Republic of Palau

2023

PALAU ECONOMIC REVIEW

Republic of Palau

January 2024

Graduate School USA

EconMAP
ECONOMIC MONITORING & ANALYSIS PROGRAM

Abbreviations

CURRENCY EQUIVALENTS

Currency unit: United States dollar (US$)

ABBREVIATIONS

ADB	—	Asian Development Bank
ADSL	—	Asynchronous Digital Subscriber Line
AFPAC	—	Automatic Fuel Price Adjustment Clause
AIFFP	—	Australian Infrastructure Financing Facility of the Pacific
AML	—	Anti-Money Laundering
ATO	—	Australian Tax Office
BGRT	—	Business Gross Receipts Tax
BPT	—	Business Profits Tax
BSCC	—	Belau Submarine Cable Corporation
CARES	—	Coronavirus Aid, Relief, and Economic Security
CBDC	—	Central Bank Digital Currency
CFT	—	Combatting the Financing of Terrorism
COFA	—	Compact of Free Association
COTS	—	Commercial Off the Shelf
COVID	—	Corona Virus ID
CPI	—	Consumer Price Index
CPRO	—	Coronavirus Pandemic Relief Option
CRA	—	Compact Review Agreement
CROSS	—	Coronavirus Relief One-Stop Shop Act
CSPP	—	Civil Service Pension Plan
DRP	—	Disaster Resilience Program
DSA	—	Debt Sustainability Analysis
EAG	—	Economic Advisory Group
EEZ	—	Exclusive Economic Zone
FAA	—	Federal Aviation Authority
FAS	—	Freely Associated States
FDI	—	Foreign Direct Investment
FDIC	—	Federal Deposit Insurance Corporation
FIC	—	Financial Institutions Commission
FMIS	—	Financial Management Information System
FPUC	—	Federal Pandemic Unemployment Compensation
FRDMA	—	Fiscal Responsibility and Debt Management Act
FSM	—	Federated States of Micronesia
GDP	—	Gross Domestic Product
GFS	—	Government Finance Statistics
GNI	—	Gross National Income
GSUSA	—	Graduate School USA
HLDP	—	Housing Loan Development Program
ICT	—	Information and Communications Technology
IHG	—	InterContinental Hotels Group
ILO	—	International Labor Organization
IMF	—	International Monetary Fund
IPP	—	Independent Power Provider

JEMCO — Joint Economic Management Committee

JEMFAC — Joint Economic Management and Financial Accountability Committee

JICA — Japan International Cooperation Agency

KASP — Koror Airai Sanitation Project

KSG — Koror State Government

KYC — Know Your Customer

LIBOR — London Interbank Offer Rate

MCA — Multi-Criteria Assessment

MTDS — Medium-Term Development Strategy

MTEF-mod — Medium-Term Economic and Fiscal Model

NDBP — National Development Bank of Palau

NIIP — National Infrastructure Investment Plan

NOAA — National Oceanic and Atmospheric Administration

OAE — Open Access Entity

OEK — Olbiil Era Kelulau

PBL — Policy-Based Loan

PDP — Palau Development Plan

PEFA — Public Expenditure and Financial Accountability

PEWA — Palau Energy and Water Administration

PFM — Public Financial Management

PFTAC — Pacific Financial Technical Assistance Center

PGST — Palau Goods and Services Tax

PHA — Palau Housing Authority

PNCC — Palau National Communications Corporation

PPEF — Pristine Palau Environmental Fee

PPA — Power Purchase Agreement

PPP — Private Public Partnership

PPUC — Palau Public Utilities Corporation

PSC — Palau Stable Coin

PSDI — Private Sector Development Initiative

PUA — Pandemic Unemployment Assistance

PVA — Palau Visitors Authority

RAN — Radio Access Network

RFP — Request for Proposals

RISES — Recovery through Improved Systems and Expenditure Support

RMI — Republic of the Marshall Islands

ROPSSA — Republic of Palau Social Security Administration

RPPL — Republic of Palau Public Law

RUS — Rural Utilities Service

SEA-US — Southeast Asia—United States (cable system)

SOE — State-Owned Enterprise

TIS — Tax Information System

UCC — Universal Commercial Code

VAT — Value Added Tax

VDS — Vessel Day Scheme

WIOA — Workforce Investment Opportunity Act

WSIP — Water Sector Improvement Program

WWO — Water and Wastewater

NOTE:

Each FAS government's fiscal year (FY) ends on September 30.

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Disclaimer

The views, thoughts, and opinions expressed in this Economic Review are those of the authors and represent an independent assessment of the economic performance of Palau. This document does not necessarily represent the views of the government of Palau, the Graduate School USA, the US Department of the Interior, or any other organization, committee, group, or individual, real or implied.

Foreword

This Review, the sixth of its kind for Palau, has been developed to assist the Republic of Palau (RoP) in implementing the renewed terms of economic assistance under the Compact Review Agreement signed in September 2010 and approved and funded by separate acts of the US Congress in 2018. This Review has also been designed to assist the RoP in overall policy and economic management. It has been developed under contract with the US Department of the Interior's Office of Insular Affairs and administered through the Graduate School USA's Pacific Islands Training Initiative. The Review is intended to assess the RoP's economic performance and policy environment and to present a comprehensive set of economic statistics.

On behalf of Graduate School USA and EconMAP (Economic Monitoring and Analysis Program), the review was authored by Mark Sturton; Glenn McKinlay compiled the statistical data sheet. Additional inputs were received from Emil Friberg, Kevin O'Keefe, and Jason Aubuchon. Special thanks are extended to: Hon. Kaleb Udui, Minister of Finance; Casmir Remengesau, Director of Planning and Budget; Muriel Sinsak and Limei Tesei of the Department of Planning and Statistics; and the many civil servants and business operators from the RoP, who supported the preparation of this Review and its statistical tables.

A digital copy of this review is available online at **http://www.econmap.org**.

Key Features in the Review

Palau's economy is projected to decline by a total of 21 percent in FY23 compared with the pre-pandemic levels of FY19. Due to the impact of COVID-19, GDP contracted by 6.7 percent in FY20 and a further 13.9 percent in FY21, despite the assistance of the government- and donor-supported mitigation programs: the CROSS and US CARES Acts, respectively. Although the pandemic diminished in FY21, the economy continued to contract in FY22 by 1.5 percent followed by a nominal improvement of 0.2 percent in FY23, as construction slowed and weakened the recovery.

Although inflation in Palau has been historically low, oil and food prices rose rapidly in FY22 and FY23, reflecting both imported inflation and the impact of the PGST. Inflation averaged 13.2 percent in Palau in FY22 due to rising food and fuel prices. This increase reflected global supply shortages, expansionary fiscal policies in the world economy, and the Ukraine war. As inflation began to abate in the global economy in FY23, the introduction of the PGST in Palau added a spike to local inflation. While the impact of PGST is a onetime occurrence, inflation continues to be high (12.4 percent) in FY23.

COVID-19 mitigation programs, including the CROSS Act and U.S. CARES Act, proved highly effective. The CROSS Act received a very favorable international reaction. At the start of the pandemic Palau reacted quickly with the passage of the CROSS Act, which was complemented by the U.S. CARES Act. The combination of the use of Palau's internal savings, donor support through the Asian Development Bank, and eligibility under the U.S. CARES Act enabled Palau to maintain momentum in the domestic economy, reduce job loss, increase household incomes, avoid widespread poverty, and maintain the social fabric. Palau's performance to support not only its own citizens but also foreign workers was widely acclaimed by the international community and generated goodwill while boosting Palau's reputation.

Palau completes the successful introduction of a major tax reform initiative with the introduction of two new taxes. A major development in FY23 was the introduction of a tax reform package, including a value-added tax known as the Palau Goods and Services Tax and a Business Profits Tax. The design of the reforms as widely debated in a series of hearings and state-level town hall meetings. An economic symposium was held in May 2021 supported by the Chamber of Commerce, and the bill was passed into law in September. Revenues from the PGST exceeded expectations and helped restore fiscal balance in FY23, reducing the need for deficit financing. The major drawback was a large increase in inflation mirroring the 10 percent rate of tax and the return to profitability of businesses following the negative impact of COVID-19.

Total financing needs of 22 percent of GDP were required to maintain government operations during the COVID-19 crisis. Palau has generally run a conservative economic policy and maintained fiscal balance. However, with the onset of the pandemic the fiscal position deteriorated rapidly, and Palau recorded its largest deficit ever of 13.0 percent of GDP in FY20. Under tight controls the deficit fell to 7.4 percent in FY21 and by FY22 had largely been eradicated, falling to 0.2 percent. In FY23 the deficit rose to 1.7 percent reflecting increases in several areas of expenditures despite the beneficial impact of the PGST. Overall, Palau recorded a total deficit of 22 percent of GDP during the COVID-19 period, FY20-FY23.

External debt to GDP ratio is projected to have maxed out at 71 percent in FY23. The debt to GDP ratio rose rapidly to 70 percent in FY21 and rose slightly in FY23. In FY24 it is projected to fall to 67 percent and gradually decline thereafter. While further debt will be incurred during this period, growth in the economy and the impact of inflation will result in stabilization of the debt to GDP ratio. Debt service has also risen due to the increase in international interest rates but hopefully will fall as global inflation comes under control. However, the availability of the CRA-23 grant stream for fiscal consolidation––six years at $10 million annually––will greatly assist Palau to reduce its indebtedness.

Palau initiates two fintech innovations: the Palau Stable Coin and Digital Residency program. The PSC project, in effect a Central Bank Digital Currency, underwent a trial with 168 volunteers and was reported to be favorably received. However, no Bank in Palau or in the US has agreed to act as an exchange, and in the absence of any existing financial institution assuming that role, it would need to be undertaken by the Ministry of Finance. A Digital Residency law has been passed by the OEK and digital IDs have been issued. Mailboxes are to be issued and available to digital residents for mail forwarding. Both initiatives have attracted attention, and there are concerns about the capacity of Palau to regulate the new initiatives and ensure AML/CFT regulations are complied with.

The SOE sector in Palau has underperformed, but reforms, including full cost recovery, will improve performance and hopefully reduce fiscal risk. The SOE sector is not large in Palau as compared to other Micronesian economies. However, it has underperformed and has posed significant fiscal risk. Reforms have been implemented at the PPUC to enable full cost-recovery tariffs in the power, water, and wastewater sectors. These reforms will place PPUC on a financially sustainable trajectory and reduce fiscal risk, relieving the burden on the national government.

Without reform RoPSSA is projected to collapse in FY29. In the absence of reform, RoPSSA is projected to collapse in FY29 and pensioners would only receive about $0.50 per dollar of earned benefits. At a participatory workshop in November 2021, reforms were crafted to set RoPSSA on a financially sustainable trajectory. An increase in the contribution rate of 2 percent was proposed along with modest reductions to benefits and with indexation of benefits. The proposed reforms were drafted into law and submitted to the OEK for consideration. The IMF indicated during the recent Article IV consultations that the reforms were in accordance with policy, but the OEK has yet to act.

Without reform the CSPP is projected to collapse in FY26. In the case of the CSPP, the fund is currently projected to collapse in FY26 when beneficiaries would receive $0.58 per dollar of earned benefits as the scheme defaults to a Pay-as- You-Go system. A participatory workshop was held in November 2022 to redesign the system by closure of the existing defined-benefit scheme and replacing it with a defined- contribution system. Existing liabilities would be made good through reform of the benefit stream, allocation of 3 percent of the annual civil service wage bill, and allocation of 2 percent of PGST. Further work has outlined the structure of the new DC with the intention to present the combined package of closure of the DB and initiation of the DC at a future workshop in early 2024.

Agreement over the terms of the second Compact Review Agreement (CRA-23) is reached with the US but awaits approval by the US Congress. The major areas of economic assistance include:

1. Annual grants of $20 million for operations to be used for education, health, climate

adaptation and the environment, the administration of justice and public safety. The agreement allows for an annual 2 percent adjustor in lieu of inflation indexation.

2. Infrastructure grants of $5 million plus the 2 percent adjustor.
3. Infrastructure maintenance grants of $5 million a year plus 2 percent adjustor.
4. A series of 6 annual grants of $10 million beginning in FY24 for fiscal consolidation of debt incurred before April 1, 2023.
5. Two tranches of $50 million to be deposited in the Palau COFA Trust Fund.

The economy is projected to grow strongly in FY24 and FY25 by 14 percent and 11 percent, respectively. Based on flight patterns planned for FY24 the tourism recovery is projected to finally get underway, and when coupled with revitalized growth in construction, the economy is projected to grow by 14 percent. In FY25 these trends are projected to improve and a further 11 percent in GDP growth is forecast to return the economy to FY19 levels. In the longer term through FY30, growth is projected to be, on average, close to 3 percent.

Fiscal balance is projected to be restored in FY24 without need for deficit financing or drawdown of COFA funds. Strong performance in tax revenues due to the implementation of the tax reform initiative is set to continue in FY24. If the US passes the CRA-23 legislation during the fiscal year, additional funds will become available; thus, non-tax revenues are projected to expand significantly. Due to the uncertainty of the timing of the CRA-23 renewal, there will continue to be constraints on spending; as a result, the fiscal position is expected to generate a surplus of $13 million (3.9 percent of GDP) without any additional need for funding or drawdowns from the COFA Trust Fund. Even with delay in the passage of CRA-23 beyond FY24, the fiscal position is projected to remain healthy.

Fiscal outlook over the medium- and longer-term looks favorable and raises the potential for new initiatives. In FY25, with CRA-23 funding levels assured, an increase in expenditure is projected to catch up with past inflation, and the fiscal surplus will fall to $9 million (2.2 percent of GDP). Going forward with expenditure policies in line with past practice and recovery in the tourism sector, the fiscal position is projected to continue to improve. This raises the issue of the best use of funds and the possibility for Palau to embark on a program of self-finance infrastructure.

