



Government of Palau

Medium Term Fiscal Strategy

Rational and Description

Fiscal Years 2021-24

Fiscal Strategy

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A Our Fiscal Strategy – Background and Policy Actions

Our Fiscal Strategy is required under law by each new administration. Under the Fiscal Responsibility and External Debt Management Act (FRDMA), signed into law as RPPL No. 11-13 on November 18, 2021, the President of Palau is required to prepare a Fiscal Strategy (FS). Our FS is anticipated to cover each four-year administration or at intervals warranted by circumstances. The FS presented in this document is in fulfillment of that requirement and will be transmitted to the OEK and will be available online to the public at large.

1 The Economic and Fiscal Situation of Palau and Outlook

The economic impact of the COVID-19 pandemic has had an unprecedented impact on our economy. As the tourism sector collapsed in FY20, Gross Domestic Product (GDP) declined by 10% despite impacting only seven months of that fiscal year. The pandemic led to a further reduction in GDP by 13% in FY21. The combined impact through FY21 was an overall reduction of 23% from the level of economic activity in FY19. In fact, economic activity in FY19 was already at a low point in the economic cycle and well below the productive capacity of our economy. Thus, a more accurate indicator of the loss in economic output from our true capacity would be even greater than a 23 percent decline.

Pre-pandemic fiscal performance had been strongly positive, but as a result of the pandemic Palau has run large fiscal deficits. Fiscal performance had been strongly positive in the years preceding the pandemic, with our nation generating significant fiscal surpluses in the period from FY14 through FY18. The impact of the pandemic reversed that positive trend. In FY20, Palau ran a fiscal deficit of \$25 million, equivalent to 10% of GDP. Not only did our nation face a reduction in tax revenues, but we also initiated a series of mitigation programs to support the private sector and the newly unemployed. There was a further fiscal deterioration in FY21 as the impact of the public health crisis was felt during the full fiscal year. Our nation recorded a record FY21 deficit of \$37 million, equivalent to 17% of GDP. Overall, during this period Palau incurred a total of \$60 million in concessional debt from the Asian Development Bank (ADB) and the ratio of external debt to GDP rose to 78%. From the low level of 33% debt/GDP ratio in FY19 this was a large and unexpected increase; however, it was an increase that enabled our economy, our private sector and our affected workers to be protected from what would have been unthinkable outcomes.

Economic recovery is projected to be slow and not until FY24 is the economy anticipated to return to pre-pandemic levels. At the end of FY21 the outlook appeared favorable for a gradual but sustained recovery. However, the emergence of the highly contagious Omicron COVID-19 variant in December 2021 changed the outlook and it is currently anticipated that there will only be a 3% increase in GDP for FY22. This is still 20% below the FY19 level. Projections for the economy remain conservative for FY23, but by FY24 the economy is projected to have recovered and our visitor arrivals are projected to reach 90,000 which matches our visitor total in FY19.

The external debt to GDP ratio will rise to very high levels before falling to more sustainable levels but projections suggest that a modest fiscal adjustment may be

required in the long-term. In FY22, it is anticipated our government will need to draw down a further \$30 million under sub program-2 of the ADB Policy-Based Loan (in addition to the \$25 million originally incurred in FY21 under sub program-1) to support government operations and to extend expenditures on mitigation programs. The outlook for external debt indicates that the debt/GDP ratio will increase to 87% in FY22, but by FY25 will have declined to 52%. That level of external indebtedness is deemed to be a sustainable level and one which recent analysis by the IMF suggests will not present a threat of debt stress. As our economy improves, tax revenues will increase and the need for costly mitigation programs will be reduced and then eliminated. Our fiscal position will gradually improve. However, our fiscal projections suggest that even after the economy recovers, tourists return, and mitigation programs are no longer needed, we will still have a fiscal deficit to which we will need to adjust through a combination of economic growth policy and 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 our high value tourism strategy and diversification and support for new opportunities in the international finance sector.

