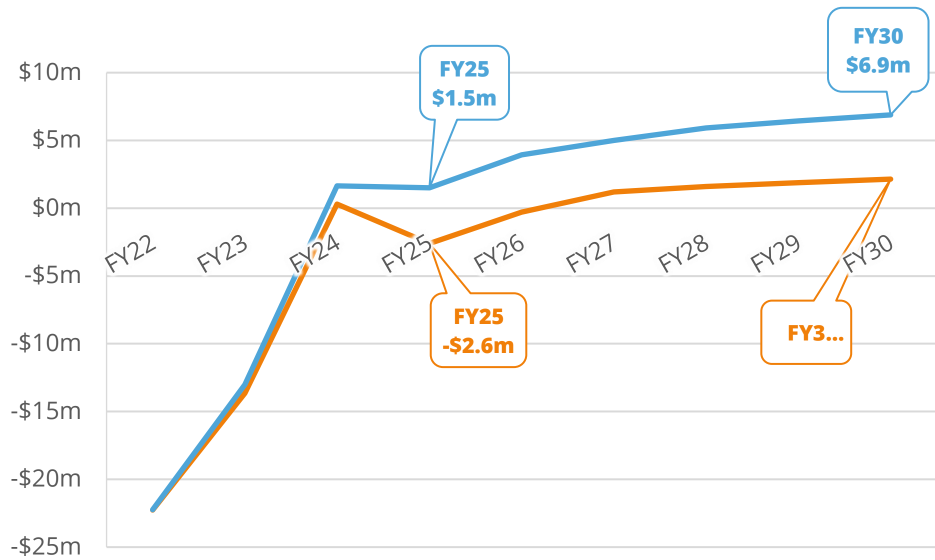


Figure 22 Fiscal deficit with and without minimum wage increase: FY22-FY30

million. For a system under financial stress these increases are welcome, but it should be noted that in the process of time, the increase in contributions will be paid out in benefits to members of the program. Similar increases, albeit of lesser magnitude are projected for the CSPP, but make little difference to the projected collapse of the system.

ii Delay in the Timing of the Economic Recovery

Under the weak recovery scenario fiscal adjustment or additional donor financing would be required. In accord with the requirement of the fiscal responsibility law this section undertakes sensitivity analysis on the projected level of recovery. While the projected recovery in the *Update* assumed a conservative trajectory, in this section the implications of a further delay in the return to former levels of visitor arrivals is assumed. It is projected that in FY23 visitor numbers only attain a level of 22,750 rising to 58,500 in FY24, 88,750 in FY25, and thereafter converge with the base recovery projection. Figure 23 provides a comparison of the two projections. The weak recovery scenario while pessimistic would imply not only that demand for travel remains weak, but that supply constraints remain in the recruitment of labor to replenish foreign workers that have been repatriated, and also that airlines place a lower priority on restarting former routes to Palau from Korea, Taiwan, Hong Kong and Japan. The fiscal implications of the further delay in recovery are indicated in Figure 24. By FY24 government deposits are falling rapidly and in FY25 turn negative implying the need for additional financing. By FY25 government cash reserves have fallen by $19 million compared with the base trajectory and Palau may need to consider further donor supported funding.

iii Supplemental Budgets and Restoration of the FY22 Budget Cuts

Projections assume the 10% reduction in the FY22 budget appropriation will remain in force. The projections prepared with the economic model are based on the assumption that the FY22 budget Act RPPL 11-12 will be executed in accordance with the law, whereby the full budget was authorized but only 90% was appropriated. This implied a 10% budget cut in departmental expenditures. Given the reduced prospects for a speedy recovery, the *Update* has been prepared