1. Recent Economic Performance

Economic Performance

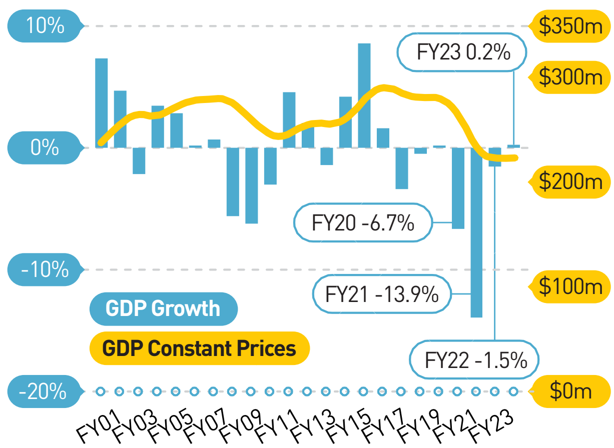
Palau's economic growth has been modest and has displayed considerable volatility. Palau's economic performance during the pre-COVID-19 period FY00––FY19, had been modest with economic growth trending at 0.5 percent during the period,[1] see Figure 1. Palau's low average growth fluctuates between periods of strong growth in construction and the tourist industry against periods of substantial contraction. During the initial part of the 2000s through FY05 the economy grew by an annual average of 3.2 percent due to a combination of the the Compact Road construction and rising tourism. As these influences ended and with the global financial crisis of 2008 and 2009, there was a period of contraction (FY05-FY10) during which overall GDP declined by an annual average of 2.8 percent. From then on Palau underwent a tourism expansion phase, which grew by an annual average of 3.6 percent. But this growth ended in FY15 when the economy contracted by an annual average of 0.5 percent through FY19 as visitor arrivals decreased to a level only 5 percent above the FY05 level.

Palau's economy is projected to have declined by 21 percent in FY23 compared with pre-pandemic levels of FY19. FY20 was set to be a good year for the Palau economy as construction activity picked up pace, and in February the tourism industry was set

1 Trends estimated using log-linear regression.

Figure 1: Palau real GDP annual growth, FY19 prices, percent

Palau economy falls by 7 percent in FY20, and further 14 percent in FY21.



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 6.7 percent in FY20 and to have fallen further by an additional 13.9 percent in FY21 as the full force of the collapse in the tourism economy was felt. Figure 2 indicates the sources of growth by main elements of demand. In FY20, while tourism demand was the main force in the loss of economic activity, capital investment and government expenditures helped maintain the level of activity. The drop in FY21 reflects the virtual disappearance of visitors throughout the entire fiscal year and a large reduction in the level of construction. However, the positive impact of the mitigation programs (Cross Act and CARES Act) supported household incomes and expenditures, which otherwise would have fallen precipitously.

In FY22 as the recovery in tourism failed to occur, high rates of inflation reduced

> *Economy is projected to fall by 21 percent by the end of FY23 compared with FY19.*

Figure 2: GDE, contribution to growth

Tourism and investment are the main drivers of economic growth.

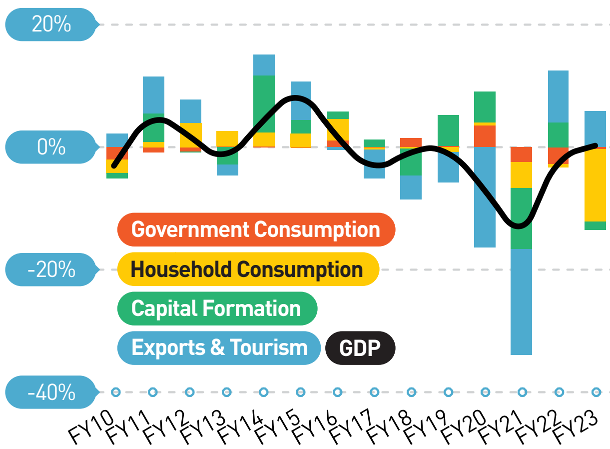
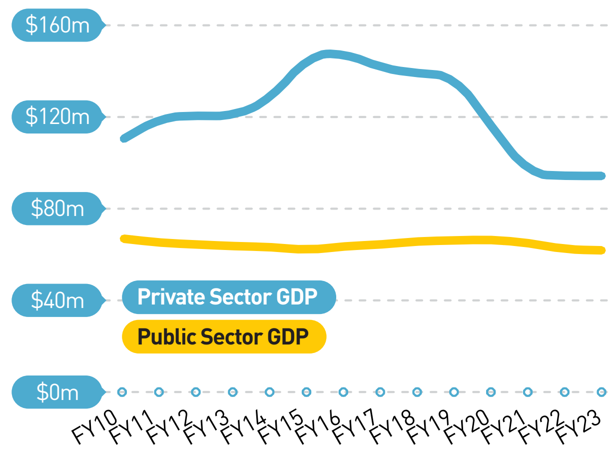


Figure 3: Private and public sector GDP, constant prices, FY19

Private sector performance has been volatile and bore the brunt of COVID-19.



demand and the economy contracted further. Despite a minor improvement in tourism and construction, the economy continued to decline in FY22. Post-COVID-19 global supply constraints and expansionary fiscal policies led to a sharp increase in global inflation. This was further compounded by the war in Ukraine that forced up oil and food prices, which led to a 13.2 percent surge in inflation in Palau. This combination of forces led to a 1.5 percent contraction in GDP.

The economy remained depressed in FY23 despite the emergence of recovery in the tourism sector. By FY23, it had been expected that the economy would be well on the road to recovery, as had happened in several other South Pacific tourist destinations. However, the East Asia region, Palau's major tourism market, was slow to resume outbound travel. During early 2023 flights resumed from Taiwan and Macau, which sped up the recovery. In addition to persistent global inflation, Palau implemented the tax reform package in January 2023 with the introduction of a 10 percent PGST. This kept inflation high (12.4 percent for the year). Although the tourism and construction sectors improved, the large increase in consumer prices drove down consumer demand and limited GDP growth to a modest 0.2 percent.

Private sector experienced most of the impact of the pandemic and fell by 32 percent through FY23. Figure 3 indicates the impact of the COVID-19 pandemic on the private sector. While the public sector is projected to have remained largely unchanged—thanks to the government and donor financing that helped maintain basic services—the brunt of the COVID-19 pandemic impact fell upon the private sector. In FY20, the private sector economy took a 16 percent cut due to the collapse of the tourist economy after April 2020 and the concomitant effects on secondary industries. In FY21, an additional reduction of 18 percent reflected the full-year impact of the reduction in tourism. Overall, a massive loss in output of 32 percent hit the private sector during the FY19-FY23 period.

Gross National Income per capita

GNI per capita is projected to have fallen from $16,030 in FY19 to $14,698 in FY22, reflecting the impact of the COVID-19 pandemic and the reclassification by the World Bank of Palau as a middle-income country. The population of Palau consists of Palauans and a large number of foreign workers, mostly Filipinos. Since 1986, the Palauan component of the population remained largely static and grew by 0.1 percent (after allowing for external migration) and was 12,436 in FY20. The number of foreign residents has grown from 1,550 to 5,178 over the same period, reflecting the local shortage of tourism-industry workers. Real GDP per capita rose by 1.3 percent per annum during FY00-FY19. Gross national income per capita attained a level of $16,030 in FY19, placing Palau in the World Bank's high-income group. However, the World Bank reclassified Palau as a middle-income country in 2022 due to the impact of the pandemic. This had important implications as it enabled Palau to have more favorable access to donor grants and financing.[2]

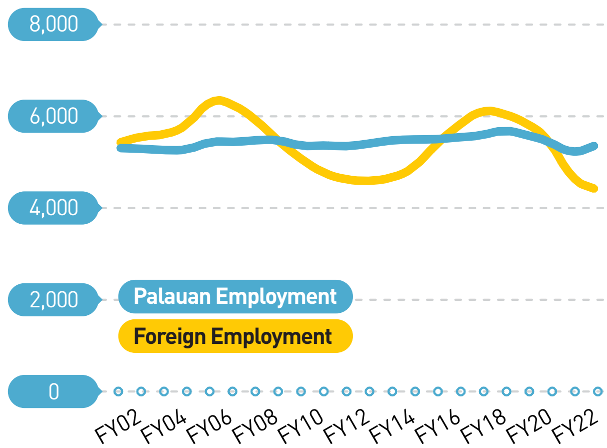
Employment

Early projections of job losses turned out to be less dire than original estimates with a loss of 1,670 jobs in FY22 compared with FY19. The labor market in Palau was comprised in FY19 of 5,585 Palauan workers and a larger number, 5,858, of foreign workers. In normal times the Palauan segment is close to full employment with excess demand supplied by foreign workers. During the FY00-FY19 period the Palauan segment had grown by an annual average of 0.3 percent with the number of foreign workers fluctuating with the demands of the economy, see Figure 4. Initial projections of the impact of the pandemic on employment suggested that a total job loss of up to 3,100 could be anticipated or 27 percent of the labor force. However, final employment data for FY22 indicates that 1,670 jobs were lost or 15 percent of the FY19 level.

2 World Bank country income rankings are based on the Atlas method, which attempts to smooth exchange rate and inflation fluctuations and is not directly comparable to the Palau GNI per capita estimates, which are based on nominal GNI divided by the population.

Figure 4: Employment by Palauan and foreign workers

Before COVID-19 employment in Palauan segment was stable with changes in demand for labor impacting the foreign workforce.



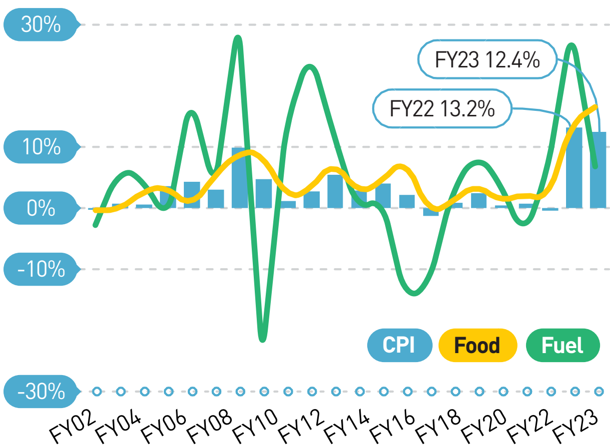
The impact of job loss has been mitigated by the private sector retaining workers on reduced hours and government employment schemes. Data on employment for the private sector indicates a loss of 1,486 jobs, and a 23 percent decline in private sector employment since FY19. However, the Social Security records on which these figures are based do not account for the reduction in working hours and reduced pay rates used by tourism operators to offset lost revenues during the pandemic. Thus, on a full-time equivalent basis, the loss of private sector jobs would have been considerably higher than the figures imply. The resulting impact of the COVID-19 pandemic on employment turned out to be less dire than anticipated due to employers retaining workers on reduced hours and with the positive impact of mitigation programs, which supported wage levels and reduced private sector costs.

Inflation and Wages

Inflation in Palau has historically been moderate, but a range of forces led to a rapid increase. Trend inflation in Palau averaged 2.8 percent between FY00 and FY21

Figure 5: Consumer price index

Inflation rose to 13 percent in FY22, as fuel and food prices rose rapidly, and by 12 percent in FY23 reflecting the impact of the introduction of PGST.



Inflation is projected to reach 13 percent during FY22 and a further large spike of 12 percent in FY23.

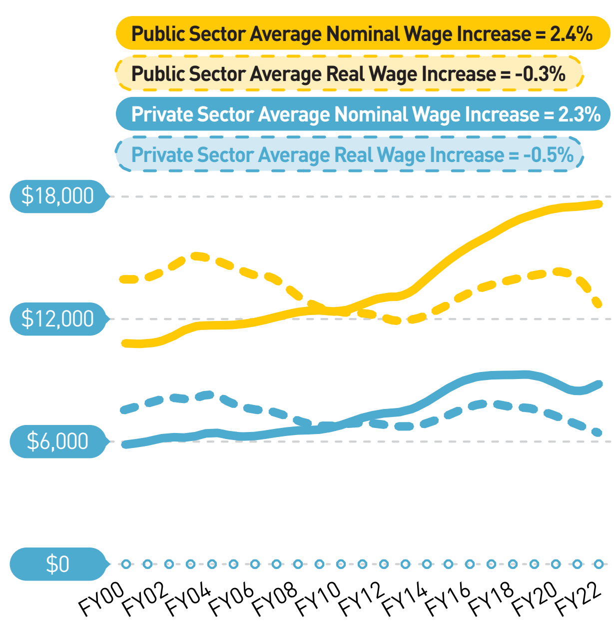
and has generally been moderate except for the global financial crisis when food and fuel prices rose rapidly. During the FY00-FY21 period, see Figure 5, inflation in fuel prices accelerated and subsequently fell to low levels while food prices and the Palau CPI were generally moderate. In FY22 these trends came to an end, and Palau experienced the same forces as seen elsewhere in the world. The expansionary fiscal policies enacted during the COVID-19 era and supply shortages that resulted as the world emerged from the pandemic pushed the world into an inflationary environment. Coupled with the Ukraine war, which led to rapidly rising fuel and food prices, the world entered an inflationary situation not seen since the 1970s and 1980s. As a result, inflation in Palau rose to 13.2 percent in FY22.

The introduction of the PGST led to an increase in inflation of 10 percent without any offset in prices due to the removal of legacy taxes. However, as inflation was starting to come down, Palau introduced a 10 percent PGST, which led to a spike in prices and 12.4 percent inflation in FY23. This was despite the repeal and removal of both import taxes and the gross receipts tax. The private sector effectively added 10 percent to former price levels without any downward adjustment due to the removal of the legacy taxes. This resulted in an erosion of household real incomes and a corresponding increase in private sector profitability. In other words, the introduction of the PGST led to an unanticipated shift in the distribution of income.

Real wages have declined in both private and public sectors with a considerable differential between the two. Nominal wages in the private and public sectors have grown by 2.3 and 2.4 percent respectively, since FY00. Public sector wages were 99 percent above those in the private sector, see Figure 6. Real wages declined by -0.5 percent and

Figure 6: Nominal and real wages, FY10 prices

Real wages improved after the tourism boom reflecting low inflation, but fell significantly due to recent inflation post-COVID-19.