The current economic position and projection of the economy form the basis on which our FS has been crafted. Of course, the projection and timing presented 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 will need to undergo fiscal adjustment to restore fiscal balance and stability. This will 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 of reducing or eliminating the need for restrictive fiscal policy. Clearly, the most favorable outcome is accelerated economic growth, albeit not at the cost of our people’s health in the short-run or our nation’s pristine environment in the long-run. The administration strongly supports this option combining a planned approach to achievement of our high value tourism strategy together with the development of new opportunities that our inherent sovereignty and our enhanced communications capacity now provide in sectors such as the international finance sector. Our Fiscal Strategy is not intended to outline these new economic policies. Rather it is intended to discuss those elements of fiscal policy that will support a growth-oriented economic strategy and that will tightly align with the principles of fiscal responsibility outlined in our law.

2 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.

3 Departure from Several Principles of Fiscal Responsibility Due to COVID-19

The COVID-19 pandemic forced an unavoidable departure from the principles of fiscal responsibility. Analysis of the impact of the COVID-19 pandemic on our economy indicates the unavoidable need to run large fiscal deficits and incur a significant volume of external debt. The adoption of these policies did not represent any lack of responsible economic and fiscal management, but rather the need to maintain our 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 several of our principles: (i) managing operating expenditures within revenues, (ii) a loss of real national net worth, and (iii) the prudential management of debt, they helped maintain economic and financial stability and social well-being within our 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 incurrence of significant debt to finance the recent large fiscal deficit is temporary and intended to last only as long as the pandemic lasts and only until the recovery of the economy is complete. However, our fiscal analysis indicates that there remains considerable uncertainty over the period of time that will be required to restore full adherence to our principles of fiscal responsibility. Deficit financing will thus continue as long as needed to maintain government operations and to support those adversely affected by the pandemic. The administration will operate a cautious fiscal policy 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 health of our people in the short-run and without threatening our nation's pristine environment in the long-run.

FS policy action 1: Maintain our level of government operations during the pandemic period while reducing non-essential expenditures until economic recovery is achieved.

FS policy action 2: Adopt a growth-oriented economic strategy to implement our high value tourism strategy and diversification and support for develop of new opportunities in the international finance sector.

4 Revenue Policies

i Revenue Diversification

The dependence of Palau on limited sources of revenue has increased fiscal vulnerability. The tourism industry is estimated to generate 43% of total taxes and 25% of total revenues. Government revenues are thus highly dependent on one industry and indicate the vulnerability of our fiscal condition to the impact of the pandemic. However, tourism offers the most potential to support sustainable economic growth through a high value tourism strategy that assures improved quality and increased and diversified tourism products, and its implementation is critical. While tax revenues are highly dependent on tourism and the overall state of our economy, other sources of revenue have provided an important buffer in the ability of our government to sustain operations during the pandemic. Agriculture production particularly its contribution to food security and sustainable livelihoods and the Financial Sector presents great potential as well and their continued development must be pursued. Grants from the US, Taiwan, Japan, and other donor partners represent 35% of total revenues, and are independent of the level of the economic activity.

FS policy action3: Diversify the revenue base and reduce dependence on a limited range of economic activities and sources.

ii Taxation: tax reform and role of a modern regime in resource mobilization

Tax reform has been the most important element of our 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 tax advisor has been recruited to drive the process and regulations are being drafted. The Bureau of Tax and Revenue 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. It is critical that our Tax Information System (TIS) be a robust system for long-term support of our modernized tax regime. An assessment of our current Tax Information System (TIS) and Customs Information System (CIS) needs to be undertaken to identify upgrades and extensions while enabling a basic implementation of the reforms by end of 2022. Based on the assessments, we will undertake a procurement process and develop an RFP to specify the long-term needs of our tax regime and modern tax administration. The most cost-effective qualifying solution will be selected.

FS policy action 4: The tax reform initiative will be implemented efficiently and effectively with available resources by the end of 2022.