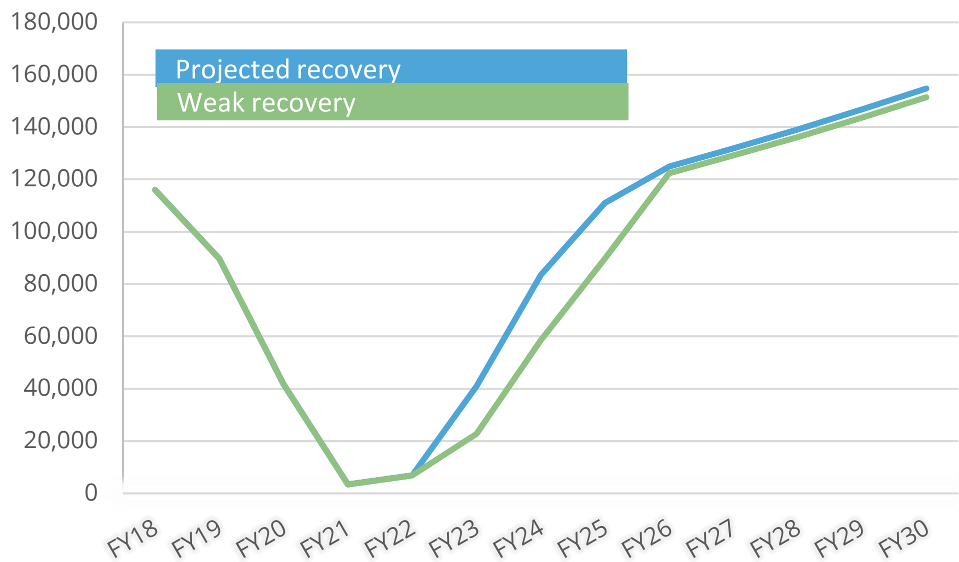


Figure 23 Visitor arrivals, projected and weak recovery, FY18-FY30

on the assumption that these cuts will remain in place in FY23 and that in FY24 no catchup for inflation will be permitted. The projections for FY25 and onwards assume full inflation catchup since the start of the pandemic. However, if the full authorization for FY22 is appropriated and maintained into FY23 there will be a corresponding erosion of the fiscal position of $10 million adding a corresponding amount to Palau's financing needs.

iv Subsidies and Transfers to SOEs and PFIs

Subsidies and transfers to SOEs and PFIs has been a major source of fiscal risk. The current set of projections include the following assumptions:

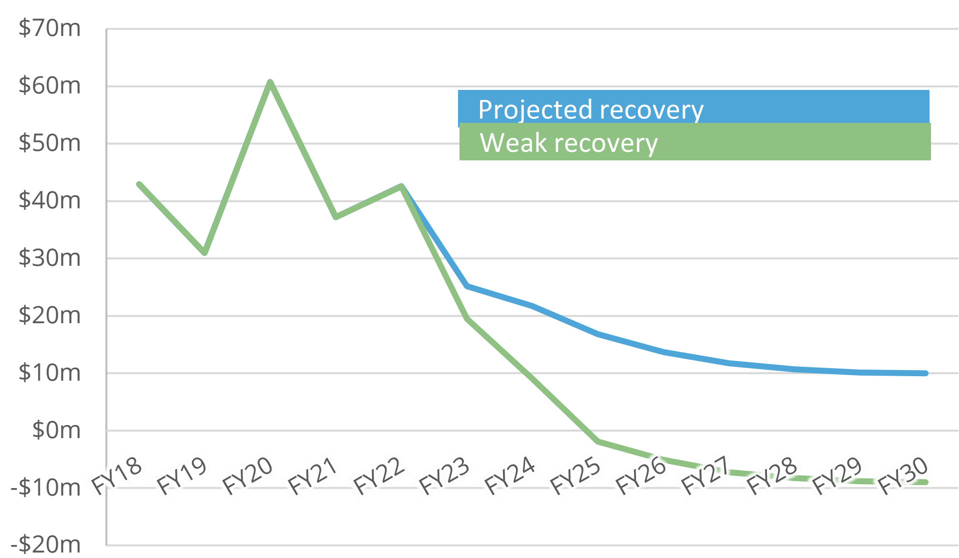


Figure 24 Government deposits (cash flow), projected and weak recovery, FY18-FY30

1. The government will continue to support water and wastewater operations of PPUC through a $2.1 million annual transfer to cover operating losses.
2. No further subsides for power will be legislated by the OEK and the full-cost recovery tariff will be implemented without adjustment.
3. The government will maintain the current level of transfers to SS through FY23 at which time the SS reform bill is assumed to be passed.
4. An annual transfer of $2.5 million will be made to the CCSP indefinitely.

These elements of expense are subject to a high degree of variability, and overtime would have a significant impact on the fiscal outcome and need for finance.

v KOROR STATE AND FINANCING NEEDS

As the pandemic has dragged on and the outlook for recovery has been pushed back, Koror State Government (KSG) is facing a deteriorating fiscal position. At the start of the pandemic Koror state was in a favorable position having built up cash reserves from previous fiscal surpluses to over $20 million. In order to address the poor outlook, with fees from the Rock Islands making up close to 70% of revenues, the state initiated a series of adjustments. However, with a similar 70% of expense devoted to payroll, options have been limited with the state running annual deficits of close to $5 million. KSG projects by the end of CY2022 the level of reserves will have fallen to $5 million leaving little room for further financing of services should the recovery be further delayed, or unforeseen events negatively impact the remaining revenues.

