Economic Impact of the Compact and Renewal on the Republic of Palau

April, 2023

ASIAN DEVELOPMENT BANK

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ABBREVIATIONS

ADB	Asian Development Bank
CARES	Coronavirus Aid, Relief, and Economic Security Act (US)
COFA	Compact of Free Association
COVID	Coronavirus Disease
CPRO	Coronavirus Pandemic Response Option
CRA	Compact Review Agreement
CROSS	Coronavirus One Stop Shop Act
CSPP	Civil Service Pension Plan
CTF	Compact Trust Fund
DBS	Doing Business Survey
DRP	Disaster Resilience Program
DSA	Debt Sustainability Analysis
EAG	Economic Advisory Group
FAS	Freely Associated States
FPUC	Federal Pandemic Unemployment Compensation (US)
FSM	Federated States of Micronesia
GDP	Gross Domestic Product
GNI	Gross National Income
GNP	Gross National Product
GSUSA	Graduate School USA
HLDP	Housing Loan Development Program
IAG	Inter-Agency Group (US)
ICT	Information and Communications Technology
MOU	Memorandum of Understanding
NDBP	National Development Bank of Palau
PACTAM	Pacific Technical Assistance Mechanism
PBL	Policy Based Loan
PFM	Public Financial Management
PGST	Palau Goods and Service Tax
PPUC	Palau Public Utilities Corporation
PUA	Pandemic Unemployment Assistance (US)
RISES	Recovery through Improved Systems and Expenditure Support
RMI	Republic of the Marshall Islands
SAFER	Sustainability Adjustment for Enhanced Reliability
SOE	State-Owned Enterprise
UNDP	United Nations Development Program

NOTES:

Palau government fiscal year (FY) ends on September 30.

Currency unit: United States dollar (US$).

Figures may not add in this report due to rounding.

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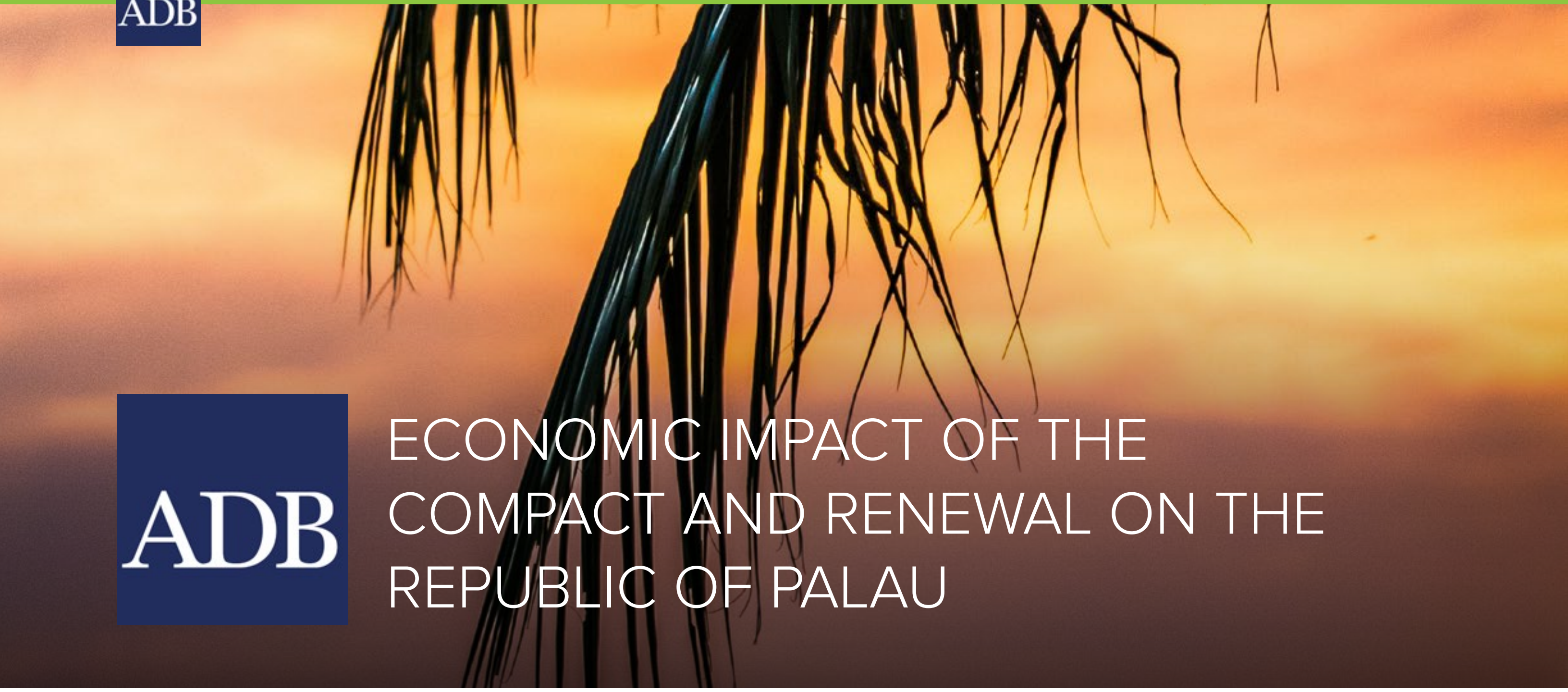

ECONOMIC IMPACT OF THE COMPACT AND RENEWAL ON THE REPUBLIC OF PALAU

Foreword

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

US announces intention to negotiate extension of Compact economic assistance. This study was commissioned in May 2019, before the US government officially announced its intention to negotiate an extension of Compact funding with each FAS, including the Republic of Palau (RoP). The US shared an undisclosed offer of assistance with each FAS, including Palau, in late 2020 as the end of the term of the prior US administration approached. In March 2022, the US named a Special Presidential Envoy for Compact Negotiations and reinitiated formal negotiations with Palau. ADB decided to continue this study along the initially conceived lines: with downward adjustment and Compact funding renewal scenarios. The downward adjustment case is noted as nearly identical to the outcome that would result even from a delay in a fully funded period of renewal with Palau. The renewal case, optimistically, provides the welcome challenge of ensuring that additional resources have the greatest sustained benefit to Palau.

COVID-19 pandemic impacts demand a reassessment of the economic outlook for each FAS. Since the findings of the original three-country study were shared in draft form with all affected parties in January 2020, the world suffered from the Coronavirus Disease-19 (COVID) pandemic, with varying degrees of impact on each FAS. This Palau country-focused study serves two purposes: (i) it includes more Palau specific detail; and (ii) it updates all the underlying model assumptions to take into account the estimated impacts of the COVID-19 pandemic on Palau. This report is based on economic data available as of August 2022.

ADB trusts that the provision of information and analyses herein will prove beneficial to all interested parties. This study builds upon the ongoing work of the Economic Monitoring and Analysis Program (EconMAP), administered by the Graduate School USA (GSUSA) with funding support from the Department of the Interior's (DOI) Office of Insular Affairs (OIA).

Importantly, this study makes no recommendations to the directly affected parties. ADB looks forward to working with Palau and its development partners to address needs as they arise. In the event of unlikely but conceivable severe fiscal outcomes, such work might entail a greater focus on mitigating the effects of fiscal adjustments. More optimistically, following the commitment by the US to extend the financial terms of

each Compact, ADB could focus more directly on policy reform and in-country economic management needs to support the achievement of enhanced private sector-led economic growth.

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

EXECUTIVE SUMMARY

Palau Compact Structural Features, Trends, and Preparedness

Compact structural features. The Compacts between the US and the three FAS delivered sovereignty and self-governance to each nation, included economic development assistance, and provided the right of FAS citizens to move to the US. The Palau Compact came into effect in 1994, with the initial assistance provided for FY95-FY09. The US provided general budget support, sector specific support, funds to establish the Palau Compact Trust Fund (CTF), federal services, and committed to constructing a road system. The Compact included a schedule for trust fund distributions starting within the 15-year period. The Palau Compact requires a review on the 15th, 30th, and 40th anniversaries of the Compact.

The US and Palau concluded a Compact Review Agreement (CRA) in 2010 for FY10-FY24 that provided budgetary support, funded infrastructure, infrastructure maintenance, and contributed to the Palau Compact Trust Fund. In addition, the agreement created an “Economic Advisory Group” (EAG) to monitor Palau’s economic progress and put forth recommendations that would set the agenda of annual economic consultations. US Congressional action to approve the CRA was delayed, and the agreement went into effect in September 2018.

Compact trends. Palau experienced economic growth during the compact period and the level of Compact transfers fell over time. The reliance of Palau on Compact transfers (including distributions from the Compact Trust Fund) has declined from moderately high levels during the initial Compact period to a projected level of 5 percent of GDP in FY24. Palau’s population is forecast to be 18,700 at the end of FY24, with emigration over the period having offset the natural increase in the Palauan population.

Preparedness. The President of Palau has designated a negotiating team led by the Minister of Finance. The Presidents of the US and the three FAS nations met at the White House in May 2019 and the US identified two co-negotiators in April 2020. Several meetings with Palau were held in 2020. Following a period of minimal formal interaction, in March 2022, the US President appointed a Special Presidential Envoy for Compact Negotiations. Palau and the US signed a MOU regarding Compact funding in January 2023.

Palau Economic and Fiscal Structure and Performance

Economic structure and performance. Palau has the most developed economy among the FAS, where the private sector represents 52 percent of GDP with tourism comprising the largest share of private sector activity during the FY17-FY19 period. The household sector, comprising subsistence and informal sector activities, represents 9 percent, while Palau’s public sector represents 25 percent of GDP. Palau has adopted a tourism-based growth model, yet it still relies on donor support for the public sector and infrastructure needs.

Economic growth has been lackluster; Palau has grown by an average rate of 0.5 percent during the FY00-FY19 period. Palau experienced the greatest volatility among the FAS due to the nature of its tourism-reliant economy.

Fiscal structure and performance. Tax revenues reflect the degree of development in the economy with Palau attaining 47 percent, the highest proportion of tax revenues of total revenues with the RMI and FSM recording 22 and 14 percent. Sovereign rents derived from fishing fees represent a modest 8 percent of revenues. Reflecting the dependent nature of the three FAS, grants remain a critical component of the landscape since independence averaging 38, 48 and 30 percent in the FSM, RMI and Palau during FY17-FY19, respectively.

Palau has maintained a conservative fiscal position and the level of government has remained constant in real terms. During the tourism boom years as revenue rose rapidly, the nation set aside the surplus into a general fund reserve that ended up serving the nation well during the COVID-19 pandemic.

The Impact of COVID-19 on the Palau Economy and Outlook

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 the FAS effectively closed their borders in March/April 2020 and as a result the FAS remained COVID-free until 2022. The restrictive travel policies and the priority placed on health, at a time of highly limited demand for international travel, served the FAS well. During 2021, the FAS benefited from the U.S. vaccination effort and in collaboration with the CDC began rolling out nationwide immunization programs. At the end of September 2021, Palau had effectively vaccinated its entire adult population, and reopened its borders to vaccinated and COVID-19 free travelers.

Mitigation programs. The FAS benefited from donor and internal programs to mitigate the health issues and economic costs of COVID-19. US health programs provided the major source of funds to mitigate the potential impact of a COVID-19 outbreak. The FAS also benefited from the US CARES Act, Federal Pandemic Unemployment Compensation (FPUC), and Pandemic Unemployment Assistance (PUA). These benefits supported the economic livelihoods of FAS workers. The ADB has been a major contributor to the FAS during the COVID-19 pandemic. The ADB provided $118.63 million in resources to Palau, including $115 million in loans, $1.77 million in grants, and $1.86 million in technical assistance (TA). The loans included a $55 million Policy Based Program loan to support government operations and mitigation programs, but contingent upon a series of reforms. In addition, the Palau CROSS Act provided unemployment benefits to foreign workers, a temporary jobs program and provided relief to affected segments of the private sector.

Economic Impact. In the case of Palau, the COVID impact has been devastating, with GDP falling by 8.9 percent in FY20 and a further 13.1 percent in FY21. With Palau reliant on an industry dependent on travel, it saw the total collapse of its tourism sector. With strong donor support, Palau has been able to insulate the impact of COVID-19 from the non-tourism-based economy, but the private sector contracted by over 42 percent.

Fiscal impact. The COVID-19 pandemic precipitated a series of unprecedented deficits, reaching 17 percent of GDP in FY21 at the height of the adverse economic impact and before the anticipated recovery. Total financing needs to amount to $106 million or 45 percent of average GDP during FY20-FY23. External debt is projected to rise from 31 percent of GDP in FY18 to 93 percent of GDP by the end of FY22. The ratio will fall with the anticipated economic recovery, to 61 percent by FY25 and from that point gradually decline to more sustainable levels.

Modeling the Impact of Non-Renewal of Compact Economic Assistance

Palau non-renewal scenario. In this case Palau continues to enjoy access to Head Start and other Federal programs. The modeled adjustment after FY24 entails a reduction in CTF drawdowns sufficient to ensure achievement of sustainable perpetual status. This amounts to a $6.6 million adjustment equivalent to 2.3 percent of projected FY24 GDP. The model assumes three adjustments in FY25: a freeze on civil service recruitment, no award of annual increments, and a 5 percent real reduction in purchases of goods and services, as well as government transfers. GDP is projected to fall by 0.8 percent, with similar minor impacts on employment, household incomes, and induced out-migration.

The Independence Illustration. In this illustrative case, Palau does not have access to any US assistance, including Federal programs. The modeled adjustment after FY24 entails a reduction in CTF drawdowns sufficient to ensure achievement of sustainable perpetual status. This amounts to a $6.6 million adjustment equivalent to 2.3 percent of projected FY24 GDP. With the additional loss of federal programs, the total adjustment is $15 million annually or 5.3 percent of projected FY24 GDP. The model assumes severe adjustments in FY25 to civil service employment and wages, as well as government purchases and transfers, as well as negative impacts on employment and household income, and increased out-migration.

Modeling the Impact of Compact Economic Assistance Renewal

Compact renewal scenario. In the case of Palau, the original Compact structure differed from that of the FSM and RMI. To place all three FAS on a structurally equivalent basis the Compact renewal scenario for Palau model equates its renewal structure to that of the FSM and RMI. Operating grants are assumed to be $15 million plus $2 million for infrastructure maintenance and $0.5 million for audit in FY25. Infrastructure grants are set at $6.5 million annually. Finally, an additional annual contribution to the CTF of $11 million annually is assumed to make it perpetual.

Compact renewal supports growth with resources for infrastructure. By providing greater resources for infrastructure, which will otherwise be severely limited due to the high debt-to-GDP levels, the economy grows. The projections indicate that GDP growth will average 3.9 percent per year during FY24-FY30. Employment and household incomes follow similar patterns and migration is held in check. Additional infrastructure helps strengthen the economy of Compact extension.

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PALAU COMPACT 101: STRUCTURAL FEATURES, TRENDS, AND PREPAREDNESS

1 PALAU COMPACT 101: STRUCTURAL FEATURES, TRENDS, AND PREPAREDNESS

This chapter describes the structure and timing of the initial and subsequent Compact funding periods for Palau, followed by a timeline of key trends during those two distinct Compact periods. The Compact of Free Association represented the choice Palau made in order to terminate its status as a territory under the United Nations (UN) Security Council mandate for the Trust Territory of the Pacific Islands. The Compact relationship delivered sovereignty and self-governance to Palau and the nation is governed according to its own constitutional provisions. Palau has demonstrated its commitment to free and fair democratic elections. The Compact also included economic assistance provisions to support the development of the economy and the ultimate achievement of self-reliance.

Compact Structural Features

Palau Initial Compact Period (FY95 to FY09)

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

Palau was the last of the Trust Territory of the Pacific jurisdictions to be under the oversight of the UN Security Council. The Trusteeship was dissolved on November 10, 1994 by the unanimous approval of UN Security Council Resolution 956. On December 15, 1994, UN Resolution 49/63 granted Palau membership in the UN. Palau has, at least until the past few years, typically been within the top three countries in the UN with respect to coincidence of votes with the US. As of November 2022, Palau had diplomatic relations with more than 99 countries.