FS policy action 5: An assessment of the current TIS and CIS will be undertaken, and the results will inform the preparation of a RFP specifying the requirements of our new tax regime and modern tax administration. The most cost-effective qualifying solution will be selected.

iii The role of the Compact, COFA Trust Fund, and grants.

The Compact of Free Association has played a key role in the financing of government; successful conclusion of our Compact renewal negotiations will play a key role in our FS. The Compact of Free Association has provided a backbone of resources to support the provision of government services, through direct budgetary support under the original Compact and the Compact Review Agreement (CRA), access to Federal Programs and Services, and drawdowns from the COFA Trust Fund. At the current time Palau is in the process of negotiating a renewal of the Compact for a further period, possibly for as long as 20 years. Key objectives are continuation of budgetary support at an increase from the current level of transfers from the CTF to reflect the impact of inflation over the initial 30-year period and the enhanced security partnership with the US, additional funds to support the establishment of a perpetual Trust Fund, funds to develop Palau's infrastructure in an environment of potential debt stress post-recovery from the pandemic, and funds to support Climate Resilience.

Bilateral donors and relations are a key element of our FS. Palau has now attained developed country status and is currently not eligible for grant funding from multilateral sources. The multilateral agencies and certain bilateral partners now only provide loan finance. There is thus a critical role to play for traditional bilateral donors, the US, Japan, and Taiwan, to support Palau's infrastructure and social development needs without incurring issuance of new debt.

FS policy action 6: Palau will maintain and develop the existing strong relationships with its donor partners to support the provision of increased budgetary support, the COFA Trust Fund, infrastructure, and Climate Resilience.

iv Fishing Fees and Other Revenues

Revenues from participation in the Vessel Day Scheme under the Parties to the Nauru Agreement has provided an important source of revenues. While Palau's oceanic resources are limited compared with the other Freely Associated States, revenues from the VDS have experienced the same proportional growth and have played a key role in supporting fiscal operations during the FY15-FY19 tourism downturn and the COVID-19 pandemic period. Palau will look to develop its domestic fishery to expand revenue opportunities that will be a key element of our FS. Other revenues include a variety of miscellaneous fees and charges. Palau will continue to ensure these sources of revenue reflect the cost of services provided.

FS policy action 7: Palau will continue to play an active role in the PNA and maximize revenues from the VDS and the development of domestic fishery. User charges and miscellaneous fees will reflect the cost of services provided and will be extended where applicable.

5 Expenditure Policies and Delivery of Public Services

i Fiscal rules and size of government

Our administration will not adopt any specific fiscal rules to guide fiscal policy but intends over the medium term to hold the level of government constant in real terms: Many countries have adopted strict and specific fiscal rules, that govern the level of permissible deficit over the medium-term, expenditure targets over the full economic cycle or even revenue targets. Given the high level of economic volatility experienced in Palau, our administration does not propose to specify any strict fiscal rules in the FS. However, it is a key objective to return the level of expense to within the fiscal envelope as required under the principles of fiscal responsibility. Further, the need to contain expenditures as debt service obligations rise will require the real level of government to remain constant for the foreseeable future. Should economic recovery proceed on target and economic performance is favorable, surplus funds will be set aside for debt repayment, rebuilding of the cyclical reserve fund, climate resilience fund and financing of investment and infrastructure.

FS policy action 8: Our administration will maintain the real size of government constant in real terms (inflation-adjusted) and set aside fiscal surpluses to rebuild reserves.

ii The size of the civil service and wage policy.

Our administration will contain the size of the civil service and incrementally raise the minimum wage to narrow the differential with the US federal minimum wage. Consistent with maintaining the size of government in real terms, our administration will also contain the size of the civil service at current levels. Palau has long maintained a constant size in the civil service and our administration will continue that policy. A key feature of our administration's economic policy is to raise the minimum wage from \$3.50 an hour to \$6.50 and to incrementally

narrow the differential with the US minimum federal wage. This policy will be undertaken without jeopardizing the principles of fiscal responsibility and sustained economic growth.

FS policy action 9: The administration will maintain the real size of civil service at current levels.