KSG submits a three-part request to the national government. To address the situation KSG has submitted a request to the national government for a $15 million loan facility timed to coincide with the national government's request to the ADB for $30 million from Sub-program-2 of the RISES program. The request to the national government includes:

1. Creation of fiscal reserve to act as a resource for financing of cyclical events such as COVID-19 or other natural disasters. The request for $15 million would help the state rebuild the lost resources due to COVID-19 and establish guidelines on the use of the funds.
2. Request for technical assistance for Public Financing Management reforms:
    a. Reform of accounting and financial functions
    b. Revenue and resource management, and
    c. Expenditure review of departmental functions, payroll, etc.
3. Modification to the tax reform legislation to enable KSG to register for PGST. This action would benefit both the state in generating savings or refunds from PGST input tax and the national government in collection of PGST on Rock Island fees. The option to increase Rock Island fees to cover the increased PGST cost while easy to implement is not recommended. Rock island fees are effectively economic rents levied on a scare natural resource and should be determined in relation to the scarcity value of the resource rather than input costs.

The probability of the need for further fiscal adjustment is on the downside. The impact of the minimum wage, timing of the economic recovery, restoration of budget cuts, financing of Palau's SOEs and PFIs, and request for financing from KSG suggest the risk of the need for fiscal adjustment or additional financing is on the downside. The appropriate response to any fiscal deterioration will depend on its origins. If the source arises from the cyclical downturn due to COVID-19, such as funding for Koror State then a further request to development partners for additional financing would be appropriate. However, if the source arises from additions to the structural deficit, such as premature reinstatement of the recent budget cuts or subsidies and transfers to the SOE and PFI sector, then fiscal adjustment would be the appropriate response.

Part C Current and Planned Adherence to the Principles of Fiscal Responsibility

The Principles of Fiscal Responsibility state in law are:

1 Principles of Fiscal Responsibility

The principles of Fiscal Responsibility are defined in the Fiscal Responsibility and Debt Management Act (FRDMA) §105 as:

A. The government shall pursue its policy objectives in accordance with the following principles of responsible fiscal management:

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

B. Notwithstanding sub-section A above, the Government may depart from the principles of responsibility provided the:

   1. departure is temporary;
   2. President states the reason for the departure;
   3. President indicates the period of time required to return to adherence to the principles; and
   4. Should any such circumstances arise which force departure from these principles during the fiscal year, they must be timely disclosed in accordance with the provisions of the FRDMA.

As required under law the President is required to submit to the OEK at the start of each administration or as circumstance dictate a Fiscal Strategy that outlines Palau's fiscal goals and policies and that clearly demonstrates adherence to the principles of fiscal responsibility. The following discussion refers to the President's Fiscal Strategy and adherence to the principles outlined in the Economic and Fiscal Update. Since current fiscal policies have been contrary to the principles of fiscal responsibility, due to the impact of COVID-19, the Economic and Fiscal Update is required to indicate how and when Palau will return to compliance with the principles.

i *MANAGE OPERATING EXPENDITURES OVER THE MEDIUM-TERM WITHIN OPERATING REVENUES AND IN RELATION TO THE RATE OF GROWTH OF THE ECONOMY*

The COVID-19 pandemic forced an unavoidable departure from the first principle of fiscal responsibility. Analysis of the impact of the COVID-19 pandemic provided earlier in the *Update* indicates the unavoidable need to increase expenditures even as the revenue base contracted. The adoption of these policies did not represent any lack of responsible economic and fiscal management, but rather the need to maintain government operations and to pay for a significant mitigation effort to protect affected businesses, households, and affected employees from dire financial hardship. While these actions resulted in a departure from the first principle, they helped maintain economic and financial stability and social well-being within the nation during a time of unprecedented crisis.

Return to Fiscal Responsibility will be restored as soon as the economic recovery has been established. As stated in law, departure from the principles is permitted provided the departure is temporary and the President indicates the period of time required to return to adherence to the principles. The departure for the principles is intended to last only as long as the pandemic lasts and only until the recovery of the economy is complete. However, the prior fiscal analysis indicates that there remains considerable uncertainty over the period of time that will be required to restore full adherence to the principles of fiscal responsibility. Fiscal policy will be managed on a conservative basis reducing non-essential expenditures to keep financing needs to the minimum and to thus reduce the burden of debt repayment in future periods. At the same time, all efforts will be undertaken to promote a rapid recovery of the economy without jeopardizing the nation's health in the short-run and without threatening our nation's pristine environment in the long-run.

ii *MANAGE NET CAPITAL AND FINANCIAL ASSETS, INCLUDING THE COFA TRUST FUND, TO ACHIEVE RISING REAL NATIONAL NET WORTH OVER TIME*