Title II of the Palau Compact provided economic assistance for the 15-year period from FY95 to FY09, including annual and lump sum assistance as well as contributions to a Compact Trust Fund (CFT). During this period, most funding was provided under section 211(a) as unspecified budgetary support. Palau's Compact, as implemented, designated $12 million annually for FY95 to FY98, $7 million annually for FY99 to FY04, and $6 million annually from FY05 to FY09. Additional annual US transfers totalling $2.781 million were provided for categories of expenditure including: communications, marine surveillance, health and medical programs, scholarships, and as education/health block grants. Lump sums were provided in FY95 for infrastructure ($36 million); energy ($28 million), military options ($5.5 million), communications ($1.5 million), and $667,000 for surveillance, referrals and scholarships.

In addition, the US provided a total of $70 million to the Palau CFT during the first and third year of the Compact. The objective of this sum was to produce an average annual distribution of $15 million commencing on the fifteenth anniversary of the Compact for thirty-five years. Beginning in FY99 Palau was authorized to distribute $5 million annually from the CTF to supplement its budget through FY09. Notably Palau chose to forgo the available $5 million CTF distributions for the initial three years from FY99 to FY01, before beginning its annual allowable draw of $5 million from the CTF in FY02. That forbearance has resulted in a substantially larger current CTF value. Estimating the impact of the $15 million left in the CTF during FY99 to FY01 yields an end of FY20 value of $39.9 million or 14.5 percent of the end of FY20 CTF total of $275.6 million.

In addition, Palau benefited from a US-managed construction project to build the Palau Compact Road for which the US expended $149 million, which we allocate evenly across the seven years from FY01-FY07 in our Compact transfers graphic.

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

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

Palau Compact Review Agreement Period (FY10-FY24)

The first of three mandated Compact reviews was completed on September 3, 2010. The Palau Compact requires a review on the 15th, 30th, and 40th anniversaries of Compact effectiveness. These reviews (titled Section 432 Reviews) assess the operating requirements of the Government of Palau and review the nation's progress toward meeting development objectives. While the Palau Compact provided no mandate to negotiate an extension of funding, as was specified within the Compacts for the FSM and RMI, Palau made the case through the 15th year Review process, that an extension of funding was necessary to avoid a major fiscal shock. More importantly, Palau argued that an extension of funding was necessary to improve the likelihood of continued progress toward achieving the mutual goal of economic self-reliance. Three key outcomes of the negotiations are included in the Compact Review Agreement (CRA):

- The parties agreed that the originally projected 12.5 percent annual growth rate for Palau's CTF was not met and warranted redress. The review process established the objective of the US "topping up" the CTF to achieve—at least—its goal of providing $15 million annually through the fiftieth year (FY44). Midway through the review dialogue, the parties agreed to a new target of 5.5 percent nominal annual growth and used the new target for subsequent calculations.
- The US insisted on changes to the accountability provisions for transfers during the CRA period. Mutual agreement was achieved on the creation of an "Economic Advisory Group" (EAG) to monitor Palau's economic progress and put forth recommendations that would, presumably, set the agenda of annual US-Palau economic consultations.
- In addition to funding to directly increase the value of the CTF, a simplified schedule of funding was agreed as described below, to be provided in declining amounts through FY24.

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

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

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

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

i. **Budgetary support**. A total of $129.75 million was provided to support spending similar to that negotiated in the original CRA as a supplement to agreed-upon annual distributions of specified amounts from the CTF. Of this amount, $105.276 million was provided by the US through annual stopgap funding, before US Congressional authorization of the CRA, which funded the remainder.

ii. **Infrastructure**. A total of $20 million in infrastructure funds was available to fund mutually agreed infrastructure projects after funding is made available at the end of FY18. In our Compact transfers graphic we allocate this fund evenly across the three years from FY19-FY21.

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

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

The Compact Review Agreement covering the period FY10-FY24 was ultimately funded entirely with a one-time appropriation of funds during FY18. Before US action to approve the CRA, annual stopgap funding was provided against the CRA funding commitments. With US approval of the CRA in FY 18, three of the four funding streams were completely fulfilled with funds transferred to Palau at the end of FY18. Only the infrastructure maintenance funding stream continues, at $2 million annually through FY24. This funding was fully funded with the FY18 US appropriation and the US provides annual distributions from FY19-FY24, contingent on Palau fullfilling its quarterly matching requirements.

The CRA originally included a fifth funding stream, but it was reprogrammed and distributed to the existing four. The fifth stream would have provided $10 million to offset fiscal arrears that Palau had at the end of FY09. However, both parties deemed the allotment unnecessary given the passage of time and the fiscal surplus position of the Government of Palau as of the end of FY18.

Palau had agreed to the CRA with the assumption that the funding would be sourced on a “mandatory and permanent” basis, thus not subject to annual US appropriations and not subject to US government-wide sequestration events that can affect discretionary annual funding sources. Notably, all of the CRA funding was authorized and appropriated in FY18 and Palau had no reason to dispute the discretionary funding source .

The one-time, full appropriation for the period through FY24 eliminated any risk of delayed, reduced, or failed annual US appropriations or periodic recisions or sequestrations affecting the US budget.

The CRA required the establishment of the EAG, but its establishment was delayed. The EAG met for the first time in August 2022 with a visit to Palau and a second time in December 2022 (virtually). The EAG has developed an initial statement of principles and will issue its first report in early 2023. Its work can be followed at ***www.palaueag.org***.

Palau Compact Trends

Figure 2 provides four charts covering Palau Compact trends for the full timeline from FY95-FY24.

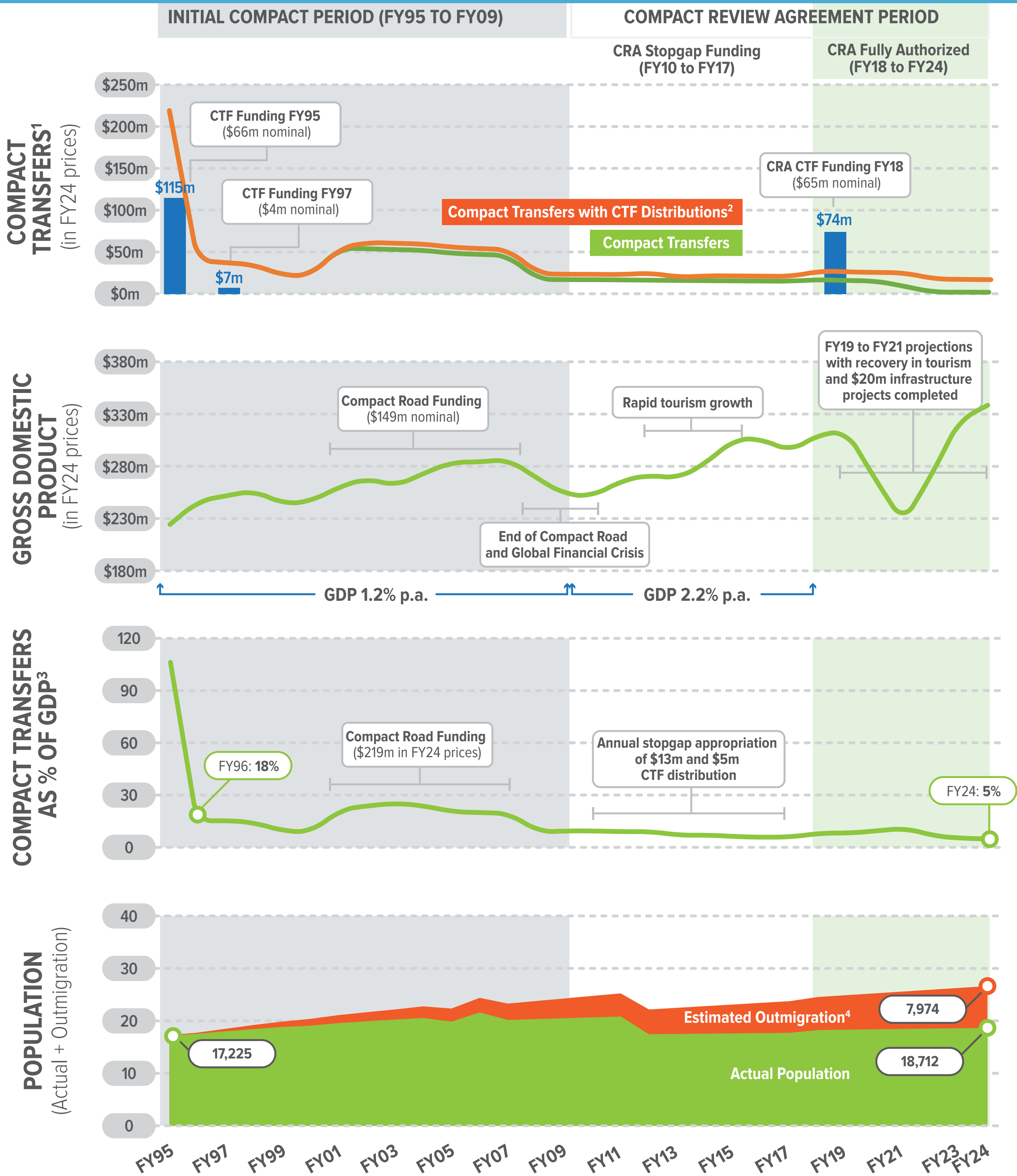
i. The first chart shows the transfers made available to Palau by the US under the initial Compact period from FY95 to FY09 and under the CRA period from FY10 to FY24. All values are expressed in FY24 prices.

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

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

iv. The fourth chart illustrates the gradual—but mounting—effect of migration from Palau. Palau’s population is expected to have grown from 17,225 in FY95 to 18,700 at the end of FY24. The Palauan population in Palau has been stable: 12,508 in the 1995 Census and 12,438 in the 2020 Census, but the median age has increased from 28.1 to 37.9. Migration under the Compact has offset Palau’s natural increase. Actual numbers are not measured but direct migration may amount to almost 8,000 by the end of FY24, not including children born to Palau Compact migrants overseas.

Figure 2: Palau Compact Timeline



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

Preparedness for the End of Compact Funding

Palau

Palau and the US are engaged in the "Second Compact Section 432 Review" to review and potentially renew economic assistance beyond FY24. Palau has created an officially designated Compact Review Committee, chaired by the Minister of Finance. The President of Palau, H.E. Surangel Whipps, Jr., met in Washington, DC, in August 2021, with the Secretaries of three US departments—Defense, State, and the Interior. In those meetings, the President stated that the US offer provided to Palau in December 2020 was inadequate and unacceptable. He also expressed a need for the parties to negotiate in a manner which would first define mutual goals and objectives, include a mutual review of the Compact relationship to date, and ensure assistance to Palau reflects the "updated value" of Palau in the context of global security realities. Subsequent to the DC visit by the President, the Palau Minister of Finance had technical discussions with the US government. After the US appointed a negotiator in March 2022, the US and Palau restarted formal negotiations. On January 20, 2023, the governments of the US and Palau signed a Memorandum of Understanding (MOU) regarding the levels and kinds of future US assistance.

USA

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

The IAG has scaled up engagement due to one key policy and one major timing factor. The policy factor of most concern to the US is the need to offset China's growing influence in the Pacific region, and specifically in the Western Pacific. This policy concern is captured by the US government's "Free and Open Indo-Pacific Strategy," which is shared in name or effect with key regional allies, including Japan, Australia, and New Zealand. This policy concern as it relates to the FAS clearly raises the visibility and importance of the relationships with Palau, the FSM and the RMI as well as the combined land and ocean space controlled through the three Compacts of Free Association.

The timing factor which has led to the increased frequency and urgency of IAG meetings is the timing built into the three Compacts of Free Association. The IAG is considering the possibility that a cessation of US funding could create a funding gap, which China could, in turn, leverage to increase its presence and influence in the FAS.

The US had hoped to conclude its review process with Palau by the end of 2020. The US established a negotiating team led by co-lead negotiators: one from the Department of State and one from the Department of the Interior. The US completed a listening tour to each FAS just prior to the outbreak of COVID-19 in 2020 and subsequently opened negotiations with each of the three FAS with an objective of completing Compact renewal agreements with each FAS by December 31, 2020. Such a timetable would still have left two additional steps: (i) approval by the US Congress, and (ii) subsequent approval in Palau of the agreed, authorized, and appropriated renewal arrangement.

As of December 2020, the US government had made written offers to extend funding under specified conditions to each of the three FAS. Those offers remain confidential outside of the parties to each bi-lateral negotiation. Beginning in January 2021 the US made it clear to Palau that the new US administration would approach FAS Compact renewal negotiations as a part of its larger Indo-Pacific Strategy. In March 2022, the US named a Special Presidential Envoy for Compact Negotiations and reinitiated formal negotiations with Palau. Palau and the US signed a MOU regarding Compact funding in January 2023.

Major Multilateral Donors

World Bank and ADB involvement in the North Pacific has increased markedly in recent years. The FSM and the RMI have recently benefited from a large increase in funding commitments from the World Bank and an unrelated, but timely, designation that allows for grant-only assistance. The grant-only status is the result of a joint World Bank-International Monetary Fund Debt Sustainability Analysis (DSA).

Palau, with a much higher level of Gross National Income on a per capita basis is not eligible for similar grant status from the World Bank, ADB or other donors. Palau is eligible for concessional loans from donors at concessional rates of interest and favorable term structures. To date, Palau has chosen not to borrow from the World Bank, but this remains a borrowing source that Palau may choose to tap in the future. However, as noted below, total external debt needs to be managed prudently in the light of COVID-19 pandemic-related borrowing.

ADB has provided significant loan-financed funding to support Palau through the COVID-19 economic and fiscal crisis. ADB follows the DSA finding and thus currently provides concessional loan funding to Palau along with periodic country-specific and regional technical assistance programs. Palau can borrow roughly $30 million annually from ADB. Prior to the COVID-19 pandemic, Palau had outstanding balances of $50 million with the ADB for loans that supported water and sanitation improvements and ICT investments. During COVID, the ADB provided $118.63 million in resources to Palau, including $115 million in loans, $1.77 million in grants, and $1.86 million in technical assistance (TA). Using the COVID-19 pandemic-related facilities: the Disaster Resilience Program and the Covid-19 Pandemic Response Option, Palau indebtedness to ADB increased markedly. Palau has also undertaken a Policy Based Loan (PBL) in the form of budgetary support to operate through the period of severe fiscal shock. The PBL is structured into two sub-programs with the policy reform requirements now completed and funds released for both sub-programs. Current debts to the ADB total $124 million in FY2022. Current program plans indicate ADB's 2023-2024 support for Palau infrastructure, sector programs, and projects is an estimated $47.7 million.

Reforms under ADB loans to mitigate the impact of COVID-19 have required strong policy actions. The impact of COVID-19 and the need to develop an economic and fiscal response have absorbed the Palau policy and legislative agenda. With support from the ADB under a Policy-Based Loan (PBL), Palau has developed a program of reforms to assist in stabilizing the nation's fiscal and economic situation and to develop long-term instruments to fulfill and reduce debt service obligations as the economy recovers. The reforms to implement a modern tax regime as well as reforms to Social Security and to the private sector regulatory environment would enable Palau to better adjust to different funding scenarios.

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

ADB has a history dating back to 1996 of supporting development partner meetings in the FSM and RMI. In addition, on a periodic basis, ADB supported FSM and RMI with technical support through resident advisory teams that facilitate effective reform and accelerate improvements in public financial management (PFM). This technical support includes substantial investment in local hire counterparts and advanced training. Donor coordination efforts to support improved policies based upon strong macroeconomic and sector data systems and policy analysis capacity would prove beneficial to Palau.

Major Bilateral Donors

The Japan aid program to Palau is currently unaffected by the potential end of US assistance arrangements after FY24. Japan aids all three FAS. Infrastructure projects remain the largest share of support. Japan also provides support for sector projects, equipment purchases, and scholarships. Indirectly, Japan funds UNDP for support to the FAS in disaster preparation and through Australia to support operating costs under the maritime patrol boat program. The Government of Japan has initiated its own "Free and Open Indo-Pacific Strategy." While its aid levels to the Pacific will increase, modalities will remain the same. There is no direct mechanism for Japan to provide budgetary support in the event of a major fiscal adjustment.

Taipei,China is an important development partner for the RMI and Palau. Programs to support RMI and Palau were recently renewed (after 20 years) to maintain a similar level of annual funding. All the support to Palau is in the form of projects.