FS policy action 10: The minimum wage will be initially raised from \$3.50 an hour to \$6.50 and thereafter increased incrementally to narrow the differential with the US federal minimum wage without jeopardizing the principles of fiscal responsibility and sustained economic growth.

iii Use of Goods and Services

Our administration intends to ensure the use of complementary goods and services in the operation of government are protected. The use of goods and services, which supports the operational needs of government, has remained stable in real terms, and indicates the supply of materials has been maintained and has been unaffected by the stage of the business cycle. It is the intention of our administration to maintain and protect the level of complementary inputs as the fiscal envelope remains tight during the recovery period in order to avoid efficiency losses.

FS policy action 11: Complementary use of goods and services will be protected during the recovery to maintain efficiency and effectiveness of government operation.

iv SOEs, subsidies, and Public Financial Institutions

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. Water and wastewater 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.

FS policy action 12: Legislation based on the former SOE policy statement for the establishment of a framework for the reform and operation of the SOE sector covering commercialization, governance, community service obligations, and establishment of an SOE monitoring unit will be submitted to the OEK.

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 will be submitted to the OEK.

FS policy action 13: Legislation specifying a set of reforms to restore long-run financial stability to the Social Security System has been 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.

FS policy action 14: 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.

v State governments

State government fiscal operations have recently posed a significant fiscal threat. After a long period of stagnation, state block grants have more than doubled since FY10 and now pose a significant fiscal risk. In some jurisdictions transfers to lower levels of government are allocated on a proportional basis to local or general fund revenues. Adoption of a rules-based approach to funding of local government would provide an equitable distribution of resources and limit the current upward spiral and threat to fiscal stability. Supporting the development and expansion of revenue options for the states particularly through basic infrastructure investments will be maintained with a view to building urban planning capacity will be pursued.

FS policy action 15: A rules-based approach for the transfer of block grants to state governments will be developed and technical assistance for building urban planning capacity will be mobilized.

vi Infrastructure and the National Infrastructure Investment Plan

Expenditures on public infrastructure projects have been declining as a share of the economy since the beginning of the millennium and the completion of the Compact Road although there has been improvement in the last two years. The second principle of the responsibility framework requires government “*to achieve rising real national net worth over time*”. It is the objective of our administration to increase spending on infrastructure once recovery of our economy is achieved, and fiscal stability is restored. The road map for public expenditure on infrastructure is outlined in the National Infrastructure Investment Plan. According to the priorities expressed in the NIIP and funding availability, projects will be selected for implementation.

FS policy action 16: Public infrastructure management will be strengthened to facilitate timely and resilient investments.

FS policy action 17: The National Infrastructure Investment Plan will provide the criteria and priority for the selection of infrastructure projects.

6 Infrastructure Financing Policies

New ways of financing infrastructure are required. Palau has currently attained high income status and will need to look to new revenue sources to supplement the traditional means of finance, capital grants and concessional loans, if it is to reverse the downward trend in infrastructure investment.

i Domestic resource mobilization

An infrastructure reserve fund will be established once the recovery is complete. A major and as yet untapped source of funds is domestic resource mobilization or generation of savings from the budget. In effect, government will save a proportion of the revenues from taxation and fees for investment in infrastructure. This would involve the establishment of an infrastructure reserve fund dedicated to infrastructure projects. At the present time and through the economic recovery it is not realistic to establish an infrastructure reserve fund. However, once recovery is complete and fiscal stability is restored, the timing would be appropriate to establish the fund through setting aside a yet-to-be-specified proportion of domestic revenues

FS policy action 18: An infrastructure reserve fund will be established once the recovery is complete and fiscal stability is restored.

ii Private Public Partnerships (PPP) and Joint Ventures (JV)

Private Public Partnerships and Joint Ventures will provide an increasingly important means of financing of infrastructure. As a means to find alternative funding sources and to expand its options for delivering public infrastructure and related services Palau has prepared a PPP policy statement. The PPP framework is anticipated to play an important role in the implementation of the projects identified in the NIIP. At the present time Palau is considering engaging in a first PPP contractual relationship under a Power Purchase Agreement for the supply and storage of electricity. This will help stabilize and reduce the cost of power in Palau. In addition to establishing a PPP framework Palau has also entered a Joint Venture arrangement with a Japanese consortium to operate the National Airport. JVs, which entail equity investment by the Government will also provide a means for the development of Palau's economic growth-supporting infrastructure.