Real net national wealth has fallen significantly in recent years and especially since the onset of COVID-19. The earlier discussion indicated the declining share of capital expenditures or public infrastructure as a share of GDP. Further the onset of COVID-19 has required significant incurrence of debt and hence reduction in net financial assets. To address these issues the government has prepared a National Infrastructure Investment Plan to identify and list priority investments. Funding for infrastructure has in the past relied on both grants and loans from bilaterals and multilateral donors. These relationships will be maintained and strengthened. With the on-going Compact re-negotiations funding for infrastructure will play a key role in Palau's development. As Palau is now classified as a "high" income country by the World Bank new sources of finance will be needed for delivering public infrastructure and related services. These include the development of Private Public Partnerships and Palau has recently issues a PPP policy statement. The domestic capital market has not been developed and affords an opportunity to issue bonds and debt instruments. This will require a credit rating with one or more of the international ratings agencies but will require careful planning. Finally, the COFA Trust Fund is an important element of national wealth but was designed as a sinking fund. A key objective is to increase contributions to achieve perpetual fund status possibly as part of the Compact re-negotiations. While recent years have seen a significant decline in net national wealth, restoration will be a long-term process.

iii MANAGE DEBT PRUDENTLY

External debt has been well managed in Palau, but recent financing needs to mitigate the impact of COVID-19 have resulted in high levels of debt to GDP. Until recently and before the COVID-19 pandemic Palau had adopted a cautious and prudent external debt policy; debt to GDP was in the 30% range. However, in the period preceding COVID-19 Palau had incurred a significant increase in debt and the pandemic itself resulted in a further substantial increase; debt to GDP is forecast to rise to nearly 90%. The passage of the Fiscal Responsibility and Debt Management Act has laid the groundwork and framework for the management of external debt and establishment of an institutional capacity to monitor, to assess the incurrence of new debt, and to conduct a periodic debt sustainability analysis (DSA). A debt management policy statement has been issued and outlines the framework for debt management. A debt management unit has been created and is being established to:

12. provide technical review on every proposed borrowing and every proposed issuance of a sovereign guarantee, in particular, assessment of the various risks involved, terms and conditions of borrowing, and debt-servicing strategy;
13. assist the Minister to develop and maintain a debt management policy for consideration by the President;
14. develop and utilize a project appraisal and approval framework for the assessment of loan-financed project and to provide subsequent advice to the Minister; and
15. undertake a periodic DSA to support the debt management component of the Annual Economic and Fiscal update as set forth in the FRDMA and render its opinion or advice thereon to the Minister.

iv MANAGE THE REVENUE REGIME TO BEST FIT THE STRUCTURE OF THE ECONOMY, TO PROVIDE FOR AN EQUITABLE ALLOCATION OF TAX BURDENS, AND TO ALLOW FOR PREDICTABILITY OVER TIME

Tax reform has been a key achievement of the administration's fiscal reforms. The passage of the Palau Goods and Services Tax, RPPL No. 11-11, marked a milestone in Palau's history. The key elements include:

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

The key challenge for successful implementation of the tax reform is the tight schedule requiring the reforms be fully ready for implementation by the end of 2022. In accordance with law a *PGST Steering Committee* has been created and initial meetings convened. A fulltime tax advisor has been recruited to drive the process and regulations are being drafted. Additional support has been obtained from the Pacific Financial Technical Assistance Centre to help in establish a modern tax administration with legal support. The Bureau of Revenue and Taxation will require implementation of modern business practices and training in the new tax regime and software. The private sector will also need to prepare for the introduction of the new taxes, filing and reporting. Reforms to the customs Act are also underway to improve border coordination and trade facilitation with support from UNCTAD and UNDP. Asycuda a modern, industry standard, risk-based, IT customs administrative system and developed by UNCTAD will be implemented over the next 15 months and integrated in the tax reform process. A review of the current Tax Information System (TIS), used for the legacy tax regime, has been undertaken with recommendations that it be upgraded with extensions to enable a basic implementation of the reforms by end of 2022. However, the current TIS was not considered to be a robust system for long-term support of our modernized tax regime. A procurement process will be established, and an RFP developed to specify the long-term needs of the tax regime and modern tax administration. The most cost-effective qualifying solution will be selected.

v MANAGE RESERVES AND INSURANCE COVERAGE TO OFFSET CYCLICAL VOLATILITY, THE COSTS OF NATURAL DISASTERS, AND THE IMPACT OF CLIMATE CHANGE