-0.3 percent in the private and public sectors, respectively. However, the rapid increase in inflation in FY22 had a significant impact on real wages. In the public sector nominal wages grew very modestly by 0.6 percent and the impact of inflation of 13.2 percent led to a nearly identical reduction in real wages. However, in the private sector nominal wages rose by 5.8 percent, reflecting post-pandemic labor shortages, and offset, to a degree, the large increase in inflation. In FY23 public sector wage earners were awarded an increase of 75¢ an hour (and again in FY24), which is equivalent to a 9 percent increase in nominal wages, but not sufficient to offset an increase in inflation of 12.4 percent. For the private sector with no wage adjustment for inflation, the result is likely to have been a substantial reduction in real income. Citizen wages were over twice the level of noncitizen wages in FY22 with a majority of Palauan workers in the public sector and a majority of non-Palauans in the private sector.

2. COVID-19 Mitigation Programs and Impact on Household Incomes

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

CROSS Act extended through October 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 most of 2022. The unemployment program was extended through October 2022, while the last beneficiaries of the temporary jobs program were terminated in July 2022.

The structure of the CROSS programs was altered in February of 2021 to rationalize and increase the efficiency of the programs. Palauans receiving unemployment benefits were transferred to the temporary jobs program, while foreign workers under the temporary jobs program were transferred to the unemployment scheme. Under the unemployment scheme foreign workers, who formerly received unemployment benefits, were expected to work for their former employers for 20 hours weekly at the minimum wage of $3.50 an hour. This led to some increase in payments from an average of $210 per month under the original program to $260 under the revisions, and with extension of the scheme for most of 2022.

The US CARES program provided an important lifeline for Palauans who became unemployed due to the pandemic: In addition to the Palau CROSS Act, the citizens of the Freely Associated States were eligible for certain unemployment benefits under the US CARES Act through the end of 2020. These benefits were extended through March under the Consolidated Appropriations Act, and again through Sept. 6, 2021, under the American Rescue Plan Act. An original $13.4 million was allocated to Palau in FY20, an amount that fell to $11.9 million in FY21 when administration of the program was halted due to irregularities in disbursements. In FY22 these issues were resolved, and Palau received an additional $22.2 million of backlog funds. By the time the program was concluded Palau had received a total of $52.2 million. 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, taking into account the various extensions under US law. 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 an additional $300 per week.

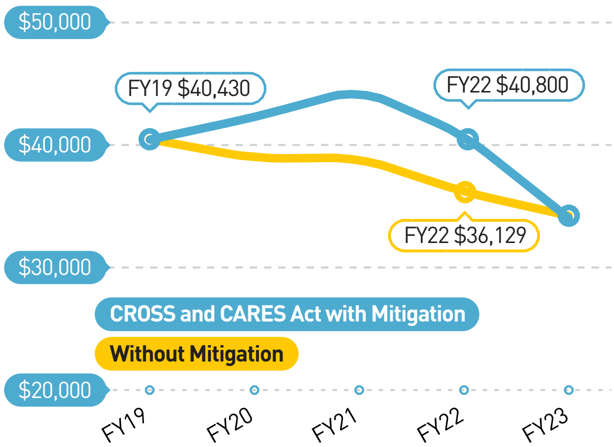
> *Mitigation programs during COVID-19 had a large beneficial impact in supporting household incomes.*

Mitigation programs had large beneficial impacts on household incomes. Utilizing the economic model used in the preparation of the Review, it is possible to exclude the receipt of funds to households through the CROSS and CARES programs and simulate the impact of the mitigation programs. In FY20 household real incomes would have fallen by 3.9 percent without mitigation but instead rose by 4.4 percent. In FY21 the impact was stronger with real household incomes rising 9.6 percent above their FY19 levels and 13.7 percent above the level without mitigation, see Figure 7. In FY22, while the CARES Act provisions had officially expired, Palau was able to draw on the remaining unspent funds, which enabled the benefits to continue. This was a fortuitous development as unlike the United States where the recovery was well underway, in Palau it had yet to start, and the remaining funds continued to mitigate the impact. The figure indicates real household incomes in FY22 were 12.9 percent above the level without mitigation, close to the level prevailing before the pandemic in FY19, despite the high level of inflation experienced in FY22. Overall, the magnitude of the coordinated government and donor response was both timely and significant. The government and donor community should both take credit for rapid and effective mitigation efforts.

Household incomes drop dramatically in the post COVID-19 period. Figure 7 also indicates the impact of inflation on household incomes in FY23. Based on termination of the mitigation programs and high rates of inflation experienced during FY23, a large drop of 22.5 percent in real household incomes

Figure 7: Household impact with and without mitigation

Household incomes rise by 1 percent between FY19 and FY22 with mitigation, and without mitigation fall by 11 percent.



is estimated compared with FY19. During the pandemic Palau was able to protect the average standard of living of its population. However, in the post- pandemic stage of FY23 but before full recovery of the economy, the impact of inflation was strongly adverse.

3. Tourism Developments and Policy

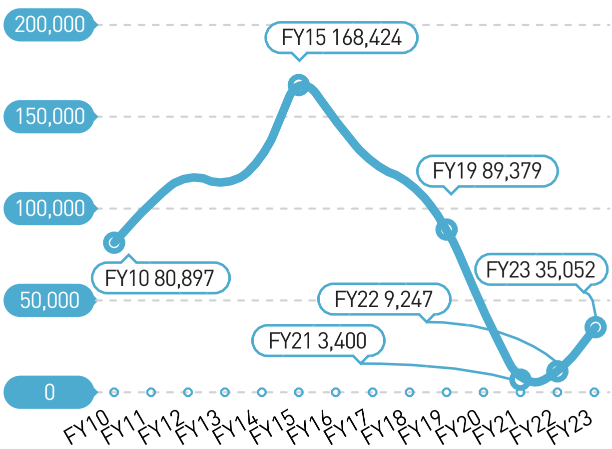
Tourism Developments

The rapid growth in tourism presented special challenges to Palau during the boom period. In FY15, annual visitor arrivals grew by 34 percent with 168,484 visitors, an increase of 87,527 visitors above the FY10 level, see Figure 8. From FY16 through FY19 the visitor numbers dropped in each consecutive year reaching a low point of 89,379 in FY19. The original increase in visitors was made possible by the large amount of excess capacity the nation had in tourism facilities; occupancy rates increased from 40 percent in FY10 to 63 percent in FY15. Most of the increase occurred in middle-to-lower-grade establishments with an associated large increase in package-tour visitors, predominantly from China.

The boom in the tourism industry encouraged new investment, but visitor numbers dropped, and occupancy rates fell to very low levels. In FY15-FY19, the drop in arrivals was strongly associated with fewer Chinese visitors due to restrictions on travel to Palau by the Chinese authorities and limitations on charter flights imposed by Palau. However, there was also a significant reduction in the more traditional, higher spending tourists. The large increase in visitors and improvement in occupancy rates in the mid-2010s encouraged additional construction in hotel facilities just as the industry was undergoing contraction. The drop in arrivals through FY19, coupled with the additional

Figure 8: Visitor arrivals

After peaking in FY15 visitor arrivals declined to zero in FY21 and FY22 due to the impact of COVID-19.



largely unoccupied facilities led to a reduction in occupancy rates to 34 percent in FY19.

The rapid increase in visitors had a significant impact on government revenues, but the marginal gain from low-spending visitors was less than the average. As a result, the impact on the economy of the upswing was less than the visitor numbers would infer, and on the downswing the impact of the loss was reduced. The fiscal surplus rose significantly to 5 percent of GDP in FY15 as tourism boomed, taking the government by surprise, which was sustained through FY18 despite the reduction in arrivals and falling occupancy rates. The impact of the volatility of tourism on government revenues appears to have been less adverse than was anticipated: a favorable result.

Tourism collapsed as COVID-19 hit in early 2020 with signs of recovery only emerging in the second quarter of 2023. FY20 was set to be a better year with 120,000 visitors anticipated, but with the advent of COVID-19 that number dropped to zero by the end of March 2020, although 41,674 visitors were recorded for the fiscal period that began in October 2019. By mid-2021 Palau had completed a comprehensive vaccination program, safeguarded the health of the nation, and loosened its borders in July. In early 2022 Palau underwent a period of rapid community spread of COVID-19 but the impact was contained and limited to 6 fatalities. It had been anticipated, following the economic recovery in other parts of the Pacific, that Palau would follow suit, but this was not to transpire. As several countries, such as Japan, were still hesitant to resume travel, tourism started out slowly in FY23. However, with the resumption of flights from Taiwan and charters from Macau in the second quarter of 2023, the recovery eventually got underway, and 35,052 tourists were recorded for the year.

> *The tourism industry collapsed with the onset of COVID-19 and is not expected to recover until FY25.*

The GSUSA projects a figure of 76,760 visitors for FY24, but subject to a significant margin of error. Looking forward the GSUSA has made projections of the tourism recovery based on the current flight pattern to Palau and those planned for 2024 for the near to medium-term[3]. Currently, scheduled flights include: United Airlines with 6 a week, China Airlines with 2, Nauru Airlines with 2 new flights from Majuro and Pohnpei, Alii Palau Airlines with 2 new flights from Singapore and the current 1 weekly flight from Brisbane and Port Moresby operated by Air Niugini. There are also currently 3 chartered flights from Macao. Programmed for 2024 there are 6 new charter flights from Macao and 3 from Korea (operated by Jeju). Based on conservative estimates of seat occupancy rates of 36 percent in FY24, a total visitor count of 76,670 is projected.

Achievement of recovery in the tourism industry is projected by FY26. For FY25 direct flights from Japan are expected to resume and, coupled with improved average

3 Information provided by the Palau Visitors Authority

seat occupancy rates of 47 percent, a total of 108,476 visitors are projected. From FY26 going forward, it is assumed Palau will slowly rebuild its tourism industry, and the new IHG hotel in Malakal and the new Four Seasons resort will start operating. Average hotel occupancy rates are expected to increase from 42.5 percent in FY26 to 55 percent in FY30. A recent study of tourism for Palau[4] indicates that hotel operators anticipate an occupancy rate of 60 percent to provide a minimum return on investment. The assumption of an increase in occupancy rates is based on the belief that the private sector will attain a normal rate of return on investment and that sufficient flight capacity will exist.

Tourism Policy

While the focus of tourism policy is currently on reactivating the industry, there is no long-term vision. Palau has adopted a policy to attract high-value tourists but lacks the necessary resources to implement this policy. As a result, tourist developments have been virtually unconstrained, and in an unregulated market, the economy has been subject to volatility and large swings in numbers of visitors. In 2015 Palau requested support from the ADB to assist with rationalization of the industry. The report endorsed the concept of attracting high-value visitors and indicated the need for a comprehensive tourism strategy or master plan. The latter was further developed under a grant from the US Department of the Interior, which only resulted in producing a Responsible Tourism Policy Framework[5]. While the RTPF outlined important broad principles, it adopted a community-based approach, which was largely aspirational. The RTPF fell far short of a comprehensive strategy with specified and implementable actions. While the current focus is to reignite the industry, the critical long-term issues of the size, location, and type of industry Palau wants to attract remain unclear. The need for a tourism strategy or master plan thus remains unfulfilled. Until a comprehensive approach can be developed, Palau remains subject to the vagaries of market forces and development of an industry that is not in accord with the RTPF.

4 Horwath HTL, Tourism Sector Assessment for the North Pacific (unpublished), Sydney, 2022.

5 Bureau of Tourism Ministry of Natural Resources,Environment and Tourism, Republic of Palau, ***Palau Responsible Tourism Policy Framework, Palau, 2016***

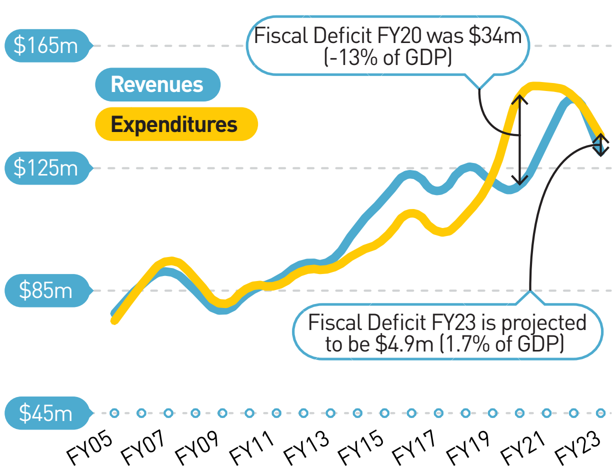
4. Fiscal Performance and Reform

Fiscal Outcomes

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

Figure 9: Government revenues and expenditures

Palau generates large fiscal surpluses as tourism industry booms but runs large fiscal deficits during COVID-19.



Total financing needs of 22 percent of GDP were required to finance the fiscal deficit during the COVID-19 crisis of FY20 through FY23. With the impact of COVID-19 the fiscal position deteriorated rapidly. From a balanced position in FY19 a very large deficit of $33.7 million or 13.0 percent of GDP was incurred in FY20. It had been anticipated that a larger deficit would result in FY21, as the pandemic covered the whole of the fiscal period. However, with rapidly rising grants levels to cover the large mitigation programs, the deficit fell to $17.3 million or 7.4 percent of GDP. The fiscal position improved significantly in FY22, despite the deterioration in the economy, as grant levels continued to rise, and the deficit fell to $0.5 million or 0.2 percent of GDP. In FY23 the government implemented tax reform that led to a significant increase in tax revenues ($16 million, 34 percent above taxes collected in FY22). However, expenditure growth was also strong, reflecting growth in wages due to: (i) the 75¢ pay award,(ii) an increase in use of goods and services, and (iii) increases in grants and subsidies. The result of these forces was that the deficit grew to $4.9 million or 1.7 percent of GDP. As a result, total financing needs during the COVID-19 period amounted to $56 million or 22 percent of GDP in order to support Palau through the crisis.

Available financing was sufficient to maintain government operations through the end of FY23. To finance the deficit Palau requested funding from the ADB to support the nation through the crisis. A series of loans were initiated: (i) a $15 million facility under the

Total financing needs arising from COVID-19 reach 22 percent of GDP in order to keep government open and sustain mitigation programs.