FS policy action 19: The use of PPPs to finance infrastructure will be pursued and a PPP monitoring unit in the Ministry of Finance will be established in close collaboration with the SOE monitoring unit.

iii Traditional sources of funding

Traditional sources of finance will be maintained and developed. Traditional bilateral partners will continue to provide an important source of finance for investment both through capital grants and concessional loans. The ADB has played a critical role in supporting Palau's development and to finance government operations and mitigation programs during the COVID-

19 pandemic. This will be maintained and developed. Palau has yet to engage with the World Bank for any major projects, but diversification of donor partners is desirable, especially for projects that require specialized or unique factors.

FS policy action 20: The administration will continue to rely on its traditional lending and donor partners but will diversify and explore new relationships where this brings specialized skills and resources to benefit Palau.

iv Domestic financial market development

Options for issuing domestic bonds will be explored once the key requirements and conditions have been met. Palau has considerable resources in the domestic commercial banking system and one of the lowest (least favorable) loans-to-deposit ratios in the world. Given Palau's favorable fiscal performance, accessing this market through issuance of domestic bonds offers the potential of a further financing mechanism. However, before development of a domestic bond market, such instruments would need to be compliant with FDIC regulations, and establishment of a credit rating with one or more of the international rating agencies would also be a pre-requisite. Careful planning will be undertaken to ensure that Palau achieves the highest rating possible. The recent enactment of the fiscal responsibility framework together with resolving issues such as the threatened collapse of the Civil Service Pension Plan and financial instability of the Social Security Administration would provide further confidence to ratings agencies and to potential bond investors.

FS policy action 21: Options for issuing domestic bonds will be explored once the key requirements and conditions have been met.

7 Cyclical and Climate Reserve Funds

The FRDMA replaces the General Fund Reserve 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.

FS policy action 22: The cyclical reserve and climate resilience fund will be established and a report of the status of the funds will be issued annually in accordance with law.

8 External Debt Policy

The FRDMA lays the framework for the establishment and management of a prudent external debt policy. 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 FRDMA thus occurred at an appropriate time to lay 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). An annual report will be delivered to the Minister of Finance, the President and the OEK.

The Minister of Finance will establish a debt management unit in the Ministry. The framework and principles of debt management are elaborated in the FRDMA and further specified in Chapter 5 of Title 40 relating to National Government Debt Management. An initial task will be for the Minister to establish a Debt Management Unit within the Ministry of Finance to assist the Minister in the overall debt management of the Republic. The key functions of the unit will be to:

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

Our administration has requested the Pacific Financial Technical Assistance Centre in Suva to assist in the development of the debt management policy. This will form the guiding principles for the new unit and development of the functions of the new office as required under law.

FS policy action 23: Capacity will be built in the new debt management unit to fulfill the requirements of the FRDMA. New loans will be appraised and an annual DSA will be prepared.

9 Fiscal Risk Monitoring

There are a variety of areas that pose significant and special fiscal risks to Palau that require careful monitoring under principle 7 of the fiscal responsibility framework. The following provides a list of areas that will be addressed in 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.***

FS policy action 24: Capacity to monitor, assess, and mitigate fiscal risks will be developed in the Ministry of Finance and the resultant analysis will be included in the Annual Fiscal and Economic Update.