The General Fund Reserve is being replaced with a Cyclical Reserve and a Climate Resilience Fund. As part of the FRDMA, Palau has reformed the prior general fund reserve and introduced two new special funds: (i) the cyclical reserve fund, and (ii) the climate resilience fund. The cyclical reserve will be funded with 2 percent of domestic revenues until 3 months' worth of domestic revenues, averaged over the prior 3 fiscal years, have been accumulated after allowing for cash management (liquidity) needs. Once funds have attained the target, contributions will cease. Withdrawal of funds will be permissible only if annual domestic revenues have fallen more than 5 percent below budget levels. The climate resilience fund will be earmarked to address climate related events and natural disasters. A smaller rate of contribution of 1 percent of domestic revenues will be set aside into the fund until a target is reached specified in regulation. Withdrawal of funds is permissible only after the President declares a state of national emergency.

vi MANAGE THE NON-PRIMARY GOVERNMENT PUBLIC SECTOR PRUDENTLY, INCLUDING ENSURING STATE OWNED ENTERPRISES AND PUBLIC FINANCIAL INSTITUTIONS ARE MANAGED TO DELIVER SERVICES ON AN EFFECTIVE AND FINANCIALLY SUSTAINABLE BASIS

The main area of fiscal weakness lies in management of the State-Owned Enterprises and Public Financial Institutions. While the Telecom sector, PNCC, BSCC, and NDBP have been financially well managed and operate on a commercial basis at full cost recovery, the PPUC in both the water and power divisions has failed to operate on a fully commercial basis. Water and waste-water operations operate far below full cost recovery, require subsidies and have failed to meet the objectives of the ADB Water Improvement Sector Program loan. Reforms have also been implemented in the power sector with support from the ADB and a new tariff has been introduced. However, after the recent hikes in world energy prices during FY22 large subsidies have been authorized, thereby undermining implementation of the needed reforms. The subsidies are highly inefficient and subsidize not only targeted low-income residential customers (10% of consumers) but also subsidize unintended operators in the private and public sectors. During the previous administration an SOE policy statement was issued to establish a guidance framework for the SOE sector. This will be re-issued in a legislative format for consideration by the OEK as an SOE Reform law.

A recent actuarial assessment of the Republic of Palau Social Security Administration established that as a result of recent awards of supplemental benefits, RoPSSA was likely to collapse within 10 years without reform. With support from the ADB a framework was developed to guide the reform process. A participatory workshop held in November 2021 resulted in building consensus for reforms to place RoPSSA on a financially sustainable path. Legislation has been drafted and submitted to the OEK.

***The financial position and potential near-term collapse of the Civil Service Pension Plan poses a huge fiscal risk to Palau*.** It has long been established that the CSPP is in greater financial distress than RoPSSA and is projected to collapse within 5 years without reform or additional transfers. It is the intention of the administration to conduct a parallel process to the RoPSSA workshop to establish a consensus on reforms to place the CSPP on a financially sustainable path. It is anticipated that deep structural changes will be required, including a move away from the current defined benefit approach toward a defined contribution approach. A participatory process will be undertaken to develop a set of reforms to restore long-run financial sustainability to the CSPP and will be drafted into legislation for submission to the OEK.

vii MANAGE FISCAL RISKS AND CONTINGENT LIABILITIES PRUDENTLY

There are a variety of areas that pose significant and special fiscal risks to Palau that require careful monitoring under the FRDMA. The following provides a list and a brief discussion of areas that will be developed in future issues of the Annual Economic and Fiscal Update as Palau builds capacity in the execution of the law.

vi. ***Macro-economic volatility***: The Palau economy is subject to a high degree of economic volatility. In the last 20 years not including the recent COVID-19 global pandemic there have been 9 years of negative growth and 6 years experiencing a greater than 5 percent increase or decrease in GDP. Such volatility has significant impact on tax revenues and provision of public services. Principle 5 of the fiscal responsibility framework provides for the creation of a cyclical reserve fund to mitigate the impact of fiscal risk.

vii. ***Financial sector crisis***: The financial sector is comprised of private and public sector entities. Public sector financial institutions pose a special fiscal risk and have been separately identified under principle 6. In the past the banking sector has precipitated at least one period of severe financial crisis but is now well regulated under FDIC provisions (for the US bank branches) and the Financial Institutions Commission (for all banks). An annual assessment of the banking sector concerning financial soundness, capital adequacy, non-preforming loans etc. is undertaken by the FIC.

viii. ***Change in debt interest rates***: Much of Palau's external debt has been incurred on concessional terms with low interest rates. However, a considerable portion is on variable international rates based on LIBOR plus a percentage. The recent rapid acceleration in inflation, shift in monetary policy and increase in US and other international interest rates indicate the need for the conduct of debt stress tests. The external debt management unit will develop a stress testing methodology for external debt as well as the standard DSA.