DRP (Disaster Resilience Program), (ii) $20 million under the CPRO (COVID-19 Pandemic Relief Option, and (iii) a further $55 million Policy Based Loan (PBL) comprised of two subprograms amounting to $25 million and $30 million each. The conditions for release of funds under Subprogram 1 were met by early 2021, with completion of the second set of conditions for Subprogram 2 at the end of FY22. The availability of $90 million in funds from the DRP, CPRO, and both subprograms of the PBL, coupled with the Palau's own reserves from the tourism boom years, turned out to be more than sufficient to meet the financing needs of $56 million to keep the government operational and maintain financial stability during the COVID crisis. While the funding obtained from the ADB was more than what was needed to cover the accumulated deficit, the strength of the tax reform initiative was significantly stronger than anticipated and further reduced total financing needs.

Fiscal Responsibililty and the RISES program

RISES program is based on the development of a Fiscal Responsibility Framework. Under an ADB-supported technical assistance project in late 2018, a fiscal strategy was outlined for Palau. The core of the strategy was that Palau should adopt a fiscal responsibility framework for the implementation of fiscal policy. The main elements of the RISES Program were as follows:

1. **Policy and legislative framework for public financial management**
   - i. Fiscal Responsibility Law
2. **Public sector reforms**
   - i. Tax reform
   - ii. Development of a Fiscal Strategy and preparation of the FY22 Economic and Fiscal Update
   - iii. National infrastructure plan
   - iv. External debt management law and policy statement
   - v. Social Security reform
3. **Private sector reforms**
   - vi. Private public partnership framework
   - vii. Arbitration law
   - viii. Corporations law and registry

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

Fiscal Responsibility Framework

Standard principles of fiscal responsibility are extended for Palau. Many countries have developed a fiscal responsibility framework, for example, New Zealand and the Cook Islands in the South Pacific. The standard set of principles has focused on (i) maintaining expenditures within revenues, (ii) managing debt prudently, (iii) predictability in the tax regime, and (iv) managing risk prudently. In Palau this list was extended to ensure that additional critical features of fiscal responsibility were included in the regime. In November of 2021 the OEK passed, and the president signed into law the Fiscal Responsibility and Debt Management Act (FRDMA, RPPL No. 11-13), which defines the principles of Fiscal Responsibility as:

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

   1. Manage **operating expenditures** over the medium-term within operating revenues and in relation to the rate of growth of the economy.

   2. Manage net **capital and financial assets**, to achieve rising real national net worth over time.

   3. Manage **debt prudently**.

   4. Manage the **revenue regime** to best fit the structure of the economy, to provide for an equitable allocation of tax burdens, and to allow for predictability over time.

   5. Manage **reserves and insurance coverage** to offset cyclical volatility, the costs of natural disasters, and the impact of climate change.

   6. Manage the non-primary government public sector prudently including ensuring **State-Owned Enterprises and Public Financial Institutions** are managed to deliver services on an effective and financially sustainable basis; and

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

B. Notwithstanding subsection A above, the government may **depart from the principles** of responsibility provided the:

   1. Departure is temporary;

   2. President states the reason for the departure;

   3. President indicates the period of time required to return to adherence to the principles; and

   4. Should any such circumstances arise which force departure from these principles during the fiscal year, they must be timely disclosed in accordance with the provisions of the FRDMA.

Palau adopts Fiscal Responsibility and Debt Management framework.

The Fiscal and Economic Update

An Economic and Fiscal Update is required under the FRDMA as part of the annual normal budget cycle and intended to indicate the economic and fiscal health of the nation. The Economic and Fiscal Update provides key information concerning the level of resources available to fund the budget (fiscal envelope) to ensure fiscal stability and sustainability over the medium-term. It further provides an assessment of whether the government is in adherence with the principles of fiscal responsibility. The first economic and fiscal update was completed in June of 2022 and a second in September 2023. The 2023 Economic and Fiscal Update evaluated each principle against performance:

1. **Fiscal balance**: Approaching adherence; fiscal balance 0.5 percent of GDP deficit in FY23; to be restored once recovery is achieved.

2. **Net National Wealth**: Not in adherence, net national wealth declined due to COVID-19; to be restored once recovery achieved.

3. **Debt**: Not in adherence; Debt/GDP has risen rapidly with significant new borrowing and reduction in nominal GDP to fund government operations during COVID; to be restored once recovery has been achieved.

4. **Revenue regime**: In adherence with Tax reform implemented January 2023.

5. **Reserves and insurance coverage**: Not in adherence: reserve funds below target and utilized to fund FY23 supplemental budget while not meeting withdrawal conditions.

6. **SOE and pension funds**: SOE sector in adherence after adoption of full cost recovery tariffs, RoPSSA and CSPP not in adherence: operating under unsustainable financial policies.

7. **Fiscal Risk**: Formal analysis needed to identify and manage fiscal risks.

Tax Reform

The tax reform bill was passed into law in September 2021. After a long history of attempts to modernize the tax regime, Palau decided to place a major focus on tax reform as part of the RISES program. An earlier version of a proposed PGST bill under consideration in 2018 was resurrected, a new section on business profits added, and coupled with various revisions for recent developments, the bill was transmitted to the OEK by the president in January of 2021. The bill as widely debated through a series of hearings and state-level town hall meetings. An economic symposium was held in May supported by the Chamber of Commerce and the bill was passed into law in September 2021. The main features of the new law are:

1. A **Palau Goods and Service Tax** (PGST) at 10 percent.

2. **Excises taxes** to replace former import duties.

3. A **Business Profit Tax** (BPT) at 12 percent.

4. Medium-size businesses will remain on the Business Gross Receipts Tax and small businesses will pay an annual fee.

5. Reform of the Wages Tax with zero rate collected on Palauans with wages less than $15,000. Standard rate of 10 percent, a top marginal rate of 12 percent.

6. The hotel-room occupancy tax will be reduced to 10 percent.

7. Introduction of a nominal **carbon tax**.

Although the tax reform was implemented over a limited time frame, it must be considered a large success. Preparation of the Palau tax reform program took place over a time span of one year and entailed training in administration, development of new IT systems, training and familiarization of the private sector, numerous public information sessions, and a major symposium devoted to the program. On January 1, 2023, the new program was implemented and, after an initial break-in period, is now well established. Support was provided by numerous donors including: the IMF, Pacific Financial Technical Assistance Centre (PFTAC), and ATO the Australian Tax Office (ATO). In light of the short period of implementation and the limited resources of a small nation such as Palau, the tax reform program must be considered successful.

The major downside of the program was the unanticipated large increase in prices that resulted at a time when global inflation was high. While some increase in prices had been anticipated, it far exceeded the net impact of the 10 percent increase in PGST and the offsetting repeal of the 4 percent BGRT and the 3 percent general import tax. It is hoped that as vendors reprice their commodities and

> *Introduction of tax reform and Palau Goods and Services Tax is a successful milestone in Palau's economic and financial development.*

competitive forces exert themselves that profit margins will revert to normal levels. It should be noted that the increase in prices was a one-time shock to the system and a similar increase will not occur in the future.

New initiatives are underway:

1. An **evaluation of the tax reform** initiative is underway with a view to initiating improvements to the system that have arisen from the experience during implementation. The tax reform program has entailed the replacement of the prior legacy inefficient taxes, the BGRT and general import tax, with modern taxes. However, the current reformed regime does not include a general personal income tax, which could form a second phase of the reforms.

2. An **evaluation of the current Tax Information System** and preparation of a needs assessment will form the basis of an RFP for the selection of a modern risk based Commercial Off-the-Shelf (COTS) IT system.

3. **Reforms to the Customs Act** are also underway to improve border coordination and trade facilitation with support from UNCTAD and UNDP. Asycuda, a modern industry standard, risk-based, IT customs administrative system developed by UNCTAD is close to operationalization and will be integrated into the tax reform process.

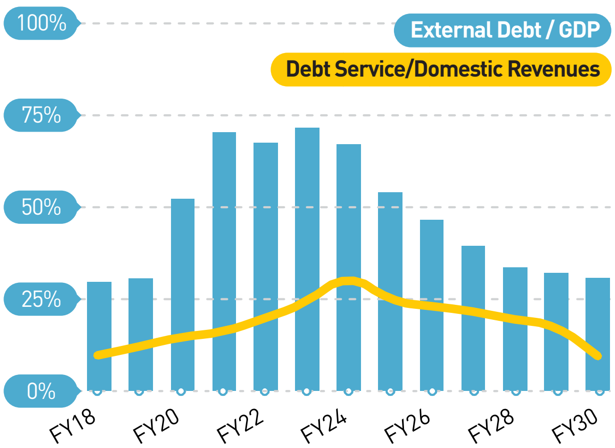
5. External Debt

External debt/GDP ratio rose rapidly to 71 percent of GDP in FY23 but is projected to decline thereafter gradually through FY30. As a result of the COVID-19 global pandemic the need for external borrowing rose sharply, see Figure 10. External debt rose from a level of 30 percent to GDP in FY19 to 52 percent in FY20, and to 70 percent in FY21. In FY22 debt levels stabilized and rose to 71 percent in FY23. While the rise in the debt/GDP ratio has reached record levels, much of the increase is due to the decline in the denominator, GDP. With recovery now under way and the with the anticipated benefit of the CRA-23 grant stream for debt consolidation, the debt/GDP ratio is projected to fall to 31 percent by FY30 (assuming Palau incurs no further external debt apart from known loans in the pipeline).

While COVID-19 has been the main cause of the rapid rise in debt, Palau has also incurred significant debt for other purposes. While much of rise in external debt, $90 million, was for deficit financing during COVID-19, Palau has also borrowed since the start of COVID-19 or is committed to borrow for other purposes: the Taiwan HLDP loan of $15 million in FY20, $5 million loan from Taiwan for Women and Youth Entrepreneurs and MSMEs re-lending in FY21, an additional ADB PBL for PPUC of $10 million in two sub-programs in FY22 and FY23, $15.8 million from Australia and JBIC for the second internet fiber project in FY23, a planned further $20 million from Taiwan for housing in FY24 and $25 million from ADB under the Sustainable Oceans and Resilience

Figure 10: External debt and debt service, percent GDP

External debt rises to alarming heights due to financing needs related to COVID-19.



Strengthening Program, a policy base loan. In all, recent additional non-COVID-19 borrowing totals over $90.8 million.

External debt service is projected to rise significantly but should not result in a high risk of debt stress. Debt service measured as a ratio of national government domestic revenues follows a similar pattern to the debt/GDP ratio. It represented 12 percent of domestic revenues before the crisis in FY18, including SOE debt service, but rose to 30 percent in FY23. However, with the benefit of the Compact debt consolidation grant, it is projected to drop back to 9 percent by the end of FY30. When removing the SOE component (including on-lent loans), national government debt service is projected to max out at 10 percent of general fund revenues in FY23 and to decline thereafter. Following a period where debt service was a minor component of the national budget, it has risen to high levels due to additional borrowing for both new projects and deficit financing.

> *External debt rose to 71 percent of GDP in FY23 but is projected to fall below 54 percent by FY25.*

The recent increases in international interest rates have added to debt service costs. However, if the CRA-23 grant stream for fiscal consolidation is strategically applied to pay down high-cost variable interest rate loans, it will greatly assist in keeping debt service at manageable levels. While the level of debt Palau has incurred is large by historical standards, it should not, given the concessional (i.e, more generous terms than market loans) nature of the debt, pose a high risk of debt stress. However, future borrowing needs to be carefully evaluated as well as interest rate risk.

Palau ceases debt service on the Koror-Airai Sanitation Project. As part of the FY24 budget the OEK legislated that the Palau government should cease all further payments on the ADB KASP project until the president and the ADB "address the circumstances and disputes concerning repayment of loans related to the unfinished Koror-Airai Sanitation Project." As a result all further ADB loans such as the Sustainable Oceans and Resilience Strengthening Program will be placed on hold. The terms and conditions of the loan will not allow the ADB to forgive or restructure the loan and Palau will be deemed in default. Other means of resolution will be required, but a way forward has yet to be established.

The Fiscal Responsibility and Debt Management Act lays the groundwork for the management of external debt. The passage of the FRDMA has laid the groundwork and framework for the management of external debt with the establishment of an institutional capacity to monitor and assess the incurrence of new debt, and to conduct a periodic debt sustainability analysis (DSA). A debt management policy statement has been issued and outlines the framework for debt management. A debt management unit has been created and is being established to:

1. Provide technical review on every proposed borrowing and every proposed issuance of a sovereign

guarantee, in particular, assessment of the various risks involved, terms and conditions of borrowing, and debt-servicing strategy.

2. Assist the minister of Finance to develop and maintain a debt management policy for consideration by the president.

3. Develop and utilize a project appraisal and approval framework for the assessment of loan-financed projects and to provide subsequent advice to the minister of Finance.

4. Undertake a periodic DSA to support the debt management component of the Annual Economic and Fiscal update as set forth in the FRDMA and render its opinion or advice thereon to the minister.

6. Public Financial Management

Public Expenditure and Financial Accountability

The PEFA is a framework for the assessment of the quality of Public Financial Management developed by the World Bank and a group of international donors. It has been implemented in many countries and provides an objective yardstick by which countries can assess and improve their PFM performance. It contains 7 major areas of public financial management and 31 individual topics:

1. Budget reliability
2. Transparency of public finances
3. Management of Assets and Liabilities
4. Policy-based fiscal strategy and budgeting
5. Predictability and control in budget execution
6. Accounting and reporting
7. External scrutiny and audit

Palau conducts a PEFA in late 2022. In March 2013, Palau invited the Pacific Financial Technical Assistance Center (PFTAC) to assist the nation in the preparation of a Public Expenditure and Financial Accountability (PEFA) self-assessment. A formal external assessment was planned for 2019 but due to COVID-19 was delayed. The agile version of PEFA, a reduced but still comprehensive

> *Palau undertakes a PEFA assessment and adopts a Roadmap for PFM reform.*

assessment, was subsequently completed in late 2022.[6] However, while the PEFA included a host of individual assessments on PFM, the report fails to provide the reader with an overall perspective of PFM in Palau. The value of the report is thus more in providing an analysis of individual elements of PFM rather than a holistic overview. That said, the assessment recognized good performance in a number of areas, specifically items: 2-4. Item 1 budget reliability scored relatively low, apart from the dimension relating to allocations for contingency reserve, while item 5 was considered a mixed bag. Due to the current tardiness of completion of the audits, item 6, scored weakly.