Australia provides a relatively small, but potentially growing, amount of support to the FAS. All three nations share an annual direct and regional aid allocation of $5 million to support regional projects, scholarships, and Pacific Technical Assistance Mechanism (PACTAM) advisors for capacity-building. All three of the FAS also benefit from Australia's Maritime Patrol program. In 2019 Australia renewed support for that maritime program to include a new fleet of boats and associated surveillance equipment. There is no direct mechanism for Australia to provide budgetary support in the event of a major fiscal adjustment.

2

PALAU ECONOMIC AND FISCAL STRUCTURE AND PERFORMANCE

2 PALAU ECONOMIC AND FISCAL STRUCTURE AND PERFORMANCE

Palau's economy is projected to recover by FY25 but will operate from a lower base than anticipated before the COVID-19 pandemic. To undertake the impact analysis and interpret the results discussed in this study, it is beneficial to not only specify the nature of the potential changes in Compact provisions, but also the recent structure and performance of the Palau economy. This analysis provides background as to the likely response of the economy to the different Compact assistance scenarios outlined later in this study. The pre COVID-19 structural analysis is followed by a discussion of the impact of COVID-19 on the economy through FY24 in the next chapter.

The assumptions of the study are that by the end of FY24, the economy will have recovered from the impact of the pandemic[1]. However, the economy will be operating from a lower base than anticipated in the original projections presented prior to the pandemic in January 2020[2] and subsequently in August 2021[3].

1 See GSUSA, *2022 Economic Brief: Republic of Palau June 2022* (EconMAP Economic Brief, posted July 10, 2022). ***https://pubs.pitiviti.org/palau-2022-brief***

2 See GSUSA, *The Economic Impacts of the End of Compact Grant Assistance in the Freely Associated States* (EconMAP, Asian Development Bank project - Draft for Discussion, March 2020). The analysis was updated in *The Economic Impacts of the End of Compact Grant Assistance in the Freely Associated States* (EconMAP, Asian Development Bank project - Draft for Discussion, April 2022; posted May 6, 2022). ***https://pubs.pitiviti.org/adb-fas***

3 See GSUSA, *Palau Country Focus: The Economic Impact of the End of Compact Grant Assistance, August 2021* (EconMAP, Asian Development Bank project – Draft for Discussion, August 2022; posted Aug. 12, 2021). ***https://pubs.pitiviti.org/palau-compact***

Moreover, performance of the CTF has deteriorated significantly with the recent market collapse[4] and the corpus projected for FY24 is now $275 million, $59 million or 18 percent below the levels projected at the end of FY21.

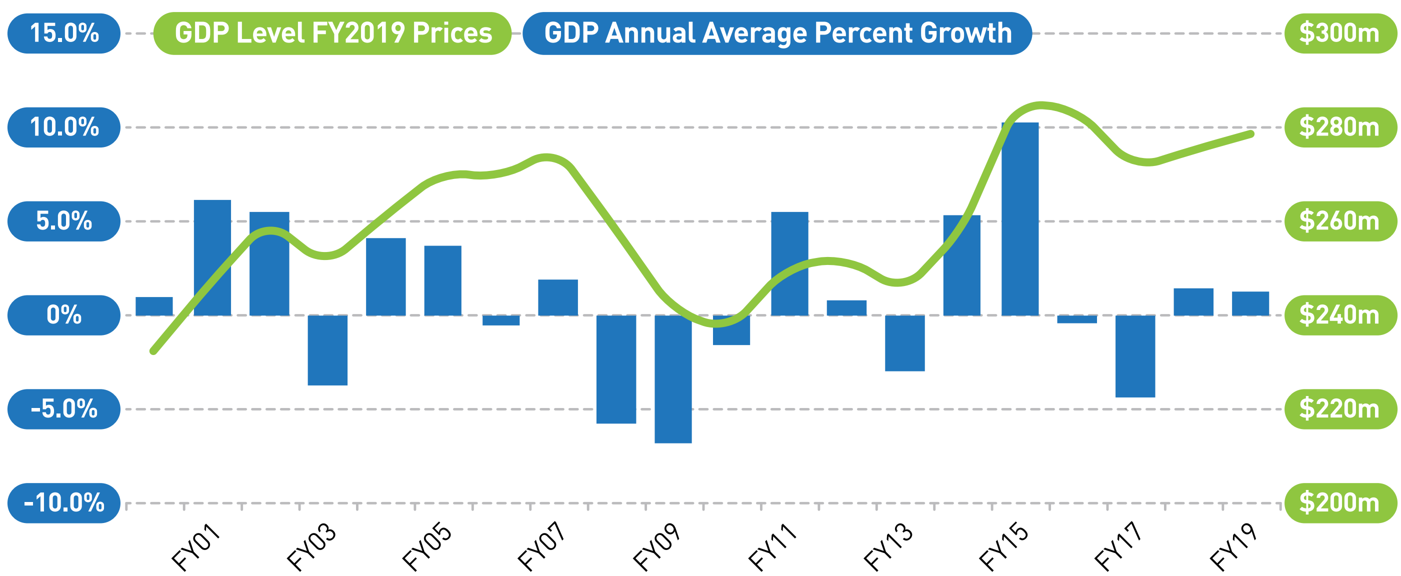
Economic Performance

Palau's economic growth has been modest and comparable to that of the RMI and FSM. Palau's economic performance during the pre-COVID period FY00-FY19, has been modest with the economic growth averaging 0.5 percent during the period, see **Figure 3**. This is comparable and about halfway between Palau's sister FAS, the RMI, which grew by an average 1.4 percent, and the FSM, which grew at an annual average of 0.3 percent. Palau's low average growth during the period reflects high volatility between periods of strong growth in construction and the tourist industry, against periods of substantial contraction.

During the last 20 years economic growth has been highly volatile. During the initial part of the 2000s through FY05 the economy grew by an average of 3.4 percent 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 of 2.8 percent during FY05-FY10. From this point going forward Palau underwent

4 Based on a market value of $258 million end of June 2022.

Figure 3: GDP Growth and Level, FY19 Prices
Palau economy averages 0.5 percent annual growth between FY00 and FY19 with a high degree of volatility



a tourism expansion phase, growing by an average of 3.9 percent. But this in turn came to an end in FY15 and the economy stagnated through FY19 as visitor arrivals contracted to a level only 5.6 percent above the FY05 level. While Palau affords a relatively high level of Gross National Income (GNI) of $15,799 per capita in FY19 which at that point placed Palau in the World Bank's high-income category, economic growth performance has been modest and highly volatile.

Economic Structure

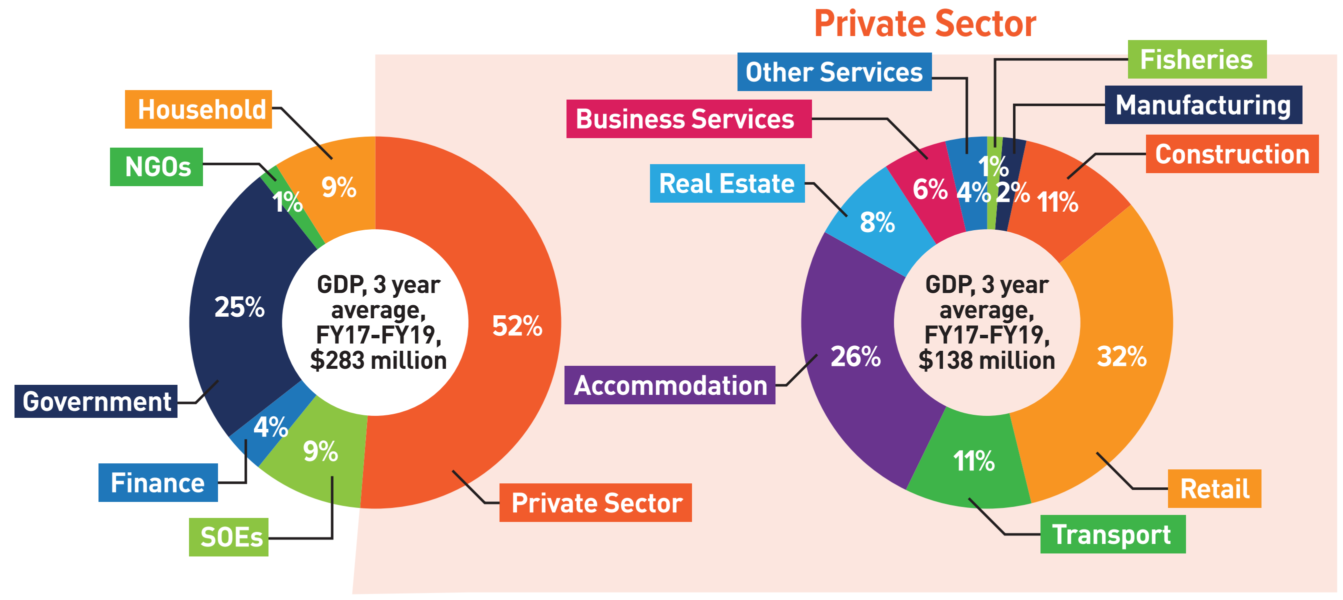
The private sector represents half of the economy, but government remains substantial. Figure 4 indicates the structure of the economy by institutional sector and the composition of the private sector by industry. The private sector represented an average of 52 percent of GDP during the FY17-FY19 period. The size of the private sector is larger than in either of Palau's two sister FAS, the RMI and the FSM, where the public sector dominates, with the private sector representing 33 percent of the RMI economy and 22 percent of the FSM economy. The government sector in Palau represents 25 percent, compared with 30 percent in the RMI and 25 percent in the FSM. As a measure of development, production of the household sector in both informal and non-marketed or subsistence production in Palau averaged 9 percent, compared with 12 and 24 percent in the RMI and FSM, respectively.

Overall tourism activity represents about 37 percent of private sector activity. Figure 4 also breaks out the structure of the private sector by industry. The large tourism sector is reflected in the accommodation/restaurant and transport industries with some production occurring in other sectors such as tourist-related retail operations. Overall tourism activity represents about 37 percent of private sector activity. Construction is also a major driver of demand, representing 11 percent of the private sector. While the retail segment is large at 32 percent servicing the local population, the remainder of private sector activities is small. During the boom-and-bust cycle described above, the large swings in the economy have been reflected by an even larger volatility in the private sector while the public sector has remained largely constant in real terms during each business cycle.

Fiscal Performance

Tax effort has increased in recent years with additional taxes on tourism. Figure 5 indicates recent trends in fiscal performance: current revenues and expense together with capital grants and fixed assets as a share of the economy. After a long period of a relatively unchanged tax effort, taxes began to rise as a share of GDP after the tourism boom of FY15. This was largely due to increases in a tourism-based tax -- the Pristine Paradise Environment Fee or departure tax, coupled with increases in tobacco taxes. An additional important revenue component has also been the

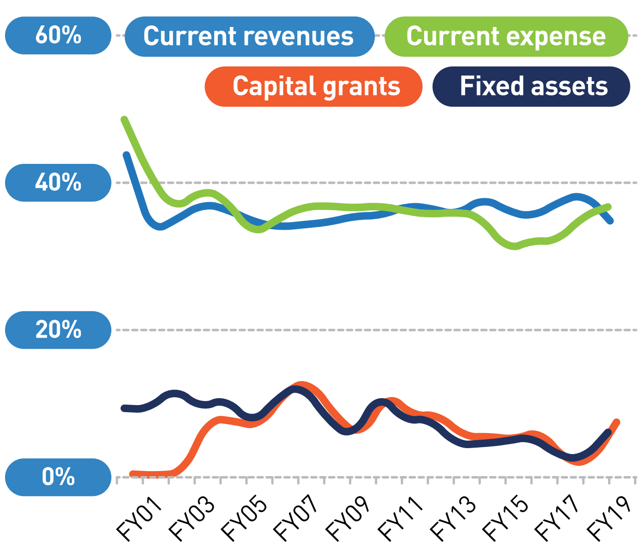
Figure 4: Economic Structure: Economy Wide and Private Sector, FY17-FY19 Average
Private sector is half of the economy with tourism (accommodation & transport) the largest industry



increase in fishing fees arising out of the Vessel Day Scheme (VDS) from the Parties to Nauru Agreement (PNA). While small compared with the other two FAS, Palau fishing fees rose from almost zero in FY05 to close to $10 million in FY19.

While government payroll has been held in check, Palau has failed to maintain the level of infrastructure. Current expenses have displayed a largely static relationship to GDP through FY14 but fell during the tourism boom years through FY17 as GDP grew rapidly. However, as economic growth weakened, expenses continued to grow and expanded as a share of GDP through FY19. Within current expenses, payroll has declined in relation to GDP falling from an average of 19 percent at the start the 2000s to 15 percent during the three years FY17-FY19. The use of goods and services has been largely constant while transfers to other components of government, NGOs and households has risen. On the capital side, both capital grants and expenditures on fixed assets have decreased as a share of the economy indicating a lack of spending on public infrastructure.

Figure 5: Government Revenue and Expenditures, as a Percent of GDP
Palau operates balanced budget but saves resources during tourism boom



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

Figure 6: Government Revenue by Source, FY17-FY19 Average
Taxes are major component of revenues, but grants are large

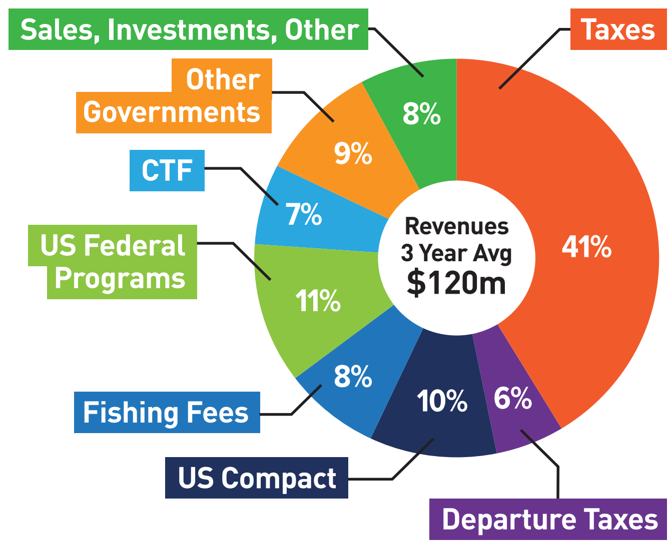
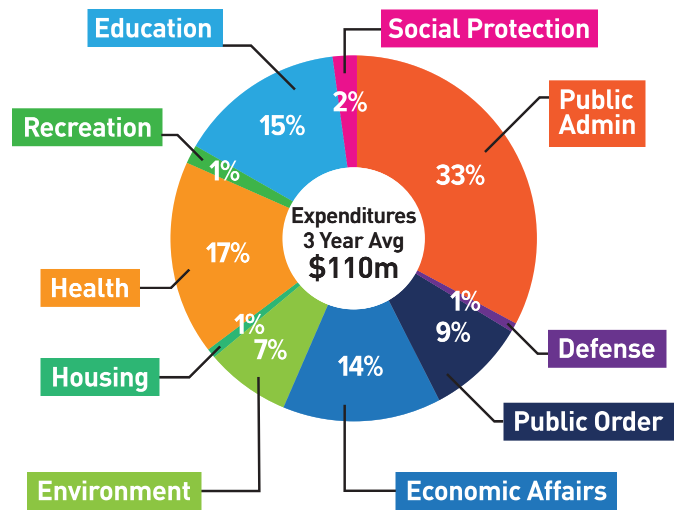