ix. ***Demographic changes***: The population of Palau is comprised of Palauans and a significant number of foreign workers primarily from the Philippines and Bangladesh. While the population of Palauans has remained largely static, under the provisions of the Compact, Palauans have the right to live and work in the U.S. Should these conditions change there is potential for significant fiscal impact. Maintaining good relations with Palau's neighbors and monitoring human and worker's rights will provide a safe and secure environment for foreign workers and ensure stability in the supply of foreign labor. The Palau economy is highly dependent on foreign workers on which the tourism economy and SS system depend. While demographic change is generally long-term in nature it requires careful monitoring.

x. ***Human trafficking***: Palau was recently downgraded to the Tier 2 watch list in the *2021 Trafficking in Persons Report*, prepared by the United States Department of State's Office to Monitor and Combat Trafficking in Persons. The report highlights the disproportionate impact of trafficking on women and girls. The government is committed to developing an action plan toward ensuring Palau's compliance with minimum standards for eliminating trafficking of persons and avoid any possible implications that may negatively affect eligibility for US Federal or other donor funding.

xi. ***Natural disasters***: Palau is subject to periodic and significant climate events and natural disasters. In the last 10 years there have been two major Typhoons and one el Nino draught. Under principle 5 of the fiscal responsibility framework Palau has created a climate resilience fund with a target of 3 months of domestic revenues ($19 million) and has subscribed to the ADB Disaster Resilience Program with immediately available loan funding of up to $20 million. Palau is projected to be subject to "significant," albeit periodic, climate events that might require greater funding and additional insurance options need to be examined.

xii. ***Government guarantees***: Most loans incurred on behalf of the public entities from institutions like the ADB are incurred by the sovereign government and are thus not guaranteed. However, there remain a small number, but important volume of lending, to the SOE sector such as the RUS loan to the PPUC.

xiii. ***Government litigation and lawsuits***: These are generally of an unknown nature and cannot be forecast in advance. However, when such events occur and are known they need to be disclosed.

xiv. ***Public private partnerships and/or private financial initiatives***: Earlier discussion in this section indicated the intent of government to utilize PPPs as a financing modality for the delivery of public infrastructure and related services. A PPP policy statement has been issued for outlining government's PPP framework. Part of the initiative includes the establishment of a PPP monitoring unit, which will be responsible for an assessment of PPP associated fiscal risk.

xv. ***Environmental degradation***: Palau devotes special attention to its environment given the special attributes immeasurable value of its natural resources. To preserve its environment Palau has declared a marine sanctuary over much of its EEZ and prohibits commercial fishing in 80 percent of its ocean waters. The nation's tourism industry is, unsurprisingly, highly dependent on the quality of its environment. Degradation of the environment is thus a key area of fiscal risk to be closely monitored.

xvi. ***Local government and/or developed administrations***: Transfers to state governments have grown strongly with a near-doubling in the last 10 years. This poses a significant fiscal risk. The Fiscal Strategy released by the President indicates the intent to implement a rules-based approach to the funding of the state governments to moderate the recent rapid acceleration in funding. The issue of the vulnerability of Koror state to fiscal risk arising from the COVID-19 crisis has been outlined above. The state has proposed establishment of a reserve fund which will provide an important element of a strategy to reduce fiscal risk.

xvii. ***State owned enterprises and public financial institutions***: The SOE and PFI sectors are a special area of fiscal risk and have been included under principle 6 of the fiscal responsibility framework. The former SOE policy statement will be incorporated into law with the requirement for the establishment of an SOE monitoring unit to address SOE performance and risk. It is likely the PPP monitoring unit and SOE unit will be combined into a single body.

FRDMA Principles: Compliance and Performance Matrix: Linkage to FS Policy Actions

	Principles	Status	Return to adherence	Linkage to Fiscal Strategy policy actions
1	Manage **operating expenditures** over the medium-term within operating revenues and in relation to the rate of growth of the economy	Not in adherence due to COVID-19	Economic and fiscal recovery achieved; balanced budgets restored [est. FY24/FY25]	FS policy action 1 FS policy actions 8-11 FS policy action 15
2	Manage **net capital and financial assets**, including the COFA Trust Fund, to achieve rising real national net worth over time	Not in adherence net national wealth declined due to COVID-19; net capital fell pre-COVID-19	Economic and fiscal recovery achieved; NIIP implemented [est. FY24/FY25]	FS policy actions 2-3 FS policy action 6 FS policy action 16-17 FS policy action 19-21
3	Manage **debt prudently**	Not in adherence Debt/GDP has risen rapidly; will decline with sustained economic recovery	Economic and fiscal recovery achieved; balanced budgets restored [est. FYFY25/26]	FS policy actions 1-2
4	Manage the **revenue regime** to best fit the structure of the economy, to provide for an equitable allocation of tax burdens, and to allow for predictability over time	Approaching adherence Tax reform signed into law & Implementation pending	End of CY22	FS policy actions 3-5 FS policy action 7 FS policy action 10 FS policy action 23
5	Manage **reserves and insurance coverage** to offset cyclical volatility, the costs of natural disasters, and the impact of climate change	Approaching adherence Minister of Finance to establish reserve funds	End of FY22	FS policy action 18 FS policy action 22
6	Manage the **non-primary government public sector** prudently, including ensuring State Owned Enterprises and Public Financial Institutions are managed to	Not in adherence SOEs and PFIs have not been managed prudently	Awaiting SOE Executive Order to be passed into law and effort of SOE Unit [est. 3-5 years]	FS policy action 12-14