With the PEFA complete Palau requests PFTAC for assistance with design of a road map. With the agile PEFA assessment complete, Palau was able to request that PFTAC to assist in the preparation of a PFM road map to improve PFM performance. The PFM road map was completed with government approval in November 2023.[7] The PEFA assessment provided a holistic assessment of PFM in Palau. The purpose of the road map was not to address all the elements of the PEFA but rather to highlight the priorities and sequencing of activities appropriate to the context of Palau, taking into consideration staffing capacity and other resource constraints. The areas of focus identified include:

a. Macroeconomic and fiscal forecasting
b. Planning and budgeting
c. Financial reporting
d. Public Investment management
e. Internal audit
f. Procurement
g. Asset management
h. SOE oversight
i. Fiscal risk management
j. FMIS rollout
k. Strengthening general transparency
l. Revenue reforms
m. Debt management
n. Budget execution
o. Strengthening PFM in state governments

During the recent COVID-19 period Palau embarked on a series of PFM reforms in advance of the PEFA Assessment or Road map. These included many of the elements of the ADB RISES program, namely the Fiscal Responsibility and Debt Management Act, including Fiscal Strategy and Economic and Fiscal Update, the tax reform initiative, the national infrastructure plan, and initiation of reforms to the RoPSSA and CSPP social security and pension schemes. The period also saw the adoption of a modern FMIS, the underlying framework for sound financial management. The PEFA and PFM Roadmap thus arrived at a fortuitous time to assess the reforms already undertaken and to provide a way forward to maintain the momentum.

PEFA provides a suitable measure of financial management that shows investors and donors that Palau is financially sound and well managed. An important further consideration is that as Palau graduates from developing country status to high income, it will need to show financiers and donors that Palau is a financially sound and well-managed nation. The PEFA and adoption of the PFM Roadmap provide a desirable and objectively verifiable method to assess reform efforts, which the nation can present to investors and rating agencies.

6 PFTAC, *Public Expenditure and Financial Accountability (PEFA) Performance assessment report, 2022, Suva.*

7 PFTAC, *Republic of Palau Public Financial Management Reform Roadmap and Action Plan, November 2023, Palau*

The Palau Development Plan - 2023

Palau has undergone a series of development planning exercises to enhance economic growth and development. There have been a series of national and state planning initiatives in Palau, the major examples being the Palau 2020 National Master Development Plan (NMDP)(1993) and the Medium-Term Development Strategy (MTDS) (2009). The earlier plans would be considered traditional economic development plans, largely focusing on optimizing economic growth and development, given a limited set of resources, but subject to social, cultural, and environmental considerations. In that sense prior development plans addressed a classic economic resource allocation problem: maximizing return from a limited set of scarce resources that are subject to a set of constraints.

The PDP defines 5 pillars of development: Social, Culture, Environment, Economic, and Governance. It departs from the standard economic allocation problem. The long-term vision of the Palau Development Plan (2023) is to "substantially enhance the quality of life of current and future generations of Palauans." The Plan then goes on to define its 5 pillars:

1. Progress the quality of **social** support,
2. Nourish Palauan **culture** and identity,
3. Maintain the **environment** and counter climate change,
4. Restore **economic** growth, and
5. Strengthen **governance** in support of growth.

The target of the PDP is put well-established processes and programs in place by 2026 for each of the five pillars. The PDP thus switches from the standard optimizing economic allocation problem to the development of the five pillars, only one of which is economic.

> *Palau Development Plan establishes a framework for budget preparation.*

The PDP has two dimensions: the 5 pillars and country versus community development. The PDP is divided into two major parts: an initial discussion of the status of development in the five pillars, and a second part that outlines sector development programs and strategies. The Plan indicates that development priorities can be considered at a country level (national) and a community level (urban, rural, and outer island). The Plan thus has two dimensions, the five pillars and the two geographical levels, all of which have equal ranking.

The heart of the Plan is in the 16 development sectors, which align with government Ministries, Bureaus, and Agencies. The discussion in each of the sectors follows a standard format: a Status report, Key issues, Strategy, and Priorities and Projects. Included at the end of each chapter there is a key monitoring matrix, which indicates sector performance and financing priorities. Performance is evaluated by the sector's national impact, outcomes, and outputs. The matrix contains a budget for each sector's inputs by activity. These matrices form the core of the Plan and guide resource allocation during the annual budget process. The Plan is thus ideally constructed to fulfill CRA-23 requirements, as follows: (i) that use of Compact funds must be in accordance with PDP priorities, and (ii) the annual economic consultation is required to consider progress with implementation of the PDP.

The PDP contains a Multi-Criteria Analysis for CapEx and priority recurrent expenditure selection. Following the sector chapters, the PDP includes a chapter on capital and recurrent expenditures, and (ii) a chapter on financing. Capital expenditure (CapEx) as identified in the National Infrastructure Investment Plan follows a 5-part selection process:

1. Compile list of all proposed capital expenditures (NIIP),
2. Assess each proposal's readiness for appraisal,
3. Approve the Multi-Criteria Analysis (MCA) criteria,
4. Use the MCA to score proposals that are ready for appraisal and prioritize them, and
5. Seek funding.

Selection of projects is equally weighted by the score of each pillar. Readiness for selection includes a list for approval by 8 government ministries and bureaus. The Multi Criteria Assessment measures each project against the 5 pillars with each pillar accorded equal ranking. In the case of the economic pillar a simple cost-benefit analysis is applied. The MCA scores -1 to 3 are applied to each pillar and the average calculated for each project, which are then ranked. A similar ranking process is applied to prioritize new recurrent initiatives. The results of ranking in the PDP indicates most projects would be selected on the value of their social, cultural, and environmental impact as opposed to using a standard cost-benefit analysis.

A major area absent from the PDP is a macroeconomic framework. The macro framework, the underpinning of the standard development plan, enables assessment of the economic impact of the plan and whether sector operations and projects are financially viable. In other words, are the financial implications of the plan matched by financial resources? The PDP does include a final chapter on Financing, but this is more a general discussion of different sources rather than discussing whether the Plan is financially viable or feasible. This raises the issue of domestic resource mobilization and fiscal policy. Palau has until now funded capital projects through external sources, that is, either grants or loans. As graduation to high-income status re-emerges as the economy fully recovers, the issue of generation of domestic savings through use of fiscal and financial sector policies will arise. While the PDP will provide an important role in annual budget formulation, strategies to address resource mobilization, both domestic and external, are not adequately addressed.

Financial Management Information Systems (FMIS)

New FMIS has been successfully implemented with the first audit completed but delays have been incurred in bringing the audits up to date. The former FMIS used in Palau has now been replaced by the Tyler-Munis system utilizing funds provided from CRA-10. The system is used by many US governmental agencies and will fulfill compliance with US government accounting standards and Federal Program requirements. The system has a broad array of reporting tools, which Finance staff are gradually acquiring. The implementation program was successfully conducted mid-FY20, and the system is now deployed and operational. Considerable time was taken in tidying up data for the migration and switch to the new information system. and delays were incurred due to COVID-19 before the new system was ready for audit. The audit was completed on April 24, 2023, almost 3 years behind schedule. The departure of Deloitte and Touche from the region further delayed matters, but preparation of the audits has now been contracted to Ernst and Young. Many former Deloitte employees have transferred to E&Y, which should help expedite matters. A contract has now been signed with E&Y to undertake the FY21 audit and to implement a program to bring the audits up to date within 9 months of the end of the fiscal year initiated.

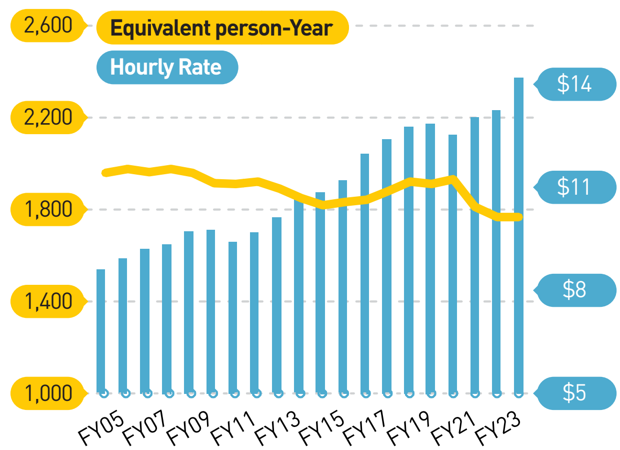
New FMIS does not integrate GFS or performance budgeting management reports. The original intent was that the new system would provide statistics compatible with the IMF standard Government Finance Statistics (GFS) to support management and fiscal policy design. While some chart of accounts improvement was achieved, and account codes were mapped to GFS categories, the standard account codes do not provide sufficient information to map directly to GFS. The new system thus is unable to directly produce a GFS report of sufficient quality for fiscal management and is thus unable to fulfill a major PEFA component. It is possible to compile GFS statistics from the FMIS, but this requires a separate data dump, establishment of correspondence tables, and, in some cases, coding of individual transactions. In addition to the GFS a similar integration of output/performance budgeting into the new FMIS would have been desirable. Thus, while the new system has been successfully implemented, it does not provide integration with either fiscal reporting or modern budgeting requirements.

Public Sector Payroll

The government has maintained control over the size of the civil service and payroll cost. An important component of PFM and fiscal policy is control over payroll cost. Trends in government payroll indicate a slight decrease in equivalent person-years of 0.1 percent per annum between FY04 and FY23, see Figure 11. Hourly rates of pay (including benefits) have risen from $8.60 to $14.16 per hour, which is an average annual growth of 2.6 percent; however, once the cost of living as measured by the CPI is factored in, real government wages have largely stagnated falling by an average of just 0.1 percent. The Figure reveals the impact of periods of fiscal constraint after the global financial recession in 2008-2009 and the impact of COVID. During these periods both employment and wage rates fell, including reduction in working hours and overtime. In the aftermath of the COVID-19 period there was also a large emigration of public servants to the US.

Figure 11: Government payroll: equivalent person-years and hourly wages

Government payroll (equivalent person-years) has been tightly controlled.



Although payroll costs have been well controlled, other areas of expense have grown. While the total cost of the government payroll has risen by an annual average rate of 2.5 percent, payroll costs have fallen both as a share of total expense, and as a share of GDP. In effect government policy has been able to keep control over the size of government and payroll costs; however, other areas of expense have grown. While the reduction in payroll cost is a favorable outcome, the implicit increase in expense directed to other government entities and SOEs is a source of concern.

7. State-Owned Enterprise Reform

> *SOE sector underperforms but adoption of full-cost-recovery tariffs adopted in power, water, and wastewater will lead to a brighter future.*

The SOE Sector

The SOE sector is small in Palau but has posed significant fiscal risk. The SOE sector in Palau is smaller than those in other Micronesian economies. There are four major SOEs: the Palau National Communications Corporation (PNCC), the Palau Public Utilities Corporation (PPUC), the National Development Bank of Palau, and a more recent addition, the Belau Submarine Cable Company (BSCC). Airport operations and the Post Office are government departments, and the port is owned by Koror State but operated by a private company under a 25-year concession. The operation and upgrade of the airport terminal has been restructured under a Joint Venture between the government, JICA, and a private Japanese corporation.

The SOE sector in Palau has underperformed, especially in the power and water sectors. An assessment of the private sector conducted in 2017[8] found a series of weaknesses related to the management and operations of the SOE sector. The report indicated that there was no legal framework to support the commercial operations of the sector, and unsurprisingly, the sector had performed poorly. Board members were frequently found to be political appointees and frequently lacked experience in the functions of the SOE. SOEs are not required to operate on a commercial basis, and prices have been set at "affordable" rather than commercial rates. There was no way to monitor the sector, and corporate planning was found to be weak. As a result, maintenance is often insufficient and excessively deferred, resulting in disruption of services and, ultimately, in higher capital costs.

Legislation to support the commercial operation and management of the SOE sector based on best practice has yet to be considered by the OEK. In 2014 the president issued an SOE policy with the primary objective that SOEs should operate commercially as successful businesses, which would allow them to recover all their costs, including the costs of capital. A set of policy principles was outlined to support the primary objective. These included specification of community service obligations (CSOs), a contractual arrangement for the government to purchase the delivery of services it wished to provide below cost to consumers, appointment of qualified directors excluding political appointees, preparation of annual statements of corporate intent, business plans, performance monitoring, and benchmarking. Enactment of the SOE policy statement into law is part of the administration's recently published Fiscal Strategy. However, draft SOE legislation to set the basis for operations and governance of the sector has yet to be transmitted to the OEK. A long history of involvement of the OEK in the sector and replacement with a rules-based efficient system founded on best practice is likely to take time.

8 Private Sector Assessment (PSA) of Palau: *Policies for Sustainable Growth Revisited: A Private Sector Assessment for Palau, the Pacific Private Sector Initiative, Sydney, Australia, 2017.*

Reforms in the utilities sector

Power Generation and Distribution

PPUC engages with the ADB for a power sector policy-based loan to avoid insolvency. PPUC is responsible for both power generation and distribution and, since 2013, the provision of water and wastewater services. In the power division PPUC operated until recently on a cash-flow basis well below cost-recovery levels. Management results were weak, and maintenance of plant was deferred due to the weak financial position. In 2020 PPUC was reported to have been insolvent. As a result of the emerging crisis the ADB was asked to support a series of reforms through a policy-based loan,[9] the Palau Public Utilities Corporation Reform Program. Subprogram 1 of the loan, entailing financing of $5 million, contained four key areas of reform: (i) tariff reform and adoption of cost recovery with procedures for implementing subsidies for low-income households, (ii) financial management improvements, (iii) corporate governance improvement, and (iv) market access for private sector participation in the development of renewable energy.