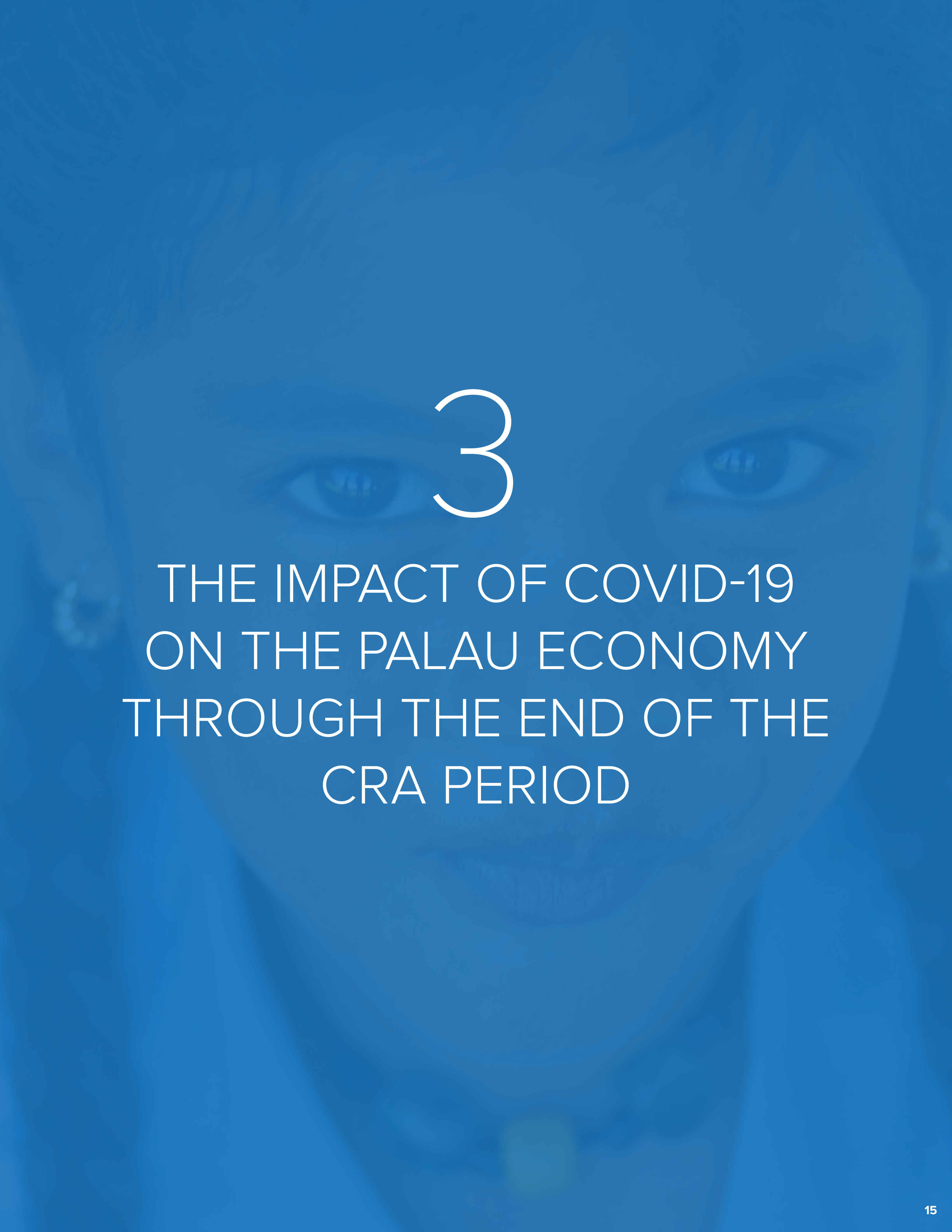
Figure 7: Government Expenditures by Function, FY17-FY19 avg.
Administration is the largest component of expenditures



Fiscal Structure

Significant reliance on grants has resulted in an inelastic revenue trend. Figure 6 indicates the structure of revenues by function. While the major share of revenue is taxes (including the Pristine Paradise Environmental Fee), which represents 47 percent of revenues, it is a relatively low proportion of overall revenues. This feature has both strengths and weaknesses: it provides some insulation of the revenue base from declines in economic activity, but also leads to a lack of buoyancy with respect to economic growth as many of the other sources such as grants are fixed in nominal terms. The economy remains highly dependent on foreign assistance from its donor partners: US Compact grants, federal programs and other country grants represent a total of 30 percent of total revenues, with drawdowns from the COFA Trust Fund equivalent to 7 percent. As already noted, fishing fees have grown in significance while other government fees, sales, and investment earnings account for 8 percent.

Public administration expenses are high in Palau compared with health and education. Figure 7 provides a broad picture of government expenditures by function. About a third of expenditures, 32 percent, are allocated to social services in education and health. This compares with the FSM at 35 percent and RMI at 40 percent. The directed nature of Compact funding in the two other FAS may account for the higher level of outlays on these two priority areas, together with preferences for social spending especially in the RMI. In Palau a significant proportion of expense, 33 percent is allocated to general public administration.



3

THE IMPACT OF COVID-19 ON THE PALAU ECONOMY THROUGH THE END OF THE CRA PERIOD

3 THE IMPACT OF COVID-19 ON THE PALAU ECONOMY THROUGH THE END OF THE CRA PERIOD

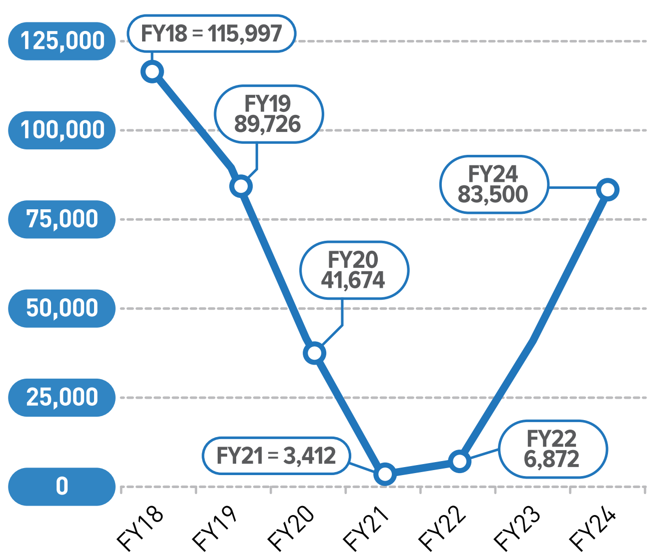
In the previous section we discussed recent economic and fiscal performance and important structural features of the economy before the impact of COVID-19. In this section we model the impact of the COVID-19 pandemic on the economy since FY19 and during the remaining years of the CRA period through FY24.

Impact on the Tourism Sector

After a favorable outlook for tourism at the start of FY20, the pandemic hit and total visitor arrivals virtually disappeared. The first four months of the FY20 fiscal year were favorable with visitor arrivals reaching 32,255 and Palau was on track to attract 120,000 visitors by the end of FY20. Following the emergence of COVID-19, tourism numbers dropped rapidly, and by the end of March had collapsed. By the end of the FY20 the total number recorded visitors were 41,674 a 54 percent reduction from FY19, see Figure 8. By mid-2021 Palau had largely completed a comprehensive vaccination program that safeguarded the health of the nation and loosened its borders in July. While a limited handful of visitors arrived from the US, including US military personnel, travel from Palau's main tourism markets of China, Japan, Korea, and Taipei,China remained effectively closed. By the end of FY21 the total number of recorded visitors to Palau was a mere 3,412.

Recovery in Palau's tourism economy remains elusive. In late 2021 and early into 2022 Palau underwent a period of rapid community spread of COVID-19, but the impact was contained with 6 recorded deaths. By June 2022 the earlier waves of COVID had largely dissipated but visitor arrivals remained largely non-existent. China was continuing its zero tolerance COVID-19 policy. The Korean market was showing some signs of re-opening, but Japan and Taiwan continued to take a very cautious approach. In addition, lack of available airline routes or schedules to Palau, and the high cost of fuel and travel resulting from both the global economic recovery and the war in Ukraine, challenge the outlook for tourism recovery. With the lack of visitors, the remainder of FY22 was bleak, with a total of 6,872 visitors for the year.

Figure 8: Reported and Projected Visitor Arrivals
Visitors disappear during the COVID-19 pandemic with full recovery not projected before FY24



Full recovery of the tourism industry is not projected until FY25. Looking forward, a total of 41,000 visitors is projected for FY23 assuming most markets recover by 50 percent and China travel remains closed. For FY24, 83,500 visitors have been projected by which time most markets would have recovered and China would start to travel again. An eventual recovery is projected for FY25 with the number of visitors returning to 111,000, a level not far below the FY18 level.

Mitigation Programs

The Palau CROSS Act provides support to the private sector to mitigate the impact of the COVID-19 pandemic. A major pillar of the government's response to the pandemic was Palau's enactment of the CROSS Act and its series of programs designed to mitigate the impact on affected private sector businesses and households. In April 2020, the President of Palau signed into law the Coronavirus One-Stop-Shop Act (CROSS). A total of $20 million was appropriated for an eight-month period through the end of January 2021, to be funded by an ADB loan. The law provided a variety of programs to mitigate the impact of the COVID-19 pandemic: an unemployment program for all those who lost their jobs, a temporary jobs program for a limited number of individuals, relief to the private sector through a loan program disbursed by the National Development Bank of Palau (NDBP), and a lifeline utility service program for low-income households.

CROSS Act extended through June 2022. By the expiration date of the CROSS Act at the end of January 2021, funds used on the program turned out to be considerably less than the $20 million originally projected. Unused funds available at the end of this period enabled continuation of the program through the end of FY21 and a further extension through June 2022. However, the structure of the program was altered with Palauans transferred to the temporary jobs program and foreign workers returned to their former employers. Foreign work force employees were expected to work 20 hours weekly at the minimum wage of $3.50 an hour, with savings from the original cost of $400 per month to $280 per month.

US CARES program provided an important lifeline for Palauans who became unemployed due to the pandemic. In addition to the Palau CROSS Act, citizens of the Freely Associated States were eligible for certain unemployment benefits under the US CARES Act, initially through the end of 2020. These benefits were extended through March under the Consolidated Appropriations Act, and again through though Sept. 6, 2021, under the American Rescue Plan Act. An original $13.7 million was allocated to Palau in FY20 but fell to $10.1 million in FY21 as administration of the program was halted due to irregularities in unemployment disbursements. In FY22 these issues were resolved, and Palau received an additional $19.7 million after the conclusion of the programs in September 2022. The unemployment benefits were provided under two facilities: the Pandemic Unemployment Assistance (PUA) and the Federal Pandemic Unemployment Compensation (FPUC). The PUA provided $397 a week for Palauans for an effective total of 79 weeks. Under the FPUC, individuals were eligible for an initial $600 per week through July 31, 2020, which was extended from January 1, 2021, at a reduced rate, allowing unemployed individuals to receive $300 per week.

The fiscal policy response to the pandemic was designed to (i) support the domestic economy, and (ii) to mitigate the impact. In March of 2020, as the consequences of the COVID-19 global pandemic were becoming understood, the government designed a set of policy actions to support the economy and mitigate the negative consequences. The first objective was to limit the economic consequences of the crisis emanating from the tourism sector, through maintaining the level of government operations to support demand for the local economy. The policy to support the domestic economy through an accommodating fiscal policy can be considered successful. While the overall economy contracted by 20.9 percent over the FY19-FY21 period and the tourism sector fell by a massive 85.6 percent, the domestic private non-tourism sector contracted by only 12.1 percent, implying that much of the impact on the economy was contained within the tourism industry.

The fiscal policy stance is assumed to remain unchanged through FY24 with allowance for inflation once recovery has been established. The outlook through the remainder of the CRA period, FY22-FY24, assumes the original authorization for the FY22 budget is fully appropriated. Given the weak fiscal outlook, it is assumed that no increase in departmental budgets is allowed in FY23, but that the tax reform initiative is implemented on schedule. In FY24, the recovery is still not complete and only a modest allowance for inflation is budgeted, despite the recent worldwide surge. To support the economic recovery with a pool of available workers, it is assumed that the government will continue to finance the CROSS program, but that the need for expenses on these programs will decrease in relation to the speed of recovery. By FY24 it is assumed these COVID programs will end.

Economic Impact

Palau's economy is estimated to have contracted by 25 percent over the FY19-FY22 period. 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 8.9 percent in FY20 and to have fallen further by an additional 13.1 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 but includes the positive impact of the mitigation programs: the CROSS and CARES Acts provisions, see Figure 9. Earlier estimates for FY22 had anticipated that the recovery would be well underway to regaining some of the lost ground. However, the current position (July 2022) suggests that visitor arrivals are not expected to show any signs of recovery until FY23. GDP is now projected to fall 3.3 percent in FY22 and by a total of 23.5 percent over the FY19-FY22 period.

The economy is projected to start a slow recovery in FY23 and achieve full recovery by FY25. In FY23 the economy is projected to grow by 12.8 percent, albeit from a low base. However, this level of economic activity remains 17.4 percent and well below the level prevailing in FY18, a healthy year of economic activity. The tourism recovery is expected to proceed in FY24 and GDP to attain a value 8.2 percent lower than the FY18 level, six years earlier.

The private sector experienced most of the impact of the pandemic and is projected to have fallen by 42 percent over FY19-FY22. Figure 10 indicates the impact of the COVID-19 pandemic on the private sector. While the public sector is estimated to have remained unchanged—thanks to donor financing to maintain basic services—the brunt of the impact of the COVID-19 pandemic fell upon the private sector. In FY20, a large reduction of 20.9 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 22.7 percent occurred, reflecting the full-year impact of the reduction in tourism with a further loss of 5.2 percent in FY22. Overall, a massive loss in output of 42.0 percent hit the private sector during the FY19-FY22 period.

Impact on Employment and Household Income

Job losses turned out to be less dire than original projections, with final figures indicating 1,687 jobs had been lost by FY21 compared with FY19. . The labor market in Palau was comprised in FY19 of 5,539 Palauan workers and a larger number, 5,890, of foreign workers. In normal times the Palauan segment is close to full employment with excess demand supplied by foreign workers. 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

Figure 9: GDP Growth and Level, FY19 Prices
Total reduction in GDP FY19-FY22 of 23 percent anticipated

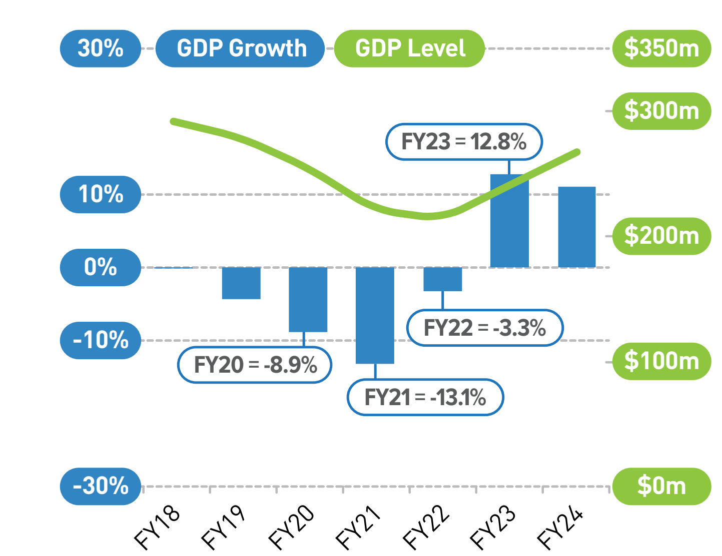


Figure 10: Private Sector GDP Growth, FY19 Prices
Total reduction in private sector contributions to GDP FY19-FY22 of 42 percent anticipated

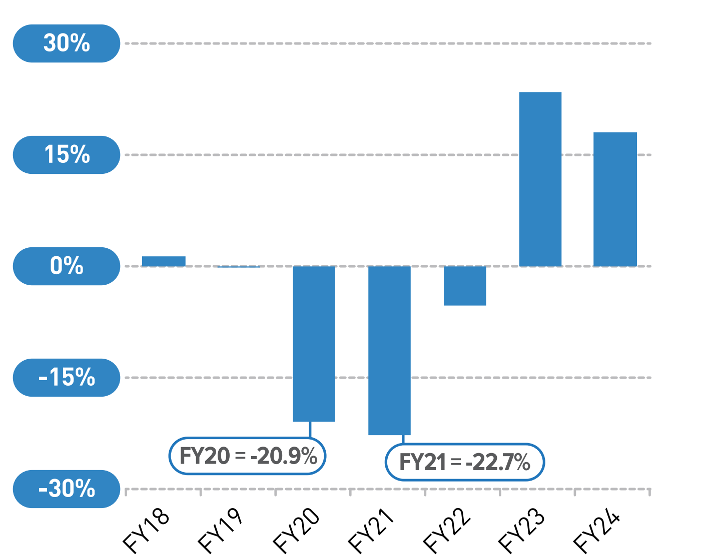


Figure 11: Employment of Palauan and Foreign Labor
Palauan and foreign worker employment falls through FY22