	Principles	Status	Return to adherence	Linkage to Fiscal Strategy policy actions
	deliver services on an effective and financially sustainable basis			
7	Manage **fiscal risks** and contingent liabilities prudently	Deemed in adherence Formal analysis to be undertaken on all fiscal risks	Deemed in adherence as of FY22	FS policy action 7 FS policy action 21 FS policy action 24

Appendix 1 Economic and Fiscal Forecasts as required under the Fiscal Responsibility Law RPPL 11-13

	FY21	FY22	FY23	FY24	FY25
Per Capita Income measures					
GDP current prices, $ million	218.0	219.3	254.6	293.2	327.9
Population	17,048	17,248	17,442	17,637	17,648
GDP per capita $	12,790	12,714	14,597	16,625	18,583
GNI per capita $	13,859	14,206	15,954	17,872	19,826
GNDI per capita $	15,641	15,844	17,156	19,239	22,084
National accounts					
GDP, at constant FY2015 prices, $ million (ave. GDP(P) a	**220.6**	**212.6**	**240.1**	**268.9**	**292.2**
GDP, % growth	**-13.2%**	**-3.6%**	**12.9%**	**12.0%**	**8.7%**
GDP production, $ million	**220.6**	**212.6**	**240.1**	**268.9**	**292.2**
Agriculture and fisheries	8.6	8.5	8.5	8.5	8.5
Manufacturing, utilities, construction	28.8	25.3	27.9	27.5	31.1
Wholesale and retail trade	36.7	35.4	37.1	38.9	40.3
Accomodation, restaurants and transport	7.0	9.8	22.6	37.8	46.9
Public admin, Health and education	66.5	66.1	65.7	65.9	66.3
Other services	50.6	47.1	54.4	62.5	68.0
Taxes less subsidies on products	22.4	20.4	23.8	27.9	31.1
GDP by Expenditure, $ million	**196.6**	**208.9**	**223.0**	**229.4**	**253.3**
Final consumption expenditure, government	99.7	90.0	94.3	102.0	108.9
Final consumption expenditure, households	200.2	171.2	174.4	184.8	194.4
Gross capital formation	86.9	73.7	82.1	77.2	90.5
Gross domestic expenditure	378.0	328.9	344.3	356.9	386.2
Exports	13.8	18.9	62.4	113.7	143.5
Less Imports	181.6	173.9	227.1	258.5	284.6
Prices (annual percent change)					
Consumer price index	0.5%	13.7%	1.6%	0.0%	2.3%
Average wage	1.1%	-1.3%	2.2%	0.8%	1.4%
Export price Index	-2.8%	18.2%	-2.0%	-2.4%	1.5%
Import price Index	1.5%	14.8%	-2.1%	-0.2%	1.7%
Terms of trade	-4.3%	3.0%	0.0%	-2.3%	-0.2%
Employment and Wages					
Number of employees	**10,174**	**9,912**	**10,340**	**10,762**	**11,335**
% change	*-7.9%*	*-3.8%*	*6.6%*	*4.9%*	*6.8%*
Private sector	5,415	5,297	5,713	6,094	6,622
% change	*-13.5%*	*-2.2%*	*7.8%*	*6.7%*	*8.7%*
Public sector	3,910	3,858	3,868	3,902	3,946
% change	*-2.4%*	*-1.3%*	*0.2%*	*0.9%*	*1.1%*
Other	849	757	760	766	767
Palau citizens	5,237	5,468	5,550	5,600	5,666
Foreign workers	4,907	4,445	4,791	5,162	5,669
Average annual wage	**14,121**	**13,942**	**14,244**	**14,355**	**14,559**
% change	*1.1%*	*-1.3%*	*2.2%*	*0.8%*	*1.4%*
Private sector	9,652	9,664	10,108	10,132	10,382
% change	*-8.2%*	*0.1%*	*4.6%*	*0.2%*	*2.5%*
Public sector	21,439	20,832	21,312	21,822	22,370
% change	*4.3%*	*-2.8%*	*2.3%*	*2.4%*	*2.5%*
Average annual real wage (FY21 prices)	**14,121**	**12,262**	**12,337**	**12,431**	**12,329**
% change	*0.7%*	*-13.2%*	*0.6%*	*0.8%*	*-0.8%*