PPUC petitions for new cost recovery tariff, which was approved by the Palau Energy and Water Administration. While delays in processing the PPUC PBL Sub- program 1 were experienced due to compliance in corporate governance, the program got underway in 2021. PEWA, the Palau Energy and Water Administration or regulatory body approved (i) a new cost-recovery tariff regulation for PPUC's electricity tariffs, and (ii) guidelines for the electricity tariff petition by PPUC. Subsequently a cost-recovery tariff was petitioned by PPUC, adopted, and approved by PEWA.

Palau executes its first Private Public Partnership with an Independent Power Producer for the supply of solar/battery electricity. A Power Purchase Agreement was executed between PPUC and Solar Pacific, a private company, for the supply of solar/battery electricity and now provides for 20 percent of Palau's electricity needs. The PPP was financed by $22 million of funding through the Australian facility AIFFP, Australian Infrastructure Financing Facility of the Pacific, $18 million of which was loan financed and the remainder was in the form of grants of $4 million. The PPP between PPUC and Solar Pacific, the first of its kind in Palau, will achieve the initial target of Palau's plans for renewable energy. The second phase to bring Palau up to 45 percent, also to be implemented through an IPP and PPA, is targeted to be completed during 2025. The second phase will require substantial grid upgrades and will entail support from Japan.

The current subsidy to reduce the tariff of electricity to residential customers encourages carbon emissions and is inefficient. Given the large increase in global fuel prices during 2022 and subsequent large increase in the Automatic Fuel Price Adjustment Clause of the electricity tariff, the OEK approved a $2.55 million subsidy in the FY22 budget to offset the increase. In the FY23 and FY24 budgets a further $1.6 million was appropriated but limited to residential customers with an allocation of $0.10 per kw/hr. for the consumption of the first 500 units. While the desire to offset the rising costs of living was widespread in many countries, the across-the-board nature of the subsidy is inefficient. The recommended policy is to target the subsidy to low-income and disadvantaged households while allowing the affected households to allocate the benefits to best fit their needs. In the Palau case the subsidy winds up benefiting households outside the target group and encourages allocation of resources to carbon-emitting processes. The issue for Palau is to establish an effective social welfare program and identification of low- income or disadvantaged households.

9 Palau Public Utilities Corporation Reform Program (Subprograms 1 and 2), Completion Report, ADB, Manila, April 2023.

Water and wastewater services

Water and wastewater services operate at significant loss and well below full cost recovery. In 2010 Palau initiated a Water Sector Improvement Program, WSIP, with $15 million in funding from the ADB. The program was intended to (i) initiate the legal and policy framework for water sector improvement, (ii) establish an independent corporation for improved water services, (iii) adopt and achieve full cost recovery in the sector, and (iv) provide effective public consultation. While it was recommended by the ADB that water services would be established as a new SOE, the delivery of water services, formerly provided through a government department, were merged with the PPUC. While the WSIP program was followed with increases in water tariffs, these were not sufficient to achieve full cost recovery, and PPUC continued to record a large operating loss. Based on unaudited data for FY23, operating revenues were 57 percent of total operating costs.

Subprogram 2 of the PPUC PBL was focused on water services with a central target of achieving full cost recovery. In mid-2022 the original ADB-funded Palau Public Utilities Corporation Reform Program was extended through Subprogram 2 and intended to focus on Water and Wastewater Operations, WWO. The program, a policy-based loan, with further funding of $5 million, was primarily intended for improvements in the water sector but also maintained support for corporate and financial management. The program entailed: (i) tariff reform with adoption of cost recovery for WWO together with a system of subsidies for low-income households. A similar process of issuing regulations for setting cost recovery tariffs and petition by PPUC was established, as in the case of the power sector. The PBL further entailed (ii) enhanced financial management, (iii) enhanced corporate government incorporating many of the reforms outlined in the SOE policy framework, and (iv) procedures for PPPs, including energy, to strengthen market confidence that PPAs are based on justifiable, objective, and transparent criteria.

New full cost recovery tariff implemented for WWO with large increases for residential customers but offset by OEK legislated subsidies. In 2023 a petition was made to PEWA for the adoption of a full cost recovery tariff in the water sector, and public hearings were conducted. While the new tariff included large increases for the residential sector, tariffs for the commercial and government sectors remained largely untouched. After the hearings were conducted PEWA approved the new tariffs, but in the FY24 budget the OEK implemented a series of subsidies for the residential sector similar to that for power. For water and wastewater, the OEK legislated that the first 2,500 gallons would be free of charge. A provision of $960,000 was made in the FY24 budget to cover these costs. As in the case of power, the subsidy is insufficient and lacks focus on the target group.

OEK legislates to terminate all further debt services on the ADB KASP loan. The second ADB-supported program in the WWO sector, the Koror-Airai Sanitation Project (KASP $28 million), entailed substantial upgrading of sector infrastructure. After many years of delays and contractual issues, the funds have been largely exhausted and the project is incomplete. Additional funding of $5 million is needed. As a result of the poor execution of the program, the OEK, not without some justification, legislated that the government of Palau should cease all further payments on KASP debt service until an agreement is signed between the president, the representative of PPUC, and the ADB. Palau will thus be considered in default, not only on the KASP loan but also all other ADB debt until the issue is resolved.

ICT Reforms

Laying of new fiber optic cable connecting Palau to the internet backbone has

significantly improved internet access. Reforms in the Telecom sector have progressed positively with the creation of the Palau Submarine Cable Company, an SOE created (with an ADB loan) to manage a new fiber-optic link to the internet backbone. Palau has partnered with the SEA-US cable project linking Indonesia, the Philippines, Palau, and Yap to Guam, Honolulu, and the US mainland. Laying of the cable was commissioned at the end of 2017 and has now been operational for several years. Previously, ICT services had been very poor in Palau with some of the highest prices in the Pacific region. The introduction of the SEA-US cable into the local network represented a quantum change in the economic and social fabric of Palau.

Moratorium on competition in the ICT market extended for 5 years. A key element of the ICT reforms was the passage into law at the end of 2017 of a Telecom reform bill supported by the World Bank. The new law enabled competition in the marketplace and removed the monopoly and protected position that was held by the existing providers, which included the Palau National Communications Corporation. The law also created a new regulatory office, the Bureau of Communications, in the Ministry of Infrastructure, Industries and Commerce, which regulates the sector and issues licenses to potential new entrants. The original law provided a moratorium of up to 3 years on new entrants, but this has now been extended to 2025.

Palau embarks on a second fiber project PC2, which will guarantee redundancy in case of system failure. In addition to the original cable project (PC1) BSCC is currently engaged in implementing PC2, a second fiber project to guarantee connectivity and provide redundancy should there be a failure or break in the initial cable. The PC2 project will involve a 110-km link with a large-capacity submarine optical cable that connects Southeast Asia and the US mainland (Echo subsea cable system). While construction of the Palau side of the project is largely complete, there have been some delays in fulfilling regulatory requirements in Singapore, and the new fiber is now expected to go live mid-2025. Financing for the project stems from a series of sources, which include Japan ($8 million in loans), Australia ($7.75 million in soft loans), and US Compact and other grants ($11.8 million).

> *ICT services have improved tremendously, and with RUS financing for fiber to the home/premises will complete the groundwork of a modern IT infrastructure.*

Successful application to RUS under the ReConnect loan and grant program will enable Palau to extend fiber connectivity to the home/premises. As a result of the two fiber projects, Palau will now have reliable high-speed access to the internet. However, the fiber connection only provides a trunk to the major telecom hubs in Palau and is yet to be distributed to the home/premises. The current infrastructure only supports relatively slow speeds through the antiquated copper system that are insufficient for supporting the uninterrupted internet-based calls that are now commonplace after the COVID-19 era. PNCC made an application under the RUS ReConnect Loan and Grant Program to replace the existing copper infrastructure with fiber to the home/premises. The application was successful, and Palau has been awarded a grant of $35 million. This will enable Palau to complete the original intent of the ICT project by providing high-speed coverage to the home/premises in nearly all parts of the nation. Initial design of an RFP has commenced and is expected to be bid on in early 2024. The project will be implemented under a design/build process and expected to be completed in five years.

A further project to modernize Palau's mobile network will upgrade the system to enhance and extend service including

the introduction of 5G. In addition to the ReConnect project Palau has initiated a Mobile Network Modernization project with support from the US Trade and Development Agency.[10] A grant of $850,000 has been awarded to PNCC for technical assistance to: support the modernization of Palau's mobile network, expand connectivity for its population, and prepare for the rollout of 5G services. The TA will provide PNCC with data, analysis, designs, and detailed implementation plans for replacing Palau's existing national mobile network (based on Huawei equipment) with secure and trustworthy technology while enhancing service for users. Implementation of the project would represent the first commercial deployment of Open Radio Access Network (Open RAN) architecture in the Pacific Islands, which allows interoperability of equipment and avoids locking into a single supplier. Funding for implementation of the project will be supported from the US Coronavirus Capital Projects Fund of $14.24 million.

A major policy issue concerning ICT policy has been over the level of pricing. At the time of the introduction of the initial fiber optic, there was a large reduction in the price of internet services. Since that time prices have fallen indirectly due the provision of increased bandwidth at the same cost. This allowed a risk-free solution to the implementation of lower prices without changing the volume of sales. As a result, pricing policy has been very conservative and by international standards prices have remained high at $120 for 20/1 meg ADSL connection. A condition of the RUS $35 million grant requires the provision of affordable internet prices to households. An average price for basic internet service (25 meg) of $30/month is just 2 percent of average household incomes, which is considerably lower than current pricing and will prove challenging to PNCC.

10 US Trade and Development Agency, ***Palau Partner on Mobile Network Modernization*** https://www.ustda.gov/ustda-palau-partner-on-mobile-network-modernization/, June 21, 2023.

Starlink offers competitive broadband internet to remote areas at affordable prices. The recent advent of StarLink, a series of low orbit satellites providing high speed internet service for about $90-$120 (25-220 meg) a month has had a significant impact in the Pacific. The FSM Telecom regulator has licensed the product despite a request by the current internet provider for a ban of Starlink. In the Marshall Islands the authorities have allowed but not licensed Starlink. In Palau the regulator issued a regulation banning the product. This clearly appears to be an anti-competitive move to restrict competition. While licensing Starlink might have little impact on the residential section of PNCC's customer base, it would likely significantly erode profits from commercial customers. During the implementation of the RUS fiber to the home/premises project, there may be some justification for the current policy to enable a smooth introduction of the new service. However, once the RUS and the mobile network modernization projects are complete, the ban on Starlink should be lifted.

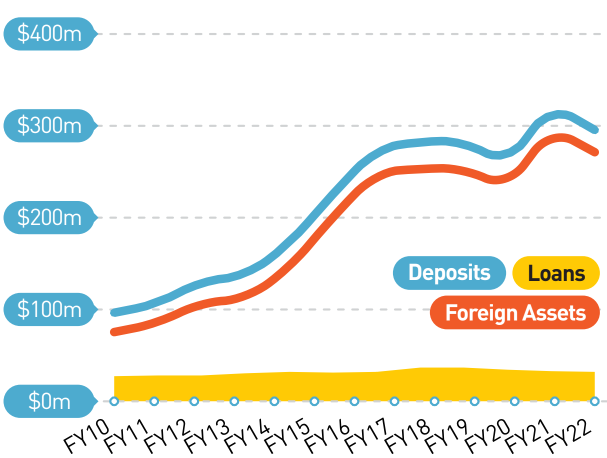
8. The Financial Sector

Banking

Deposits grew rapidly in Palau during the tourism boom years and after a period of stagnation rose rapidly during COVID-19. The deposit base in the Palau banking system ($295.4 million in FY22) grew very rapidly in the tourism boom period FY11-FY16, which reflected the booming economy, foreign direct investment, and land-lease purchases, see Figure 12. After the peak in tourism in FY15 the deposit base stagnated and contracted in FY19 with the weak economy. However, in FY20 deposits grew rapidly in all sectors. Government deposits reached high levels reflecting large yet-to-be-spent COVID-related borrowing. Both the private and household sectors recorded growth in deposits despite the massive contraction in the tourism industry. Household deposits reflected the observed trends in other countries, that is, large unemployment benefits and lack of consumption opportunities led to accumulated savings and deposits due to the uncertainty of the time. In FY21 and FY22 the deposit base contracted. While household deposits grew, following the same trends as during the first year of COVID, private sector deposits stabilized despite the massive contraction in the sector, and there was a large reduction of 30 percent of government liquidity as COVID-19-related borrowing was spent down.

Figure 12: Commercial bank deposits, lending and net foreign assets

Commercial bank lending remains weak; funds invested offshore; deposit growth picked up during COVID-19.



Private sector credit remained low even during the COVID-19 period as businesses had to cover fixed costs as sales diminished. While deposit growth has been rapid, lending performance to the private sector has been weak. Before the pandemic, lending to the private sector in FY19 was $33.7 million (12.9 percent of the deposit base), probably the lowest in the region. In FY20 despite the dire state of the private sector, credit to tourist operators remained subdued reflecting caution both from lenders and borrowers alike. Private sector credit contracted further in FY21 but improved slightly in FY22 with the private sector loans-to-credit ratio rising to 10.7 percent. The difference between the large deposit base and the low level of credit is invested offshore in commercial bank foreign assets ($271 million in FY22).

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

National Development Bank of Palau

The NDBP plays a significant role in the financial sector of Palau. The NDBP has been a long-standing entity in the financial sector in Palau and the size of its lending portfolio is equivalent size to that of the commercial banks. It thus plays a larger role in Palau than in most Pacific Island economies, in part due to the modest role played by the commercial banks. The NDBP was created in 1982 by public law and is wholly owned by the government. Six members of the Board of NDBP are appointed by the president of Palau subject to the advice and consent of the OEK. The remaining member, of the Board is also the CEO and is selected by the Board. The main goal of NDBP is to promote economic development by financing new business start-ups, SMEs, and housing.