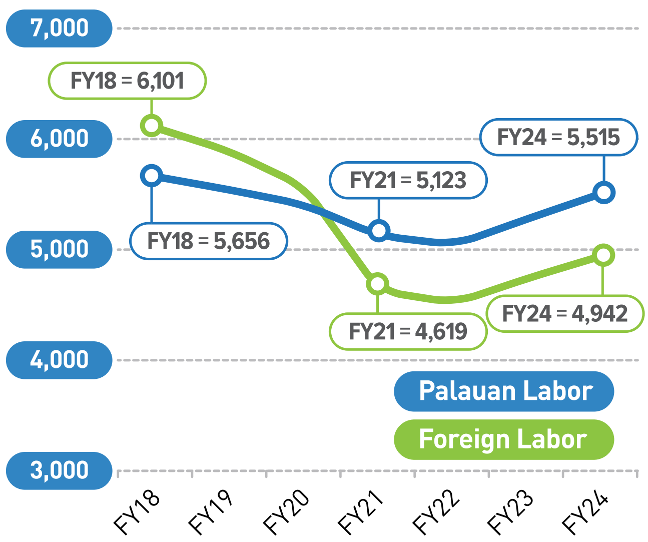
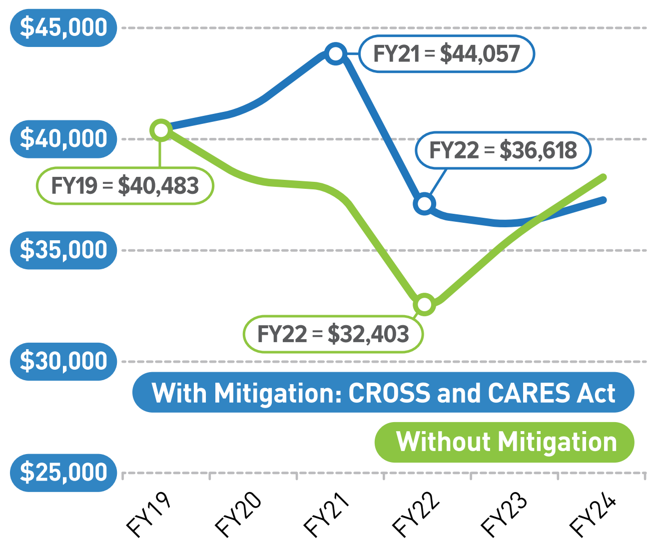


Figure 12: Household Incomes (FY19 Prices): With and Without Mitigation
Household incomes fall by 9.5% between FY19 and FY22 with mitigation, and 20% without mitigation



FY21 indicates that 1,687 jobs were lost or 14.8 percent of the FY19 level, see Figure 11. The impact of the COVID-19 pandemic on employment 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.

Mitigation programs had large beneficial impacts on household incomes. Without the CROSS and CARES mitigation programs and unemployment benefits, household incomes could have fallen by 6.5 percent in FY21 as compared to FY19, which would have resulted in rising levels of poverty in both the Palauan and foreign sectors of the workforce, see Figure 12. With mitigation based on both the CROSS and CARES Acts provisions, however, average household incomes are projected to have risen in FY21 by 8.8 percent compared with FY19. In FY22, household incomes with mitigation were 9.5 percent lower than their FY 19 level, but better than the 20 percent decline estimated in the absence of mitigation. For FY22, while the CARES Act provisions have officially expired, the remaining unspent funds will enable the benefits to continue. This is a fortuitous development as unlike the United States where the recovery is well underway, in Palau it has yet to start, and the remaining funds will continue to mitigate the impact. However, while the continuing receipt of CARES funds in FY22 is beneficial, the impact of the surge in inflation results in real household incomes declining despite an increase in nominal incomes. Overall, the magnitude of the coordinated government and donor response has been both timely and significant. The government and donor community should both take credit for rapid and apparently effective mitigation efforts.

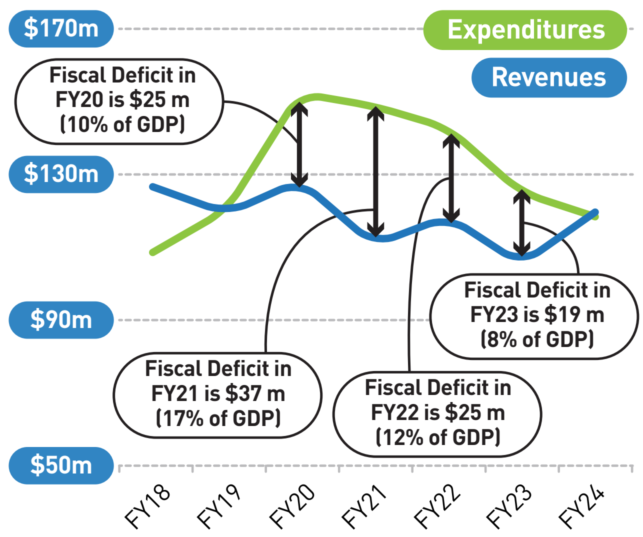
Fiscal Impact and External Debt

Total financing needs of 45 percent of GDP are required to support the national government's fiscal deficit during the COVID-19 crisis. With the impact of COVID-19 the fiscal position deteriorated rapidly. From a balanced position in FY19 a deficit of $25 million or 10 percent of GDP is estimated for FY20 rising to $37 million or 17 percent of GDP in FY21, as the impact of the pandemic was incurred during a full fiscal period, see Figure 13. Not only did tax revenues decline reflecting the impact of the loss of the visitor industry but also Palau embarked on a series of mitigation programs requiring additional expenditures under the CROSS Act.

Given that recovery of the tourism industry is not anticipated to get underway until FY23, a further deficit of $25 million or 12 percent of GDP is projected for FY22 and of $19 million or 8 percent in FY23 before full recovery is achieved in FY25. Total financing needs thus amount to $106 million or 45 percent of the average GDP level in FY20-FY23 to finance Palau through the crisis. However, in addition to the national government's funding needs, Koror state has requested loan finance of $15 million to support the state through the extended downturn now experienced due to COVID-19. Adding Koror state needs to those of the national government, total funding of $121 million or 52 percent of the average GDP level can be anticipated.

Available financing will not be sufficient to support government operations of both the national and Koror state governments through the projected

Figure 13: Revenues and Expenditures
Palau experiences large fiscal deficits during COVID-19



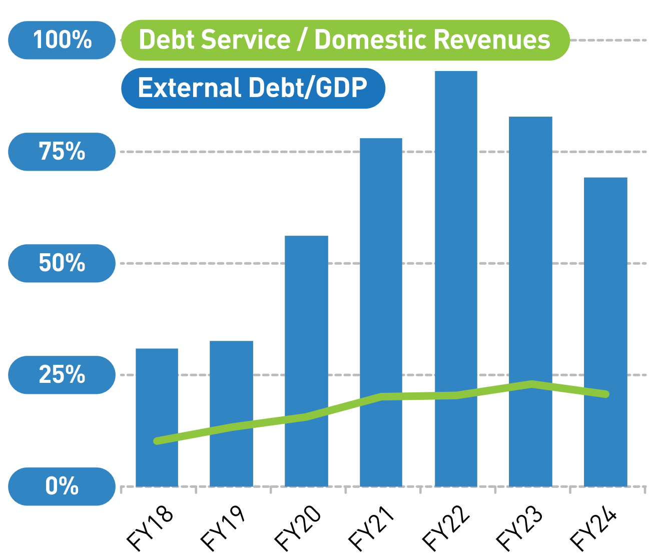
recovery period. To finance the deficit Palau requested funding from the ADB to support the nation through the crisis. A series of ADB loans, totaling $115 million were initiated: (i) a $35 million facility under the DRP (Disaster Resilience Program) (ii) $20 million under the CPRO (COVID-19 Pandemic Response Option), (iii) $5 million under Palau Public Utilities reform program, and (iv) a further $55 million under the RISES program (Recovery through Improved Systems and Expenditure Support Program), a Policy Based Loan (PBL), comprised of two subprograms. Subprogram 1 loan conditions were met, and Palau received $25 million of budgetary support in March 2021, which funded government operations through the end of FY22. The subprogram 2 loan of $30 million required a further set of deeper and more demanding reforms. Palau has now fulfilled the conditions and funds have been released. However, total funding from the ADB will not be sufficient to cover both the national and Koror state needs of $121 million through the end of FY23.

External debt/GDP ratio is projected to rise rapidly to 93 percent of GDP to finance the impact of the COVID-19 global pandemic. As a result of the COVID-19 global pandemic the need for external borrowing is projected to rise rapidly in the short term (see Figure 14). External debt is expected to rise from a level equivalent to 31 percent of GDP in FY18 to 93 percent of GDP by the end of FY22. While the rise in the debt/GDP ratio is projected to attain record levels, much of the increase is due to the decline in the GDP. For example, reevaluating the FY21 debt/GDP ratio based on the average level of nominal GDP in the FY16-FY18 period indicates the structural debt/GDP level is about 22 percent lower. After peaking in FY22, the ratio is projected to decline rapidly to 61 percent by FY25 when the economy recovers. For a country of Palau's level of income, the IMF considers a debt to GDP ratio in excess of 50 to 60 percent as an indicator of debt stress. After the recovery Palau's debt is projected to decline slowly, but regular debt sustainability analysis (DSA) will remain important.

External debt service is projected to rise significantly but should not result in a high risk of debt stress. Debt service, that is, payments made to satisfy debt obligations, 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 percent in FY23 and declines thereafter as the economy recovers. Not counting the SOE components' legacy borrowing, national government debt service is projected to stabilize at around 13 percent of domestic revenues in FY24.

After a period where debt service has been a minor component of the national budget, it will end up consuming a significant but manageable proportion. While the level of debt Palau will incur is large by historical standards, it should not, given fixed low interest rates on many loans and the concessional nature of the debt, pose a high risk of debt stress. Return of growth in the economy, the tax reform initiative, and careful control of expenditures should enable Palau to maintain fiscal and economic stability in the years ahead without risk of debt stress.

Figure 14: External Debt (% GDP) and Debt Service (% Domestic Revenue)
External debt rises to high levels before recovery



4

MODELING THE IMPACT OF NON-RENEWAL OF PALAU COMPACT ECONOMIC ASSISTANCE

4 MODELING THE IMPACT OF NON-RENEWAL OF PALAU COMPACT ECONOMIC ASSISTANCE

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

The first, "**Non-Renewal of Compact Assistance Scenario**" involves three assumptions: Compact assistance is not extended, US federal services and programs are ongoing, and distributions from the Palau CTF are modified to correspond to a FY25 level that is estimated to be sustainable with a high degree of confidence based on the projected value of the CTF at the end of FY24, and that (reduced) distribution is thereafter adjusted to fully offset the impact of inflation.

The second, the "**Independence Illustration**" is presented to indicate the economic impact that would occur if Palau was to become fully independent of US assistance, both Compact and non-Compact. It assumes that in addition to the adjustment to a sustainable level of CTF distributions, Palau would also transition to a position without any US federal programs and services. This illustration is presented not as a likely outcome, as the relationship between the US and Palau remains strong, but rather to show the ongoing value of the US relationship to Palau.

Scenario analysis utilizes economic models developed by the GSUSA for Palau. The analysis utilizes a modeling framework, developed by GSUSA, which is based on the economic sector accounts of the Palau economy and programming techniques like those utilized by the International Monetary Fund[5].

5 See GSUSA, *Palau FY18 Economic Review, July 2018* (EconMAP Economic Review, posted July 2, 2019). ***https://pubs.pitiviti.org/palau-fy18-economic-review***

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

Drawdowns from the COFA Trust Fund (CTF) are based on sustainable distributions, using a "Sustainability Adjustment for Enhanced Reliability" method hereafter referred to as the SAFER method. (The methodology is described in the team's published works.) Using a statistical method called Monte Carlo analysis, the study projects the median value of the trust fund at the end of FY24 and computes a SAFER estimated distribution for FY25. Applying this is a specific approach to how the Compact Trust Funds are managed in the future. It is recognized, for example, that in the Compact economic assistance "non-renewal scenario" the immediate shift to the SAFER distribution rule calls for a larger, one-time downward funding adjustment at the very outset of the period.

Palau could choose to take larger—even maximized—distributions in the early years. However, the modeling indicates that such an approach increases the likelihood of exhausting the Palau CTF entirely. The approach modeled—with an insistence on shifting immediately to a sustainable distribution level—may lead to an overstatement of the adjustment that is required in the near-term. But this approach has an important virtue. Painful adjustments are not masked by pushing them just beyond the horizon of the modeling results. As the next chapter shows, in the event of a robust Compact funding extension, the benefits of a SAFER distribution rule will remain while the immediate pain of a substantial adjustment would be either mitigated or eliminated entirely.

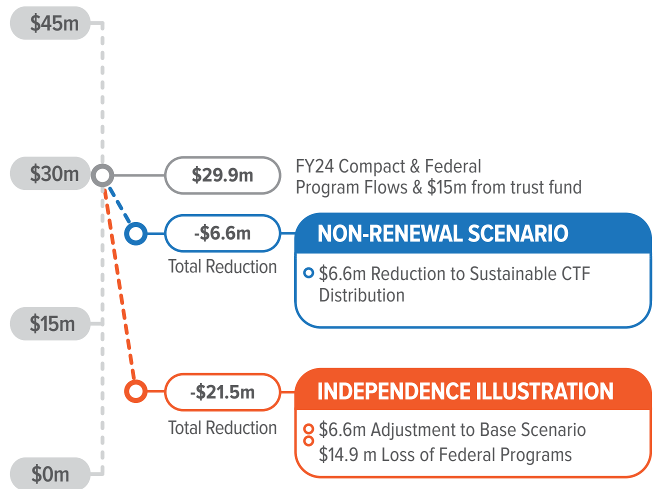
Non-Renewal Scenario

Recovery of the tourism sector and economy is projected to be well advanced by FY25 when Palau enters non-renewal Compact period after the completion of the CRA. The projections in the prior chapter set the likely path the economy may take for the remaining years of the CRA period although—based on historical experience—subject to a high degree of variance. This assumes that the recovery of the Palauan economy and tourism sector follows our projection and is largely complete by the time Compact non-renewal begins in FY25. This establishes the base year for the two scenarios examined in this chapter: the non-renewal scenario and independence illustration.

After recovery from COVID-19 the tourism economy is projected to continue to expand by 3.9 percent per annum FY24-FY30. The Palauan tourism sector was operating at low levels of hotel occupancy in FY19 before the COVID-19 pandemic, just 34 percent, and we anticipate conservatively that occupancy rates will rise to 50 percent by FY30. This imparts a strong upward growth path in the tourism sector and the economy at the same time Palau enters the post CRA period. There are thus two periods of recovery: (i) the recovery from COVID-19 during the remainder of the CRA period, and (ii) a broad tourism sector recovery during the early years of any Compact renewal period as the sector returns to normal levels of occupancy and profitability. For this study we isolate and focus upon the impact of adjustments to changed Compact funding levels as they occur during a trend period of substantial tourism recovery and economic growth.

Projections incorporate increased debt service resulting from COVID-19 associated debt repayment. As previously discussed, Palau took on significant

Figure 15: Palau Downward Adjustment Scenarios
Components and magnitudes



Note: Sustainable distributions from the CTF ($8.4 millions) are assumed to be available.

additional external debt during the pandemic. That debt, albeit concessional in nature, requires servicing. In addition, our model includes a 2.5 percent increase in the newly introduced Palau Goods and Service Tax (PGST) to service the debt in addition to possibly adjustments arising from each Compact scenario. The increase in PGST is applied under all modeled scenarios.

Palau faces modest adjustment under non-renewal scenario although when coupled with increasing debt repayment the adjustment will be signficant. The modest adjustment is the result of Palau's low reliance upon Compact assistance in relation to the size of its economy. Under the terms of the original Compact the level of distribution from the Palau CTF is limited to $15 million annually. Absent any US-Palau amendment to trust fund distribution rules that annual distribution is not adjusted for inflation.