	FY21	FY22	FY23	FY24	FY25
Tourism					
Total Tourism receipts, $ million	**6.3**	**11.8**	**51.2**	**98.2**	**126.9**
Tourist nights	**17,888**	**44,722**	**215,179**	**432,220**	**567,379**
Receipts per visitor, $	1,828	1,718	1,250	1,177	1,143
Receipts per visitor night, $	351	264	238	227	224
Average length of stay, nights	**5.2**	**6.5**	**5.2**	**5.2**	**5.1**
Tourism arrivals	**3,436**	**6,874**	**41,000**	**83,500**	**111,000**
Japan	191	382	12,500	25,000	30,000
South Korea	26	52	10,000	15,000	20,000
Taiwan	732	1,464	7,500	15,000	20,000
China	18	36	0	12,500	25,000
USA	2,087	4,174	6,000	8,000	8,000
Europe	108	216	3,000	4,000	4,000
Other	274	548	2,000	4,000	4,000
Hotel occupancy rate	1.0%	3.3%	15.4%	29.3%	38.5%
Number of Hotel rooms, yearly average	**1,944**	**1,940**	**2,015**	**2,124**	**2,124**
Government Finance Statistics, ($ million)					
Revenue	111.7	108.4	107.1	121.6	140.2
Tax revenue	41.0	39.7	46.8	60.3	71.3
Grants	57.9	54.2	44.9	45.4	52.4
Other revenue	12.7	14.5	15.4	15.9	16.5
Expense	-130.6	-116.8	-106.8	-106.4	-118.2
Compensation of employees	-46.4	-45.7	-46.0	-47.1	-48.9
Use of goods and services	-26.4	-21.2	-25.0	-30.9	-36.1
Other expense	-57.8	-49.9	-35.8	-28.4	-33.3
Net Worth and its Changes	19.0	8.4	-0.3	-15.2	-21.9
Nonfinancial assets	-18.2	-12.9	-13.4	-13.7	-20.5
Financial assets	12.2	-12.2	4.7	7.2	8.7
Financial liabilities	25.0	33.5	8.4	-8.8	-10.1
Overall fiscal balance	-37.2	-21.3	-13.1	1.6	1.5
(In percent of GDP)					
Revenue	51.2%	49.4%	42.1%	41.5%	42.7%
Taxes	18.8%	18.1%	18.4%	20.6%	21.7%
Domestic revenues	26.6%	24.7%	17.7%	15.5%	16.0%
Grants	5.8%	6.6%	6.1%	5.4%	5.0%
Expense	-59.9%	-53.3%	-42.0%	-36.3%	-36.1%
Compensation of employees	-21.3%	-20.9%	-18.1%	-16.1%	-14.9%
Use of goods and services	-12.1%	-9.7%	-9.8%	-10.5%	-11.0%
Non Financial Assets	-8.4%	-5.9%	-5.3%	-4.7%	-6.2%
Overall fiscal balance	-17.1%	-9.7%	-5.1%	0.5%	0.4%

	FY21	FY22	FY23	FY24	FY25
External Debt, $ million					
Gross External Debt, total	170.2	201.4	207.3	196.1	183.6
National Government	149.1	182.6	190.9	182.1	172.0
Public Enterprises	18.2	15.9	13.5	11.0	8.7
Gross External debt as % of GDP	78.1%	91.8%	81.4%	66.9%	56.0%
Debt Service	10.9	11.2	14.1	15.6	16.5
Debt service as % of national government revenues	9.7%	10.3%	13.2%	12.9%	11.8%
Depositiory Coporations Survey ($ million)					
Net foreign assets	281.6	388.5	405.8	449.3	492.4
Domestic claims	-10.9	-18.2	1.3	6.4	13.5
Net claims on national government	-37.2	-43.5	-26.0	-22.5	-17.5
Claims on other sectors	26.3	25.4	27.3	28.9	31.0
Private non-financial corporations	2.1	2.1	2.4	2.8	3.2
Individuals	24.2	23.3	24.9	26.1	27.8
Broad money liabilities	371.0	366.4	403.6	452.5	503.1
Demand deposits	191.3	189.8	216.0	246.0	274.5
Other deposits	179.7	176.6	187.6	206.4	228.6
Capital and other accounts	2.3	4.0	3.5	3.2	2.8
Loans to deposit ratio, %	7.1%	6.9%	6.8%	6.4%	6.2%