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

	Principles	Status	Return to adherence	Linkage to FS policy actions
1	manage operating expenditures over the medium-term within operating revenues and in relation to the rate of growth of the economy 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 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 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 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

	Principles	Status	Return to adherence	Linkage to FS policy actions
	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 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 deliver services on an effective and financially sustainable basis 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	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
7	manage fiscal risks and contingent liabilities prudently 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

C Fiscal Strategy: Policy Action Matrix

	FS Policy Action	Responsible party	Timeline for policy actions	Monitoring criteria	Linkage to FRDMA Principle
	Restoring Adherence to FRDMA Principles				
1	Maintain our level of government operations during the pandemic period while reducing non-essential expenditures until economic recovery is achieved. Maintain our level of government operations during the pandemic period while reducing non-essential expenditures until economic recovery is achieved.	Minister of Finance	i. Fiscal balance restored ii. Visitor arrivals achieve FY19 levels On-going	Government Finance Statistics and analysis of expenditures	Principle 1
2	Adopt a growth-oriented economic strategy to implement our high value tourism strategy and diversification and support for develop of new opportunities in the international finance sector. Adopt a growth-oriented economic strategy to implement our high value tourism strategy and diversification and support for develop of new opportunities in the international finance sector.	Minister of Human Resources, Culture, Tourism & Development	On-going	i. Development of a Tourism Master Plan, and ii. Policy Statement for the development of the international finance sector	Principle 2 Principle 3 Principle 7
	Revenue Policies				
3	Diversify the revenue base and reduce dependence on a limited	Minister of Finance	On-going	Review revenue trends over time	Principle 4

	FS Policy Action	Responsible party	Timeline for policy actions	Monitoring criteria	Linkage to FRDMA Principle
	range of economic activities and sources.				
4	The tax reform initiative will be implemented efficiently and effectively with available resources by the end of 2022.	Minister of Finance	End of CY22	Efficient and effective implementation of tax reform	Principle 4
5	An assessment of the current TIS and CIS will be undertaken, and the results will inform the preparation of a RFP specifying the requirements of our new tax regime and modern tax administration. The most cost-effective qualifying solution will be selected.	Minister of Finance	By end of FY23	RFP issued and vendor selected as funding is secured	Principle 4
6	Palau will maintain and develop the existing strong relationships with its donor partners to support the provision of increased budgetary support, the COFA Trust Fund, infrastructure, and Climate Resilience.	President, Minister of Finance	On-going	Successful renewal of the Compact	Principle 2
7	Palau will continue to play an active role in the PNA and maximize revenues from the VDS and the development of domestic fishery. User charges and miscellaneous fees will reflect the cost of services provided and will be extended where applicable.	Minister of Agriculture, Fisheries, and the Environment	On-going	VDS revenues, Increase in Fishery/GDP ratio	Principle 4 Principle 7

	FS Policy Action	Responsible party	Timeline for policy actions	Monitoring criteria	Linkage to FRDMA Principle
	Expenditure Policies and Delivery of Public Services				
8	Our administration will maintain the real size of government constant in real terms (inflation-adjusted) and set aside fiscal surpluses to rebuild reserves.	Minister of Finance	Until fiscal balance restored and reserved built to target levels	Government Finance Statistics, Fiscal reserve annual statements	Principle 1
9	The administration will maintain the real size of civil service at current levels.	Minister of Finance	On-going	Payroll Statistics	Principle 1
10	The minimum wage will be initially raised from \$3.50 an hour to \$6.50 and thereafter increased incrementally to narrow the differential with the US federal minimum wage without jeopardizing the principles of fiscal responsibility and sustained economic growth. The minimum wage will be initially raised from \$3.50 an hour to \$6.50 and thereafter increased incrementally to narrow the differential with the US federal minimum wage without jeopardizing the principles of fiscal responsibility and without jeopardizing sustained economic growth.	Minister of Finance	On-going	Minimum wage legislation, Government Finance Statistics, Government payroll costs monitored	Principle 1 Principle 4
11	Complementary use of goods and services will be protected during the recovery to maintain efficiency and	Minister of Finance	Until fiscal balance restored and On-going	Real expense on goods and services	Principle 1