COFA Trust Fund projected to be $275 million at the end of FY24 and will support a sustainable (SAFER) distribution of $8.4 million. Using the Monte Carlo method of statistical analysis, the median value of the Palau CTF at the end of FY24 is projected at $275 million, with a corresponding SAFER distribution of $8.4 million.[6] Implementing SAFER reduces transfers to support government operations and capital investments by $6.6 million or the equivalent of 2.3 percent of projected GDP in FY24. See Figure 15. The range of

6 Based on a market value of $258 million end of June 2022.

possible fiscal adjustments of course are numerous, but in this analysis the following assumptions are made[7]:

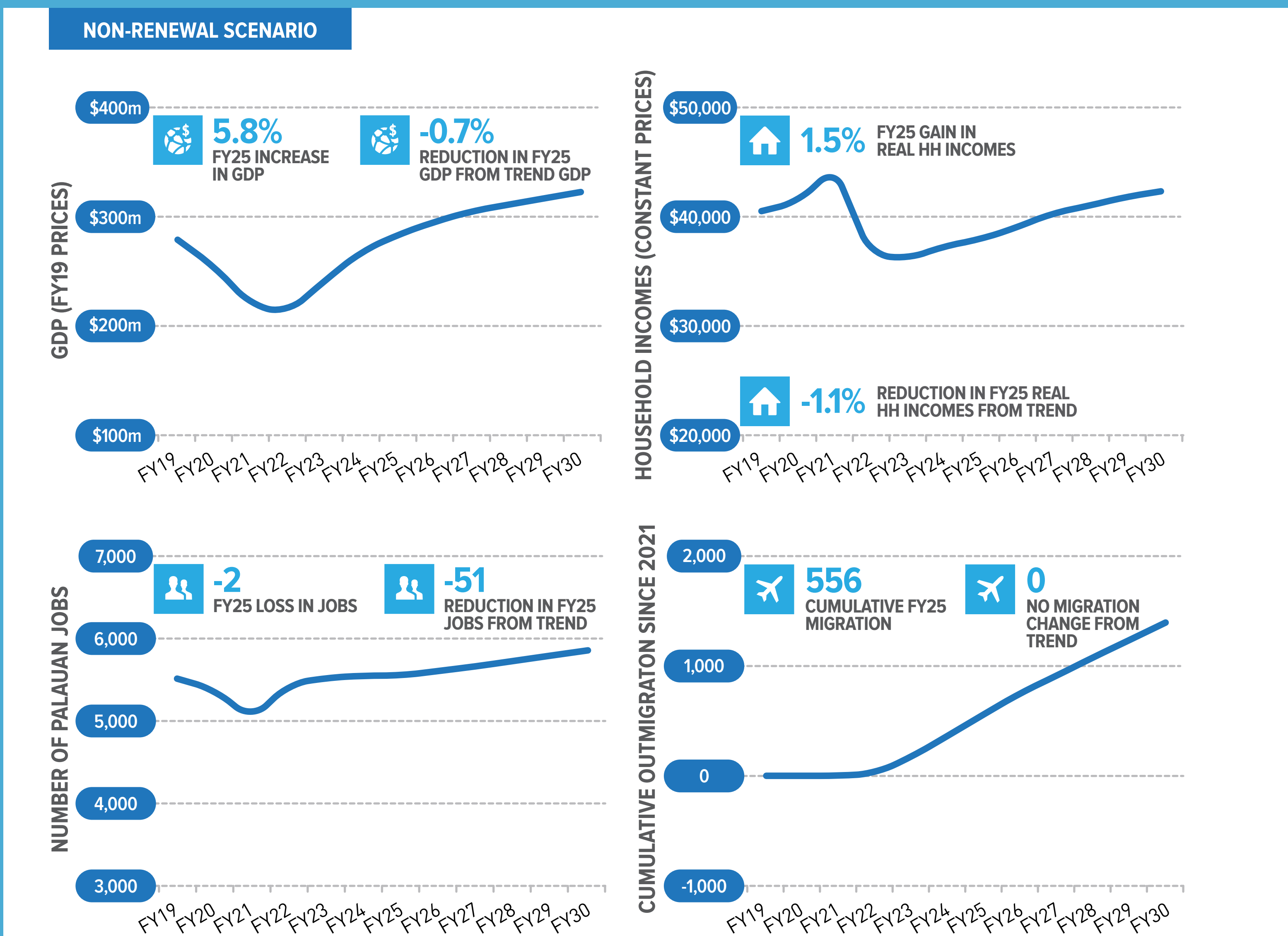
- A freeze on the recrutiment of new civil servants to replace those departing during FY25, estimated to be 3 percent
- Annual wage increments are not awarded in FY25, and
- A real cut of 5 percent in FY25 on all purchases of goods and services, and transfers to government agencies, state governments and NGOs.

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

The impact of the non-renewal scenario is a relatively small reduction in GDP growth of 0.7 percent to 5.8 percent. Figure 16 provides details of the impact of the non-renewal scenario on the economy, and the difference with the underlying trend. GDP growth is projected to grow by 5.8 percent in FY25, this is 0.7 percent below the rate that results under the modeled trend. This result may at first sight appear surprising. However, the economy is projected to be recovering from the pre COVID-19 tourism reduction. Visitor arrivals are projected to rise by 33 percent to 111,000 in FY25, approaching the level attained in FY18 of 116,000; this has a strong stimulative effect on the economy.

The impact on household incomes is larger than GDP and they fall by 1.1 percent in FY25 below trend; job losses are minor with no projected impact on trend migration. Figure 17 shows the non-renewal scenario results in a 1.1 percent decline in household

Figures 16-19: Palau Non-Renewal Scenario: GDP, Household Income, Palauan Jobs, and Migration

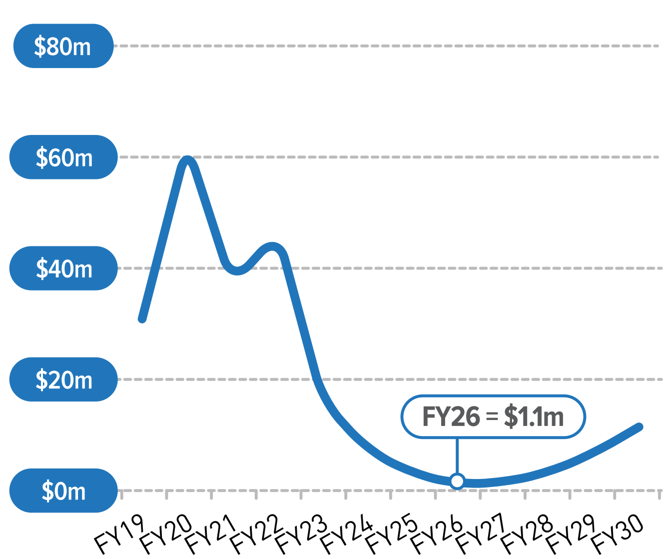


incomes relative to the trend projection. The impact on households is larger than GDP since the adjustment mechanism entails a direct impact on civil service wage and salary levels. Reflecting the underlying trend increase in GDP, the non-renewal scenario generates jobs and opportunities without stimulating any significant migratory impact, see Figure 18 and Figure 19. Again, if we isolate the negative impact of the non-renewal scenario the model shows a loss in Palauan jobs of 51 in FY25 below trend Palauan employment with no simulated impact on trend out-migration[8].

Government deposits are projected to fall close to zero in FY26, but to grow thereafter. Government deposits are a measure of the ability to finance fiscal deficits after external debt obligations are met. During FY20 through FY22, in the years before recovery, the government secured a series of loans with the ADB that increased reserves, see Figure 20. Our projections assume no further borrowing, and since the recovery is far from complete during FY23, the deposit base continues to fall and bottoms out in FY26 with only $1.1 million in cash flow remaining. These assumptions may not be entirely realistic, and the government may need to arrange additional financing until the recovery is sufficiently strong to generate enough resources to raise reserves. These results incorporate the series of austerity measures at the start of a new non-renewal Compact period and an increase in tax effort to support debt service obligations.

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

Figure 20: Government Deposits Under the Non-Renewal Scenario



Independence Illustration

The independence illustration entails the further transition to an economy without access to Federal programs and services equivalent to 5.3 percent of GDP. Under the independence illustration, an additional reduction in US funding from listed programs and services is analyzed. This additional reduction equates to $14.9 million annually or the equivalent in size to 5.3 percent of projected GDP in FY24. Taken together with the non-renewal scenario, the total annual reduction in transfers would be $21.5 million annually, or the equivalent of 7.6 percent of projected GDP in FY25.

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

Severe adjustments are required in the delivery of public services to achieve financial independence. In order to restore fiscal balance to a similar level to that achieved under the non-renewal scenario the following assumptions have been made for the independence illustration:

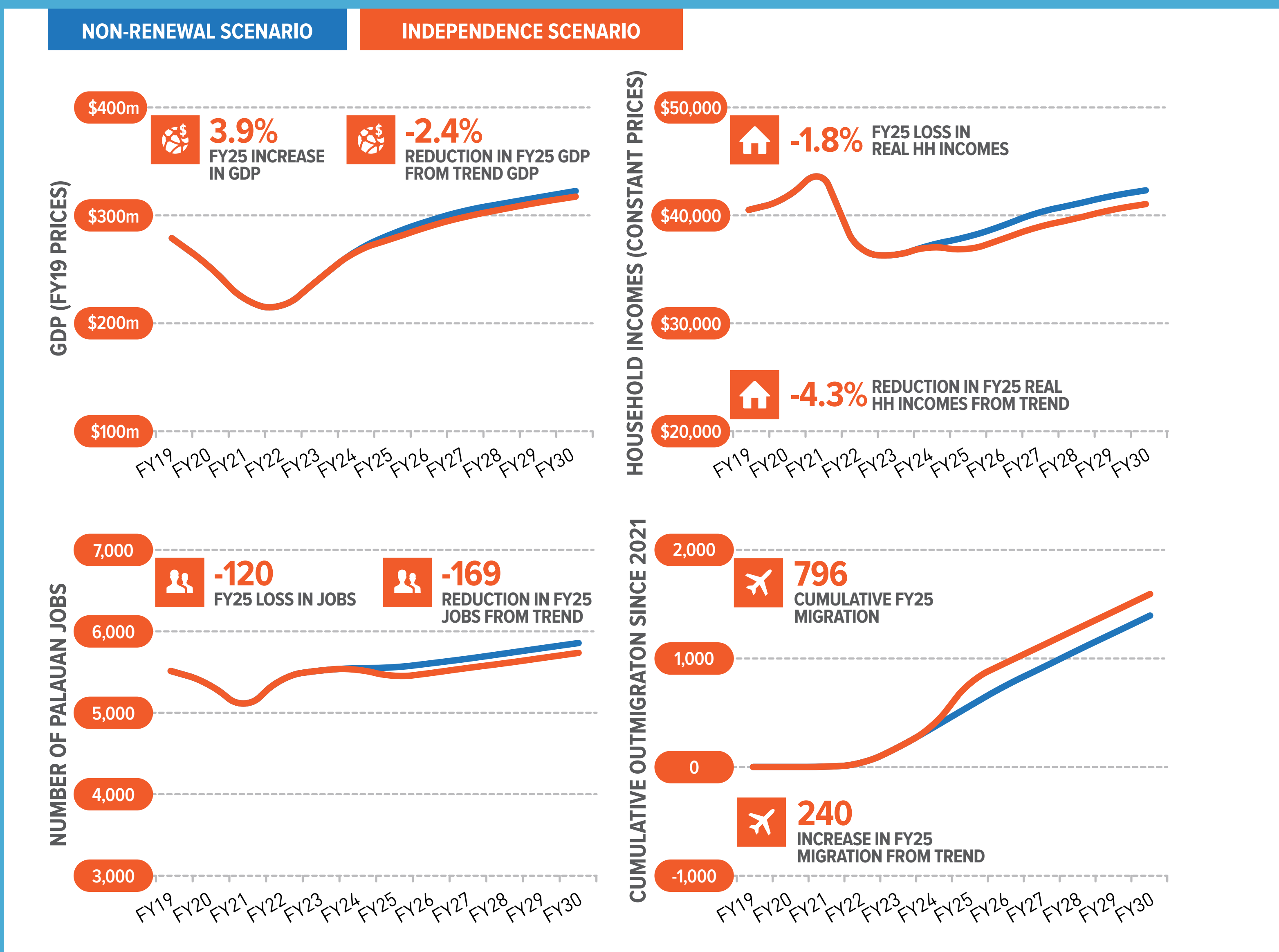
- The national government reduces the number of civil servants by 10 percent coupled with a wage freeze and additional 12.5 percent cut in salaries. A reduction-in-force is implemented in FY25.
- Reduction in all purchases of goods and services, transfers to government agencies, state governments and NGOs of 22.5 percent. The adjustments are assumed to take place in FY25.
- With the loss of US Pell education grants, it is assumed the national government funds the former grant levels with a transfer to Palau Community College to fully make up the loss.
- The same assumption is made that the national government funds the former grant levels with a transfer to the Palau Community Action Agency to maintain US Head Start (pre-K) programs.

Under the independence illustration the public sector contracts strongly as the private sector grows with continuing recovery in tourism. Under the independence illustration Palau's GDP continues to grow in FY25 by 3.9 percent compared with FY24 due to the underlying recovery in the tourism sector, see Figure 21. Compared with the model trend, FY25 GDP is lower by 2.4 percent. However, the impact of adjustment is quite different between the private and public sectors. Given the forced nature of adjustment, the public sector contracts by 6.3 percent at a rate proportional to the cut in civil servants. On the other hand, the private sector comes out relatively unscathed given the strong expansion projected in the tourism economy. This of course is completely the opposite of the impact of COVID-19 where the brunt of adjustment has been felt by the private sector. Figure 22 indicates the impact of the independence illustration on household incomes but these impacts are greater than that on GDP due to the direct impact of the austerity measures on public sector employment and wages. The isolated impact or delta between the independence illustration and the model trend is a 4.3 percent decline in household incomes.

Significant reduction in Palauan jobs is projected under the independence illustration. Figure 23 indicates that under the independence illustration, a loss of 120 Palauan jobs would be incurred, but also that this level of job loss would be 169 jobs below the model trend, inferring the overall growth in the economy would be responsible for the generation of 49 jobs. Based on FY19 data, Palau's labor market has more foreign workers (5,884) than Palauans (5,522). However, the civil service is dominated by Palauans, while the private and tourism sectors utilize a high proportion of foreign workers. The impact of the independence illustration is thus felt disproportionately in the Palauan segment of the labor market, with some of the displaced workers switching to the private sector.