While growth in housing loans has been dramatic, doubling in the last 6 years, credit to the business sector has stagnated. In FY23 unaudited information indicates the Bank had a loan portfolio of $33.5 million, 70 percent of which ($23.5 million) was lent to provide funds for homeownership. The other main area of lending is support to the commercial sector with $7.4 million in loans, representing 22 percent of the portfolio. NDBP also funds a variety of small projects in agriculture ($1.0 million), fisheries ($0.5 million), and home solar projects ($1.2 million). The main recent area of expansion has been housing loans, which have nearly doubled from $12.2 million in FY18 to the present value of $23.5 million. Perhaps not surprisingly, lending to commercial activities stagnated during the COVID-19 period. Currently, home lending is the primary function of the NDBP. While this reflects the social priority and need to increase the stock of housing in Palau, the Bank's role in financing of the commercial sector is relatively small.

The financial position of NDBP remains favorable and reflects sound management. Twenty-six percent of assets are held in cash or cash equivalents with $33.5 million, 72 percent, provided in lending to the Bank's clients. During COVID non-performing loans were indicated to have risen to as high as 15 percent but are currently recorded at 5.7 percent. On the liability side NDBP has borrowed from RoPSSA ($1 million outstanding), on-lent loans from Taiwan guaranteed by the government for Agri business ($3.6 million outstanding) and Women and Youth Entrepreneurs and MSMEs ($4.9 million outstanding). NDBP also participated in the ADB solar project ($2.5 million outstanding), as well as a few other minor debt liabilities. During COVID-19, NDBP received grants of $1.5 million in FY20 and another $0.5 million in FY22 to support the private sector under the CROSS Act. Lastly, in terms of funding NDBP was also the beneficiary of $9.0 million in grants from the government, which was originally intended to be a loan to be shared by NDBP and the Palau Housing Authority but was converted into a grant by the OEK.

> *Development Bank plays a key role in home loans and finance to SMEs but plans to take deposits and apply for a banking license require careful assessment.*

> *New Fintech innovations introduced have caused concern and will require enhanced regulatory capacity.*

A major issue confronting NDBP has been the issue of deposit taking. The Bank has recently been empowered by the OEK to take deposits, but the Bank has not yet taken any. There are several issues with taking deposits. First, the portfolio of NDBP is largely in long-term assets, that is, 68 percent of loans have a duration of over 3 years. Deposits are by nature short-term and highly liquid. The current portfolio of the Bank is thus not well structured for deposit taking. Second, the Bank needs to acquire a banking license from the Financial Institutions Commission. This will entail re-engineering business processes to fulfill the conditions of acquiring a license. It is possible that the Bank could take institutional large deposits and structure a matching loan portfolio. However, the Bank needs to carefully consider whether the process of acquiring a license would alter its fundamentally developmental and nonprofit nature. That is, the requirements of deposit taking and acquiring a license may thus conflict with the basic principles of the Bank.

Financial sector digital innovations

Palau adopts Fintech (Financial Technology) as a means to diversify the economy. Palau has recently adopted a program of financial innovation in the digital area involving two projects: (i) the creation of a Palau Stable Coin (PSC), and (ii) the establishment of a digital residency program. Both projects are of an innovative nature and intended to diversify the economy.

Stable Coin

Ministry of Finance launches trial Palau Stable Coin project. The PSC is intended to act as a stable coin backed by the US dollar. It has been developed in collaboration with Ripple and uses the XRP Ledger. The objectives of the program are:[11]

> *To promote the use of the PSC at a national level and make it a convenient and cost-effective way of payment, giving people innovative and secure ways to access and transact with their money without physically going to a bank, handling fiat cash, or paying higher fees associated with credit cards and other electronic payment systems.*

It is intended to fulfill the functions of a central bank digital currency (CBDC) and act as legal tender in Palau. It has as yet to be adopted and established in law. A trial project has been conducted over a 3-month period with recruitment of 168 volunteers who are government employees. Volunteers were able to spend 100 PSC at participating local retailers. Both the volunteers and retailers are reported to have responded positively to their experience using the PSC.

Many regulatory, capacity, and institutional issues need resolution before a successful launch of the PSC can be achieved. At the time of the IMF Article IV consultations, no commercial bank operating in Palau was willing to accept transactions in PSC or act as an exchange. In addition, no US-based financial institution has shown interest. In the absence of any existing financial intermediary taking on exchange functions, it would be left to the Ministry of Finance to assume the role. It is difficult to see how the Ministry of Finance could fulfill these functions when it was not established to act as a financial intermediary. The creation of a CBDC would further require enhanced regulatory capacity to protect against AML/CFT and ensure KYC standards

11 Ministry of Finance Republic of Palau, ***Stablecoin Program: Phase 1 Report, Melekeok, Palau, December 2023.***

are complied with. The current regulatory body, the Financial Institutions Commission, also has limited capacity and staff, and would need to develop skills in these areas before being in a position to fulfill the necessary regulatory functions.

Digital Residence

In November of 2021 Palau enacted legislation to create the Palau Digital Residency Program.[12] The program was modeled on that established in Estonia whereby individuals could establish a residency and identify that it was purely digital in nature. In Estonia, digital residency confers certain legal rights, such as right to sign documents, form a company, etcetera, but not the right to residency. In Palau, the digital residency program does not confer the right to residency or to obtain a driving license. Furthermore, financial institutions operating in Palau do not accept digital residency as proof of identity for the purposes of opening a bank account. As part of the program, Digital Residents are now entitled to reside in Palau for up to 180 days.

Digital Residency Office was created in the Ministry of Finance to operate the program. The law establishes a Digital Residency Office within the Ministry of Finance, and the minister has been granted powers to contract digital residence services to a Service Provider. The Digital Residency Office can approve or deny applications, create a digital residence ID, and maintain a "blacklist" of countries whose citizens are not entitled to residency. Each application with a $50 fee must contain KYC (Know Your Customer) information sufficient to establish identity and perform a security review for AML, CFT purposes. These services are undertaken in-house and through a service provider.

Once approved the digital resident is issued an ID card, which contains the applicant's legal name, date of birth, ID number, address, expiration date, and photo. Each "resident" is charged $100 per annum.

Services to Digital Residents extended to the provision of mailboxes to receive and forward mail. More recently regulations were issued that outlined the scope and provision of mailboxes to digital residents. For an appropriate fee digital residents may apply to be issued a mailbox provided by Palau's Postal Service, which will both receive mail and provide a forwarding service. The regulations make provision for the lease of land on which to build a set of new mailboxes.

As in the case of Stable Coin, the provision of the Digital Residency Services attracted considerable attention. First, the provision of mail forwarding raised concerns given Palau's access to a US zip code. Mail that includes goods could be forwarded to an address in a third country to by-pass US regulation. A major concern during the recent IMF Article IV consultations was the inability of Palau to adequately perform regulatory functions given its limited capacity. Furthermore, the provision in the Digital Residency law for name change was of particular concern, as it provides a means of obscuring beneficial ownership. In summary of the Article IV consultations the IMF Borad concluded:[13]

> *Noting the benefits to financial inclusion, Directors called for a cautious approach to Fintech initiatives. They underscored the need to first close existing gaps in the regulatory and governance frameworks, and strengthen the country's AML/CFT framework, before exposing the financial system to new risks.*

12 Olbiil Era Kelulau, *RPPL No. 11-14: to provide for Digital Residency, to appoint a service provider to administer the Digital Residency Program, Melekeok, Palau, November 2021.*

13 International Monetary Fund, *IMF Executive Board Concludes 2023 Article IV Consultation with Palau: Press Release No. 23/467, Washington D.C., December 21, 2023.*

Social Security Sustainability

Actuarial evaluation based on FY20 data indicated fund collapse by FY42. Based on an actuarial assessment[14] at the end of FY18, a relatively rosy picture had been indicated for RoPSSA with a funded ratio of 35.4 percent, and a stable cash-flow balance over the medium to longer term. A subsequent assessment[15] based on FY20 data came to a different conclusion. The funded ratio had fallen to 20.3 percent and the fund was projected to collapse in FY42. The reasons for the deterioration were analyzed and found largely due to differences in assumptions in the investment return (9 percent of the difference), increase in longevity (3 percent), and others (3 percent).

Supplemental benefits erode viability of ROPSSA and when included in the evaluation fund collapse is bought forward to FY35. However, in addition to these changes the prior evaluations had not taken into account a set of 3 supplemental benefits of $50 per month awarded to pensioners. The first was awarded in October 2014, the second in October 2017, and the third in April 2020. The second award was absorbed into the SS and accompanied with an increase in the contribution rate from 6 to 7 percent. The other two awards were unfunded and require an annual appropriation and transfer from the national treasury. The first two supplemental benefits were awarded to all pensions, current and future, while the third was only awarded to existing pensioners and the disabled. Once the supplemental benefits are included as liabilities of RoPSSA the FY20 evaluation found the funded ratio had fallen to 17.5 percent and system collapse was projected for FY35.

> *Recent actuarial evaluation of SS finds the administration is at risk of collapse, but reforms under consideration, if enacted into law, will ensure long-term financial sustainability.*

Weak market performance and poor economic performance have further eroded the financial position of RoPSSA. In FY22 a further actuarial assessment[16] was undertaken. Due to poor market performance between FY20 and FY22 and loss of contributions due to COVID-19, the position of RoPSSA was found to have further deteriorated. The funded ratio at the time of evaluation stood at 13.8 percent with system collapse projected in 6 years' time in FY29 before the end of the decade. The evaluation also indicated that should an additional $3 million be appropriated annually, which is above the average of $2.4 million between FY19-FY23, it would only push out the collapse date by two years to FY31.

Participatory process initiated to develop reforms to place RoPSSA on a sustainable trajectory. As part of the ADB RISES program (a policy-based loan to provide budget support to Palau during COVID-19), a condition was fortuitously included requiring an evaluation of SS coupled with reform options and recommendations. After the FY20 evaluation was completed, a pension working group was created to develop suitable reform options to present to a wider audience at a participatory forum of stakeholders. In November 2021 a well-attended national consultative process was convened and attended by many members of Palau's leadership, including private sector representatives and other stakeholders. A set of reforms was thrashed

14 Wilshire Associates, Inc., *Republic of Palau Social Security Administration Actuarial Valuation as of October 1, 2018, Santa Monica, CA 90401, September 2020*

15 Callund Consulting Ltd, *Actuarial Study and Assessment of the Republic of Palau Social Security Administration as of October 2020, Berkshire, UK, February 2021.*

16 Callund Consulting Ltd, *Actuarial Valuation Report for the Republic of Palau Social Security Administration: as of October 2022, Berkshire, UK, October 2023.*

out in two subgroups and were consolidated into a consensus in the plenary session.

OEK yet to act on Presidential bill to enact reforms developed in participatory workshop and reviewed by the IMF. The consensus view was that the contribution rate should be increased from the current 7 percent to 9 percent, the retirement age should be extended to 65, and full benefits would accrue after 35 years of service. Pension benefits would be adjusted for inflation but slightly less than the full increase in the CPI. The view was that SS should operate on an independent basis and without subsidy. Younger participants felt that the increase in the contribution rate was important to maintain the financial soundness of the system. However, it was noted this would increase the cost to the private sector. The results of these proposals and adjustments in spouses and dependent benefits were drafted into a reform bill that has now been transmitted to the OEK for consideration. However, the OEK has yet to take action on these reforms. During the recent IMF Article IV consultations, the IMF was asked to review the proposed reforms. In an OEK hearing of the Ways and Means Committee, the Fund indicated that the proposed reforms were in accord with IMF policy and recommended enactment into law as soon as practicable.

Civil Service Pension Plan

Milliman report indicates CSPP in imminent threat of collapse during 2023-2025. In 2019 a report was commissioned by the government of Palau to prepare an actuarial assessment of the CSPP with reform options, that is, the Milliman report.[17] The report indicated that the design of the original Plan was such that the contributions would have been sufficient in the long term to support the accrual of the Plan benefits. However, the award of benefits to employees for service prior to the start

> *The CSPP is also at risk of imminent collapse but reforms have been designed to close existing DB and introduce new DC.*

of paying contributions meant that the Fund was always in need of significant additional funding. The Milliman report indicated that the funded ratio of assets to liabilities was only 16 percent and the Fund is currently projected to crash between 2023 and 2025.

Milliman report prepared a series of reforms none of which made a significant contribution to sustainability. A series of reform options were considered, such as (i) extending the retirement age to 65 over a period of 25 years, (ii) reducing the 2 percent crediting ratio to 1 percent, (iii) establishing a DC scheme with private sector participation, and (iv) providing an additional government subvention of $2 million per annum. The reform package assumed that all pensioners in retirement or over age 55 would continue to receive pensions at their current rate. Even the addition of these options was found to have little impact on the sustainability of the CSPP and at best only pushed the eventual collapse date to 2030.

Callund report affirms Milliman report with projected collapse now projected during FY26. In December 2023 a further actuarial assessment of the CSPP was undertaken, the Callund report.[18] The findings of the assessment confirmed those in the Milliman report and stated that without reforms or an injection of cash, the CSPP would collapse during FY27. The Callund assessment indicated that CSPP had an accrued pension liability of $232.9 million, and plan assets of $23.5 million were a mere 10 percent of liabilities. In the FY20 budget, and included

17 Milliman, ***Republic of Palau Civil Service Pension Plan Strategic Review, Singapore, June 2019.***

18 Callund Consulting Ltd, ***Republic of Palau Civil Service Pension Plan Draft Actuarial Valuation Report as at October 1 2022, Berkshire, U.K. December 2023.***

under the provisions of the CROSS Act, the government transferred $4.8 million to the CSPP. During the period FY19-FY23 the OEK transferred on average $2 million to the CSPP although no funds were included in the FY24 budget. These funds have assisted in supporting CSPP but have neither changed the underlying status nor the trend of imminent collapse.