	FS Policy Action	Responsible party	Timeline for policy actions	Monitoring criteria	Linkage to FRDMA Principle
	effectiveness of government operation.			from Government Finance Statistics	
12	Legislation based on the former SOE policy statement for the establishment of a framework for the reform and operation of the SOE sector covering commercialization, governance, community service obligations, and establishment of an SOE monitoring unit will be submitted to the OEK.	Minister of Finance	By end FY22 SOE unit established. Adherence to Principles 6 approached over time	Legislation submitted to OEK Subsidies converted where appropriate to CSOs.	Principle 6
13	<u>Legislation specifying a set of reforms to restore long-run financial stability to the Social Security System has been submitted to the OEK.</u> Legislation specifying a set of reforms to restore long-run financial stability to the Social Security System will be submitted to the OEK.	Minister of Finance	Already submitted to OEK	Legislation submitted to OEK	Principle 6
14	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.	Minister of Finance	By end of FY23	Participatory process conducted and legislation submitted to the OEK	Principle 6
15	A rules-based approach for the transfer of block grants to state governments will be developed and technical assistance for building	Minister of Finance	Submission of FY24 budget to OEK	Budget includes a rules-based approach to allocation of state	Principle 1

	FS Policy Action	Responsible party	Timeline for policy actions	Monitoring criteria	Linkage to FRDMA Principle
	urban planning capacity will be mobilized.			block grants; KBRUDSAP implemented	
16	Public infrastructure management will be strengthened to facilitate timely and resilient investments.	Minister of Finance	Submission of FY23 budget to OEK	Increase in infrastructure investment/GDP ratio	Principle 2
Infrastructure Financing Policies					
17	The National Infrastructure Investment Plan will provide the criteria and priority for the selection of infrastructure projects. The National Infrastructure Investment Plan will provide the criteria and priority for the selection of infrastructure projects.	Minister of Finance	Submission of FY23 budget to OEK	Projects selected are supported in the NIIP	Principle 2
18	An infrastructure reserve fund will be established once the recovery is complete and fiscal stability is restored. An infrastructure reserve fund will be established once the recovery is complete and fiscal stability is restored.	Minister of Finance	Economic and fiscal recovery achieved	Infrastructure Reserve established and noted in financial statement	Principle 5
19	The use of PPPs to finance infrastructure will be pursued and a PPP monitoring unit in the Ministry of Finance will be established in close collaboration with the SOE monitoring unit.	Minister of Finance	PPP Unit established in collaboration with SOE Unit and On-going	PPP and SOE monitoring unit annual reports	Principle 2

	FS Policy Action	Responsible party	Timeline for policy actions	Monitoring criteria	Linkage to FRDMA Principle
20	The administration will continue to rely on its traditional lending and donor partners but will diversify and explore new relationships where this brings specialized skills and resources to benefit Palau.	Minister of Finance	On-going	New borrowing partners/sources established	Principle 2
21	Options for issuing domestic bonds will be explored once the key requirements and conditions have been met.	Minister of Finance	Economic and fiscal recovery achieved; balanced budgets restored	Policy paper prepared on bond issue once bond rating agency conditions have been improved	Principle 2 Principle 7
Cyclical and Climate reserve funds					
22	The cyclical reserve and climate resilience fund will be established and a report of the status of the funds will be issued annually in accordance with law.	Minister of Finance	End of FY22	Reserve Funds established and annual reports on fund status published.	Principle 5
External debt policy					
23	Capacity will be built in the new debt management unit to fulfill the requirements of the FRDMA. New loans will be appraised and an annual DSA will be prepared.	Minister of Finance	DSA presented with FY24 budget	Debt management unit established in the Ministry of Finance; reports support Annual Economic and Fiscal Update	Principle 4
Fiscal Risk Monitoring					

	FS Policy Action	Responsible party	Timeline for policy actions	Monitoring criteria	Linkage to FRDMA Principle
24	Capacity to monitor, assess, and mitigate fiscal risks will be developed in the Ministry of Finance and the resultant analysis will be included in the Annual Fiscal and Economic Update.	Minister of Finance	On-going	Fiscal risk monitored in the Annual Economic and Fiscal Update	Principle 7