Under the independence illustration significant Palauan migration is projected. As a result of the job losses in the public service, many of the displaced

Figures 21-24: Palau Independence Illustration: GDP Level, Household Income, Palauan Jobs, and Migration



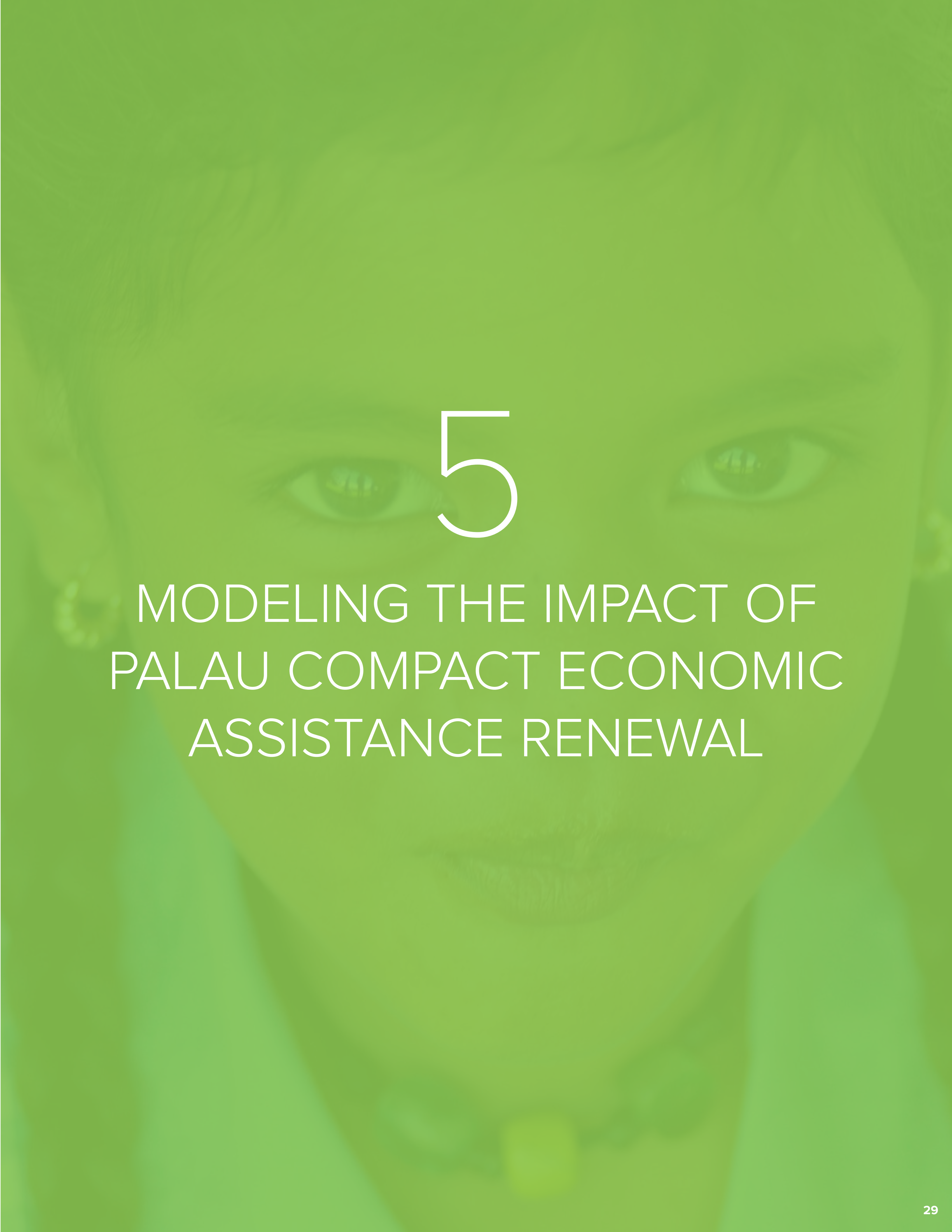
workers are likely to migrate with their dependents (see Figure 24). The labor dependency ratio in Palau is 2.0. The independence illustration projects that an additional 240 Palauans would migrate to the US.

Conclusion

While the impact of the non-renewal scenario is small, the impact of the independence illustration is masked by the ongoing tourism recovery and the effect on employment, migration and incomes would be large. This presentation of the impact of the non-renewal scenario and independence illustration has important differences compared with earlier projections prepared before the impact of COVID-19[9]. The Palau economy is now projected to experience two tourism sector recovery phases. The first is the recovery of visitor arrivals from the impact of COVID-19. By FY25 tourism is projected to return to the levels achieved in FY18 before the pandemic. The second phase of recovery is a further increase in visitor arrivals such that the hotel sector returns to normal levels of occupancy that averaged 55 percent during the FY12-FY16 period. The impact of these two assumptions is that the economy is projected to be on a rising trend as it enters the new phase of Compact relations with the US.

The negative impact of any fiscal adjustments is masked by the positive impact of the recovering tourism sector. However, the drag on growth, particularly on household incomes and Palauan employment is significant as has been outlined above. Moreover, should the tourism recovery be further delayed and take longer than assumed, the impact of these two Compact adjustment scenarios would be more adverse.

9 See GSUSA, *The Economic Impacts of the End of Compact Grant Assistance in the Freely Associated States* (EconMAP, Asian Development Bank project - Draft for Discussion, March 2020).



5

MODELING THE IMPACT OF PALAU COMPACT ECONOMIC ASSISTANCE RENEWAL

5 MODELING THE IMPACT OF PALAU COMPACT ECONOMIC ASSISTANCE RENEWAL

The non-renewal scenario and independence illustration required a series of austerity measures of raising taxes, expenditure cuts and job losses to restore fiscal balance. Chapter 4 modeled a response on the part of Palau to reduced Compact funding without any modified development partner support and based on a program of fiscal austerity to achieve fiscal balance. The non-renewal scenario outlined in Chapter 4 assumed the government implemented a program of modest expenditure adjustments, while under the independence illustration fiscal balance was restored through the brute force of expenditure cuts and job losses. Leaving behind those painful scenarios it is possible to look forward with optimism, to project the positive impact of Compact economic assistance renewal for Palau.

Palau Compact Renewel

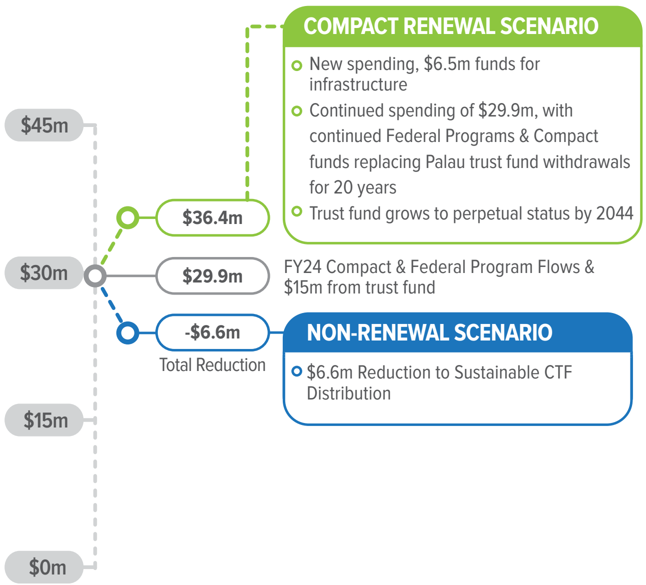
The Palau Compact renewal scenario presented assumes that assistance is provided over time, similar to the structure of past US assistance to the FSM and the RMI. The objectives of Palau Compact extension are assumed to be steady-state budgetary support, infrastructure funding in proportion to that budgetary support, audit support, and contributions to the CTF to create a perpetual fund. In the past, Palau received "lumpy" or front-loaded US transfers, especially for infrastructure, in both the initial Compact period and during the CRA period. The specific amounts modeled in this chapter for Compact renewal have been chosen to follow the structure of prior FSM and RMI Compact funding, where assistance was supplied over an extended period.

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

The Compact renewal scenario for Palau includes US support to establish a perpetual Palau CTF and a further program of investment in infrastructure. Figure 25 shows the Compact renewal scenario in comparison to the nonrenewal scenario and independence illustration outlined in Chapter 4. The scenario is for a topline value of $35 million in annual US assistance, that is adjusted for inflation using the two-thirds of the U.S. GDP deflator rate for a 20-year period. The modeled program entails the following distribution of funds by use, with their inflation adjustment:

- US operating grants are set at $15 million annually in FY24 prices (fully adjusted for inflation). In this scenario, this grant substitutes for distributions from the Palau Compact trust fund of $15 million per year. For the period FY24-FY44, no distributions will be taken from the trust fund and additional US contributions are added to the fund such that by FY44 it will have transitioned from a sinking to a perpetual trust fund.
- US infrastructure grants are set at $6.5 million annually in FY24 prices (fully adjusted for inflation).

Figure 25: Palau Compact Renewal Scenario
Components and Magnitudes



This modeled 70:30 ratio for operating grants to infrastructure grants is the same ratio used for the FSM and RMI. These annual grants represent additional resources for Palau beyond those available in FY24.

- US annual grants for infrastructure maintenance of $2 million and audit of $0.5 million (neither adjusted for inflation) continue.
- The annual US contribution to the Palau CTF for the first year is set at $11 million in FY24 prices. The amount contributed to the CFT in subsequent years is not adjusted for inflation. Rather, this component is modeled as the residual of the topline level of transfers from the US that has a two-thirds inflation adjustment, after the other three components are fully inflation adjusted. The additional $11 million in FY25 and subsequent lower annual contributions would attain a SAFER performance score of 95, regarded as attaining a perpetual status (see below for definition).

Economic growth is projected to increase by an average of 3.9 percent per year FY24-FY30, a sustained average annual 0.6 percent improvement over the model trend for the period. Figure 26 shows the potential benefits of such an extension. As in all other scenarios, the projections assume a similar trajectory for fiscal balance as under the model trend. Without the need for adjustment in FY25 to a lower SAFER distribution from the Palau CTF, the economy maintains its forward momentum, including the projected recovery of the tourism sector through the remainder of the CRA period. GDP is projected to grow by an average of 3.9 percent per annum during FY24-FY30. In comparison with the modelled trend, this equates to a 2.2 percent higher in FY25, which rises to 3.5 percent by FY30 and a sustained average 0.6 percent annual improvement over the model trend for the period. This outcome is based on an improvement in the level of private sector activity due to increased infrastructure spending, averaging 0.8 percent per year over the period, FY24 to FY30, and additional Compact funding which supports a modest expansion in the provision of public services of 0.6 percent per year. Figure 27 indicates the impact of the renewal scenario on household incomes which is 1.9 percent and 3.1 percent higher than the model trend in FY25 and FY30, respectively.

Compact extension provides a modest rise in employment and retention of Palauan jobs. Figure 28 indicates the additional hiring associated under the Compact extension scenario with modest expansion in the provision of public services adding an estimated 17 Palauan jobs in FY25 which rises to 104 Palauan jobs by FY30 compared with the model trend. Since most workers in the construction sector are foreign labor the enhanced infrastructure program does not generate a significant increase in jobs for Palauans. As a result of the increases in both civil servants and construction workers, the labor market, including both Palauans and foreign workers, expands by an additional 374 jobs by FY30 or 3.2 percent above the model trend. The projections show a small decrease of 33 fewer migrants in FY25 and 98 fewer in FY30 under the Compact renewal scenario compared with the model trend. This is shown in Figure 29.

Additional infrastructure helps strengthen the economy under Compact renewal. Finally, in Figure 30 the level of investment is indicated under both the renewal and non-renewal scenarios. Under non-renewal, public investment in infrastructure grows at the start of the projection period going into the COVID-19 period and helps sustain economic activity. However, from FY22 through FY25 a paucity of both private and public sector projects is indicated, reflecting the lack of demand for investment in the tourism industry, and a lull in public projects. From FY25 both private and public projects re-emerge as the economy gains momentum and demand for new tourism infrastructure occurs. However, under Compact renewal, the significant impact of Compact provision of additional infrastructure projects is clearly indicated, helping to lay the groundwork for future expansion in the economy. Investment is higher in FY30 by $23 million or 27 percent above the non-renewal level.

Compact Trust Fund Issues

The Palau CTF achieves perpetual status in the renewal scenario. In the described Compact renewal scenario, the additional contributions to the Palau CTF have been derived such that the CTF will achieve perpetual status by the end of FY44, see Table 1. The scoring methodology used to optimize for the SAFER method uses scores for three categories: real value of the Palau CTF, value of annual distributions, and (lack of) volatility of annual distributions. Each of these in turn is broken out into a set of sub-measures: the first an intergenerational measure estimated over the distribution period and the second a measure of long-run sustainability. A score of 95 percent is considered to be sufficient for the CTF to have achieved perpetual status.

Under the existing COFA rules a CTF score of 68 percent is computed -- far from perpetuality. In the absence of Compact renewal, the Palau CTF would score 68 percent using COFA rules and in 16 percent of simulation cases result in fund collapse during the period FY24-63. In the absence of renewal should Palau switch the distribution mechanism to the SAFER rules, sustainability of the CTF would increase substantially to 86 percent but still below the 95 percent considered necessary to achieve perpetual status. In the SAFER case zero distributions or fund collapse is avoided albeit at a lower initial distribution. Greater detail on the Trust Fund simulations, measures and methodology employed by the Graduate School can be found online[10].

The total cost to the US of the Compact renewal scenario that achieves a perpetuality status is $648

10 See GSUSA, *Palau FY18 Economic Review, July 2019* (EconMAP, posted July 2, 2019). ***https://pubs.pitiviti.org/palau-fy18-economic-review***

Figures 26-29: Palau Renewal Scenario: GDP Level, Household Income, Palauan Jobs, and Migration

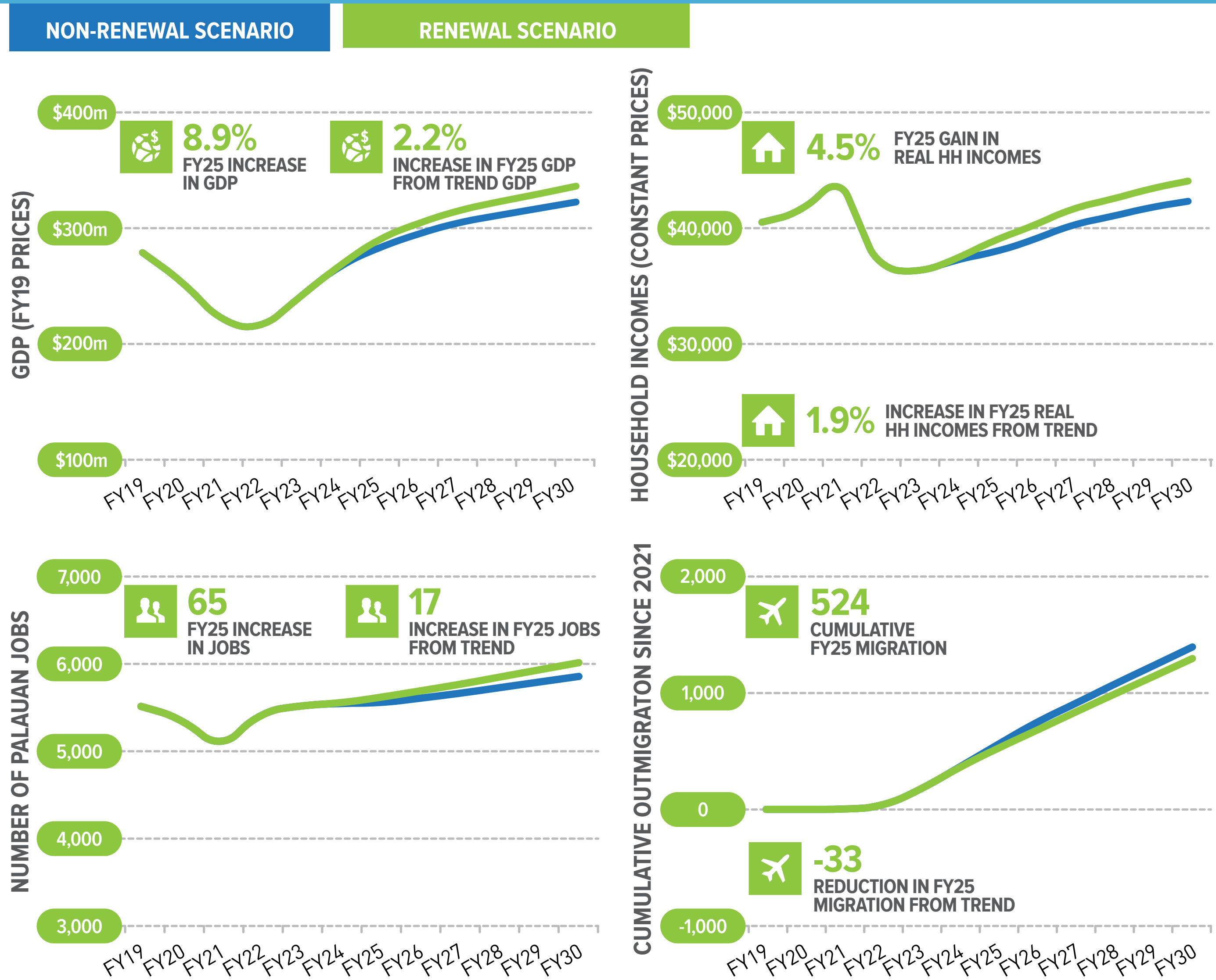
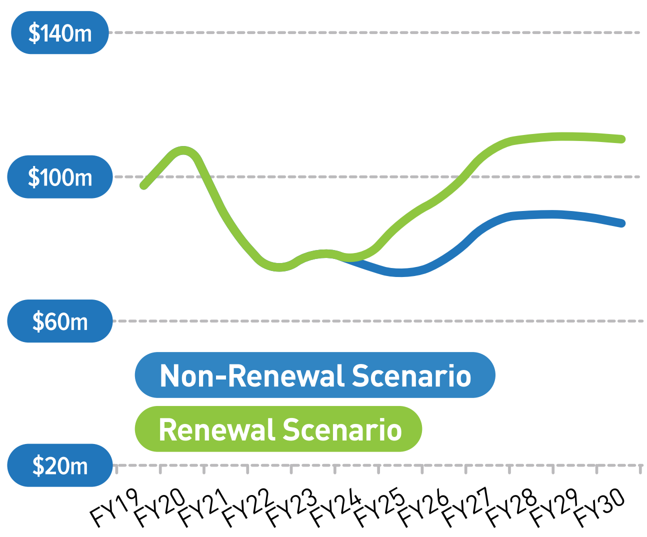


Figure 30: Investment Under the Renewal and Non-Renewal Scenarios, FY19 Prices
Investment is higher under the renewal scenario in FY30 by $23m or 27% compared with non-renewal



million in FY25 dollars. Under the assumptions of the renewal scenario outlined in this paper the total cost to the US in FY25 dollars would be $648 million. Annual grant transfers to Palau would be $35 million partially indexed for inflation which include annual contributions to the CTF.

Better Results Scenario

Creation of a stream of calibrated development assistance distributions from the CTF is outlined. Initial calculations during the preparation of the 3-Country Compact Impact paper[11] indicated that with the resources programmed into the renewal scenario, the Palau Compact Trust Fund would achieve a result sufficient to release an additional, albeit small, stream of benefits without compromising perpetuality. Since the substantial market correction experienced during the post-COVID period and due to the impact of the war in Ukraine, this favorable outcome is not currently tenable. However, should market conditions improve and a favorable Compact renewal be achieved, the creation of a stream of distributions to fund supplemental, but well-designed and monitored development projects would become viable. The level of annual distributions would be calculated to be consistent with CTF sustainability. However, the actual value of this annual distribution stream would be continually calibrated—meaning distributions would be adjusted annually—to ensure the 95 percent target was maintained. If, however, the CTF faced early and/or persistent disappointing returns, the "calibrated distribution" would necessarily be reduced—with the funds thus remaining invested in the CTF—thereby fortifying the corpus in times of need.

Reforms and Donor Support

The US has committed to a negotiation process that is likely to lead to renewal. The discussion in the previous section indicated the economic benefits of the modeled Compact economic assistance renewal. The US is committed to a negotiation process that leads to renewal.

11 See GSUSA, *The Economic Impacts of the End of Compact Grant Assistance in the Freely Associated States* (EconMAP, Asian Development Bank project - Draft for Discussion, March 2020).

Table 1: Palau Compact Trust Fund Performance under Existing Arrangement and Compact Renewal

Performance Measures	Compact renewal	Non renewal COFA rules	Non renewal SAFER rules
Evaluation period	**FY45-FY64**	**FY25-FY64**	**FY25-FY64**
Percent cases where real CTF in FY64 is above FY2024 sim value	89%	68%	88%
Percent cases where CTF value is above the PT in FY2064	97%	67%	86%
Average distribution through FY2045-FY2064 percent target	95%	63%	73%
Probability of attaining target distribution in FY2064	86%	0%	72%
Percent of cases with zero distribution in FY2025-FY2064	0%	16%	0%
Val of distribution % prior year counted for reduction years only	1%	3%	2%
No of years with reductions in distributions % total years			
CTF Performance Index	95%	68%	86%

While the eventual outcome of negotiations will likely be above the non-renewal scenario, it is not clear if the robust Compact economic assistance renewal scenario modeled will be matched or even exceeded.

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

Key Areas of Palau Public Sector Reform

The ADB RISES program policy-based loan has addressed many of the needed public sector reforms for Palau, but notable areas for improvement remain. The recent ADB PBL addressed key public sector report areas, including:

- Fiscal responsibility
- External debt management
- Tax reform
- Infrastructure planning
- Social security reform.

As part of the proposed fiscal responsibility and external debt management act, Palau has also incorporated a provision for the establishment of cyclical and climate related reserve funds.

Reform areas that are not covered under the ADB PBL include:

- Public financial management reforms
- Civil Service Pension Plan reform
- State-owned enterprises.

The CSPP is in dire need of reform to avoid collapse and the SOE sector operates below full cost recovery and also poses significant fiscal risk.

Keys Areas of Reform for Palau Private Sector Development

The 2020 World Bank's "doing business survey" ranked Palau 145 out of 190 participants but the survey has now been discontinued. While the World Bank's ease-of-doing-business survey has been discontinued, it provided a useful indicator and yardstick on the attractiveness of the business environment.[12] The 2020 survey indicated that Palau ranked 145 out of the 190 countries surveyed, in the bottom third, which suggests considerable room for improvement. Although Palau fared better than the FSM and RMI, which were ranked 158 and 153, respectively, Palau was substantially below most South Pacific nations. Further, Palau's score had been steadily dropping from 2012 when it scored 111. However, this may reflect improvements in third countries rather than any deterioration in the environment in Palau.

A further study conducted by the ADB Pacific Private Sector Development Initiative provides a useful analysis of the environment for private sector development in Palau[13], confirming the picture presented in the World Bank overview. The following are some of the identified areas affecting private sector growth in need of reform:

- The regulatory environment
- Land reform
- Credit availability
- Foreign direct investment
- Domestic fishing policies

ADB PBL includes private sector reforms that should improve the environment for private sector development. The ADB PBL also addresses a limited range of actions to improve the regulatory environment for the private sector. These include development of a framework for private public partnerships, arbitration law and corporate law including establishment of a corporation registry. Including the tax reform initiative, these private sector reforms will improve the environment for private sector development.

12 Word Bank, *Doing Business 2020*. ***https://openknowledge.worldbank.org/bitstream/handle/10986/32436/9781464814402.pdf***

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

Development Partner Support and Coordination

Donor support can provide a key role in supporting reform. The development partner community has supported reforms in the past, but the opportunity provided by a Compact funding extension could be an impetus to accelerate the reform agenda. While opportunities for growth in small remote island economies are limited, reforms in both the public sector and the environment for private sector growth could bring about better results. The development partner community has a vital role to play in building capacity and supporting reforms.

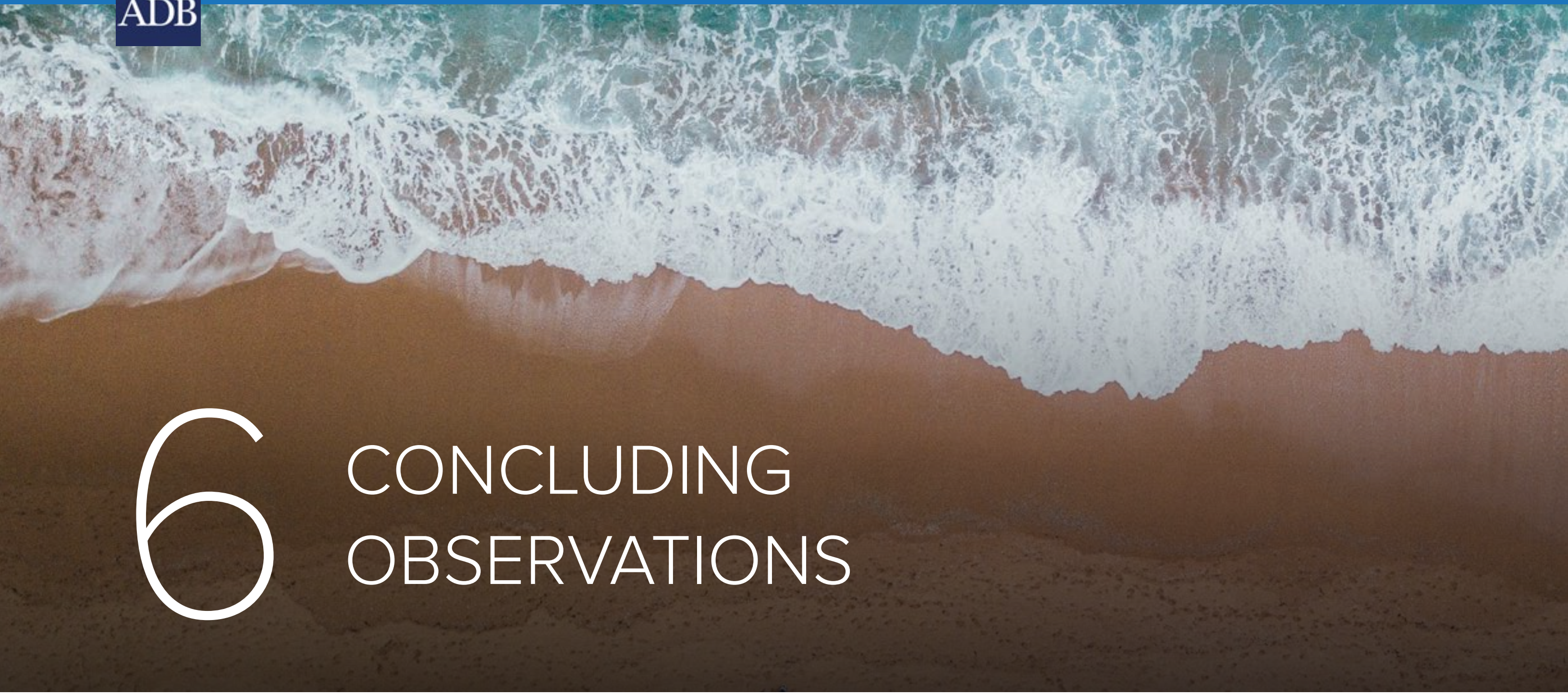
Donor support can provide a key role in support under both the non-renewal and renewal scenarios. During the last few years—with the emergence of the World Bank as a major player in the North Pacific, coupled with additional resources from ADB—the development partner community is able to finance public infrastructure alongside sustained, complementary technical assistance. Until recently Palau has not been a major recipient of budgetary support. However, the recent RISES program and PBL for the Palau Public Utilities Corporation (PPUC), have supported a wide range of reforms during the COVID pandemic and adoption of improved management and full cost recovery in the SOE sector. These programs have made important contributions to improving the environment for development and drive a path for future donor support.

In summary, in the case of less favorable Compact negotiations, coordinated donor action will be essential for mitigating shocks and smoothing adjustments. In the case of a favorable outcome of Compact funding extension, development partner actions can assist Palau to improve its economic growth rate and help ensure that growth is increasingly driven by the private sector.

Conclusion

While the provision of a more secure future would avoid a shock, it would not in itself place Palau on a higher long-term growth trajectory. At the outset of this chapter the potential impact of Compact renewal is described for the Palau economy. Clearly, continued Compact resource transfers would improve the outcome and avoid the need for the forced adjustments described in Chapter 4. Compact renewal would also, if designed appropriately and funded sufficiently, fulfill the desirable objective to establish the Palau CTF as a perpetual trust fund that would provide secure flows of resources with a high degree of confidence and without any reduction in FY25. While the provision of a more secure future would avoid a shock, it would not in itself place Palau on a higher long-term growth trajectory. That must arise from within Palau itself with targeted infrastructure development and additional development partner support through programs that support and reward pro-growth policy reforms.

6 CONCLUDING OBSERVATIONS



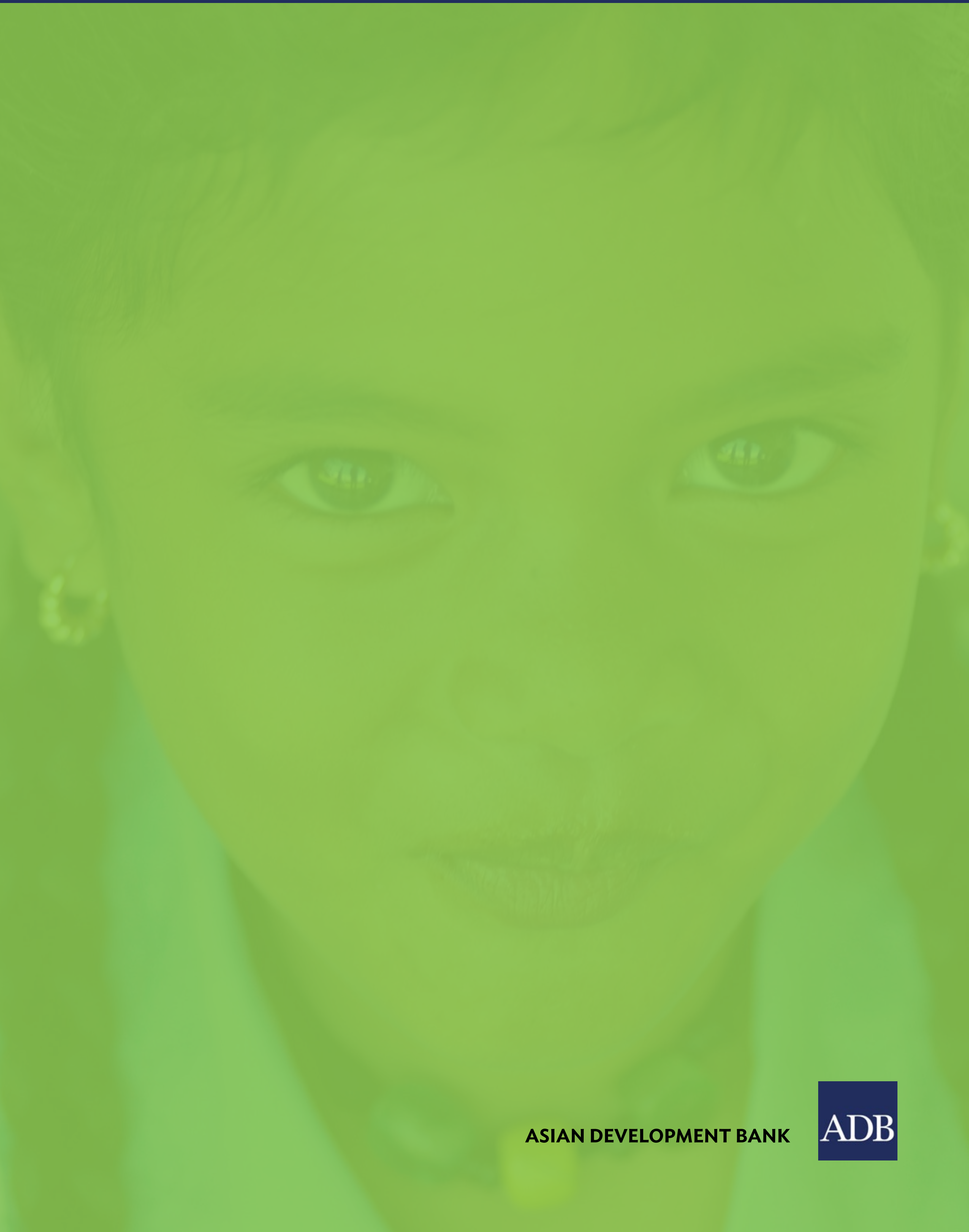
6 CONCLUDING OBSERVATIONS

This study provides relevant and timely analysis of several Compact scenarios. Following discussions with the principal parties, it is clear that the range of likely scenarios differs in some important ways from the specific scenarios modeled in this study. Still, this study's scenarios are intended to illustrate the economic and fiscal outcomes from plausible scenarios.

It seems clear that all likely negotiated outcomes will be an improvement on the Compact economic assistance "non-renewal" scenario; however, given the potential for delay in achieving mutual agreement and subsequent US Congressional approval of the assistance package for all three FAS, the results of the relatively dismal non-renewal scenario are indicative of the potential economic and fiscal shock that Palau might face even during a period of delayed and uncertain renewal. In such circumstances, transitional financial support from the US could clearly mitigate some or all of the negative outcomes projected.

It is hoped that the analysis of the Compact economic assistance scenarios in this report may prove useful to the affected parties. The modeling shows that the opportunities for improved economic performance, job creation, and perhaps even a modest reduction of emigration trends for Palau are enhanced in proportion to the level and length of ongoing Compact and related federal economic assistance.

The combination of a robust Compact funding extension will likely be coupled in time with an increase in major development partner financial and technical assistance. This will allow for Palau to prioritize and consolidate its efforts with respect to fiscal and economic reforms consistent with its own desired path to sustained economic growth.



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