Reform Taskforce adopts objective to find long-term sustainable solution to the problem. Following the pension reforms initiated during the ADB RISES program, the ADB provided further TA support to maintain the momentum. In the case of the CSPP, the pension reform task force was directed to work with the TA consultants to come up with solutions. Given the imminent collapse of the CSPP and lack of potential impact of the earlier reforms proposed in the Milliman report, a long-term sustainable solution to the problem was sought. The task force recommended the termination of the existing Defined Benefit scheme, and that all future contributions should be made to a new Defined Contribution scheme. Existing pensioners would continue to receive benefits while those in service with accumulated pension rights would be cashed out or receive modified future benefits.

Participatory workshop crafts reforms that provide a long-term sustainable solution. A participatory workshop designed along similar lines to that adopted for RoPSSA was convened in November 2022 to determine a means of meeting the future pension obligations in a financially sustainable manner. The workshop was divided into two groups and provided a set of reform options "to solve" the CSPP problem; and to provide an equitable set of reforms that was financially viable. The two groups were brought together, and differences were resolved in plenary through a set of compromises. The following list indicates the reforms adopted by the workshop:

- The normal retirement age would be 63 years;
- Unvested civil servants with less than 5 years of service would receive a cash payout equivalent to their contributions without earnings, 1,044 members;
- Vested civil servants with between 5 and 15 years of service would retain their existing pension rights, but with pension determined at the average of the high three years of salary at time of reform, 1,229 members;
- Vested civil servants with greater than 15 years of service would take a reduction in crediting rate from 2 percent to 1.5 percent at the high three years of service at time of reform, 883 members;
- Those in retirement would not be subject to reform;
- The new DC scheme would be based on 6 percent of salary for the employee contribution and 3 percent of employer's. The 3 percent difference between the employer contributions under the old and the new schemes would be allocated to support the old DB scheme.
- Two percent out of the new PGST of 10 percent would be allocated to support the old DB scheme.

Financing of the closure of the DB scheme requires establishment of a temporary line of credit. Figures 13 and Figure 14 indicate the projected profile of the closure of the DB scheme. In the first figure benefits are paid to existing and retiring civil servants entitled to a pension under the old DB scheme. Funding needs remain relatively constant until about FY40 when they trend slowly downward. The two revenue streams: the 2 percent PGST and 3 percent payroll contribution, trend upward until FY53 when further funding is no longer required. At this time sufficient reserves will have been accumulated to fund all remaining outstanding benefit claims. The second figure

Figure 13: CSPP reform DB closure: benefits and funding sources
Benefits gradually decline funded from PGST and government payroll: need for additional revenue terminates in FY53.

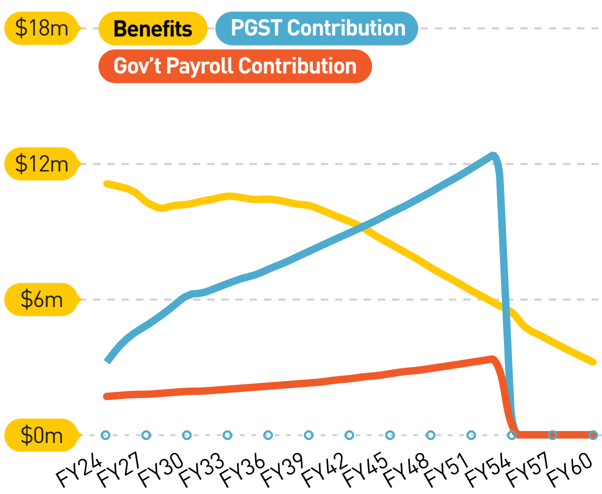
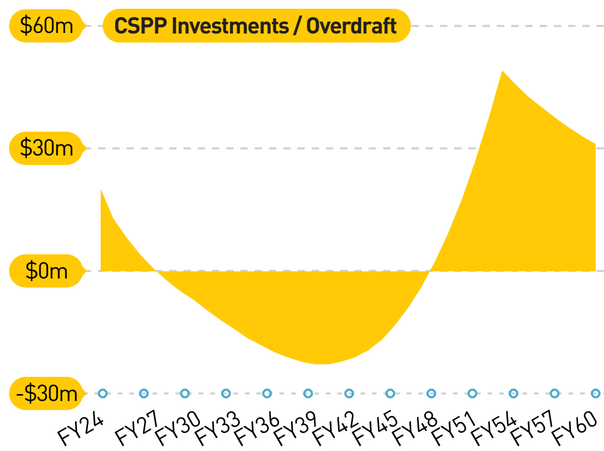


Figure 14: CSPP reform DB closure projected fund balance
Cash flow turns negative in FY28 but reverts to positive in FY48.



indicates the funding position of the CSPP investments. In the early phases, FY27-FY47, it turns negative as payments outstrip benefits and the fund is required to open a line of credit. Once the two revenue streams exceed benefit payouts, overdraft levels decline and turn positive in FY47. Once sufficient reserves have been built to fund the present value of the remaining pension liabilities, achieved in FY54, the need for further funding terminates.

A further participatory workshop to revisit CSPP reforms both DB closure and creation of new DC will be convened in the new year. Since the CSPP participatory workshop the pension task force has been working on defining the new DC scheme. At the recent Development Symposium in November 2023 and during the breakout sessions, a presentation was made on the position of the CSPP and structure of the new DC scheme. Several anomalies to the CSPP reforms were indicated, (i) the difference in retirement ages between SS and CSPP, 65 and 63 years, respectively, (ii) a discontinuity in benefits between those with 5 to less than 15 years of service compared with those with 15 plus years of service, and (iii) the relative disadvantage of those retirees with 15 years or more of service. It was further noted that that (i) the introduction of the PGST resulted in a significantly greater tax yield than anticipated during the design of the CSPP reforms, and (ii) there has been significant recent inflation and increased wages for civil servants. It was concluded that a further workshop would be necessary and should be held in early 2024 to rework the CSPP reform package, for both closure of the DB and creation of the DC. The combined package would then be worked into legislation for consideration by the leadership and OEK.

9. Private Sector Development[19]

The World Bank's Doing Business Survey

The 2020 World Bank's "doing business survey" ranked Palau 145 out of 190 participants but the survey has now been discontinued. The World Bank's ease-of-doing-business survey has now been discontinued due to certain irregularities in the implementation of the survey.[20] However, the survey provided a useful broad indicator and yardstick on the attractiveness of the business environment. The 2020 survey indicated that Palau ranked 145 out of the 190 countries surveyed, in the bottom third, which suggests there was 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. Overall, Palau's scores are generally weak and ranked in the bottom third in: starting a business, dealing with construction permits, getting electricity, protecting investors, trading across borders, and resolving bankruptcy. The discontinuation of the doing business survey was unfortunate but it is understood that the survey will be replaced with a new survey entitled B-READY, intended to measure the business and investment climate of 180 countries annually. A replacement survey will enable Palau to compare its performance with that of its peers and form the basis of a road map for future private sector reforms.

Land Tenure

Land issues have long been identified as a significant constraint to private sector development in Pacific nations, and Palau is no exception. Land may only be owned by Palauan citizens and is owned by individuals, clans, and the government. A particular issue arises because foreign-owned financial institutions cannot secure mortgages on land or land leases in the event of default since foreign institutions are not entitled to ownership. In effect the only institution that can issue mortgages against land or land leases is the National Development Bank of Palau. Lease terms can be issued up to 99 years, and limited duration is not a problem. The lack of effective land-use planning in Palau is a serious weakness. This is especially so in a tourism-based economy, where land-use planning is the major means of effective implementation of policy and attainment of high-value tourism.

The Regulatory Environment

The reformed Companies Act has been passed by the OEK, and the creation of an electronic Corporations Registry is currently under implementation. Palau's regulatory environment is based on its constitution, customary law, and common law as applied in the United States and has no Uniform Commercial Code (UCC) or equivalent. An ADB Private Sector Assessment indicated that the former Companies Act was not suited to modern commerce, and the company registry functioned poorly. As part of the ADB RISES program, Palau prepared legislation for a new reformed Companies Bill, which passed into law in September 2021 and will create a

19 This section is largely similar to that in the 2022 Economic Brief, but the material remains relevant and is repeated in the current version.

20 *"The World Bank's Doing Business Report," Congressional Research Service, October 29, 2021, Washington DC.*

modern electronic framework. The reforms were completed with support from the Private Sector Development Initiative (PSDI). The key features of the new law include:

1. A standardized set of forms will be implemented for online filing by corporations. This will allow Palau to do away with outdated, bureaucratic formalities that had caused significant delays in completing incorporation.
2. The new law will ensure that Palau complies with global anti-money laundering / countering the financing of terrorism (AML/CFT) obligations.
3. The new registry will be a source of current, accurate information that will be available online to the public.
4. The Act contains more robust provisions for foreign corporations that seek to do business in Palau.
5. Provides a new framework to assist in classifying nonprofits into (i) charitable organizations formed for the public good, (ii) religious organizations, and (iii) other entities that are formed for the benefit of their members, such as chambers of commerce.

Creation of a centralized "one-stop shop" will assist in streamlining private sector applications to operate businesses. A large number of requirements, permits, and licenses are required for a business to be allowed to operate in Palau. Many of these problems will be reduced by centralizing the system into a "one-stop shop," which has been recommended and adopted in many jurisdictions. The former finance buildings in Koror are being rebuilt for this purpose. Creation of the electronic corporate registry and the administrative consolidation into one office of the different agencies that grant approvals would greatly simplify the process. Finally, Palau lacks a bankruptcy statute. The current system protects neither debtors nor creditors. The proof of debt is long and complicated, and legal practitioners are required. There are no systematic means by which debts can be discharged, and many individuals have no means of getting out of debt.

Palau accedes to the New York Convention on the Recognition and Enforcement of Arbitral Awards. Signatories to the convention benefit from participation in a recognized means of neutral dispute resolution. They also have the ability to enforce arbitral awards in the courts of other signatory countries. This makes arbitration an attractive means of dealing with disputes for foreign investors seeking a neutral, expert, and enforceable means of resolution. In April 2021 Palau enacted the International Arbitration law, which enables commercial arbitration to take place in Palau between local and foreign parties who have voluntarily agreed to arbitration in writing. The law sets out the parameters of the way in which arbitration may be conducted in Palau and deals with the relationship between arbitration and the court system of Palau. The reforms were completed with support from PSDI and through information sessions with stakeholders from the business, legal, and judicial communities.

> *A series of reforms in the private sector: new Corporation and Arbitration laws will establish a more secure environment for private sector development.*

Foreign Direct Investment

Palau operates an old-style foreign-investment-board approach to FDI regulation, which imposes a range of bureaucratic restrictions and requirements. The Foreign Investment Act was amended in

March 2016 to provide powers to the board to control "front" businesses: businesses owned by Palauans but operated by noncitizens. The original law had a wide range of onerous requirements, was weakly enforced, and encouraged the creation of fronts. However, the issue of front businesses appears to be as widespread as before 2016; the new law, although incorporating wider powers, does not appear to have resulted in enhanced control, or improved quality or quantity of foreign investment. The attempt to restrict the prevalence of "fronts" has resulted in even greater restrictions and inhibited the introduction of a more modern law fit for the purpose. The existence of a law that is widely disregarded undermines the process of law. A more rational approach with the power to monitor the sector may be more beneficial than one which persistently fails to achieve its objectives.

Private Public Partnerships (PPP)

Designation as a high-income nation[21] requires Palau to consider new vehicles for the financing of infrastructure. Palau has traditionally relied upon government for the procurement and operation of public infrastructure projects, including the operation of utilities, which are currently under state ownership (SOEs). Infrastructure needs have generally been financed through bilateral grant aid or loan financing from multilateral donor agencies. However, due to its designation as a high-income nation, Palau must develop new means and vehicles for the financing and operation of its infrastructure. In response to these forces, Palau has developed a PPP policy statement with support from the PSDI. Adoption of the PPP policy statement by the president was an important element of the RISES program.

A new PPP unit will be created in the Ministry of Finance to identify and develop PPP projects. A new PPP unit has been formally established in the Ministry of Finance but is not yet in operation. It will assist in the development of a PPP framework that will guide the development of PPP projects and procurement. The PPP unit has been established alongside a debt management unit that forms a key part of the monitoring and loan appraisal process, which is required in the Fiscal Responsibility Framework. The PPP unit will identify candidates for PPP financing that will be considered by a PPP project ministerial committee. Once the inception stage is complete, projects will be assessed for feasibility, and then approved by the president and, ultimately, by the OEK. After contracting and procurement, projects will be subject to monitoring by the PPP unit for fulfillment and delivery of the outputs specified in the agreements.

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

21 Due to COVID-19 and the collapse in the economy, Palau has currently been reclassified as an upper middle-income country. However, as the economy recovers Palau will regain its earlier designation.

10. Compact Renewal

Background

The second Compact Review was agreed on by the US and Palau in May of 2023 and is now awaiting approval in the US Congress. The original Compact between the US and Palau was signed in January 1986, but it did not take effect until it was ratified by the people of Palau through referendum in 1993. The original Compact, which became effective in 1995 for a 15-year period, contained funding for a series of annual economic assistance grants as well as funds for a Compact Trust Fund, known in Palau as the COFA Fund. The original Compact had made provisions for a review of the terms in the 15th, 30th and 40th years. The first review (CRA-10) was completed in September 2010 and provided for continuation of a series of declining annual grants plus additional funds for the COFA fund to compensate for the overly optimistic projections in the original agreement. However, while CRA-10 was submitted to Congress for approval, it was not finally approved until 2018, eight years later. In May of 2023 the second Compact Review (CRA-23) was completed, and agreement was reached by the parties for a 20-year extension for the period FY24-FY43. At the present time the agreement is again in Congress awaiting approval.

> *Compact Review Agreement will bring a significant increase in funding, but timing of passage by the US Congress remains uncertain.*

Compact Review Agreement 2023

CRA-23 outlines important objectives and commitments made by Palau. The preamble to the agreement indicates various important aspects that form part of the annual review process. First, the agreement refers to the progress made by Palau in the adoption of the Fiscal Responsibility and Debt Management Act. Second, the agreement notes the impact of COVID-19 on the economy and challenges due to climate change, sea-level rise, and disasters. Third, the agreement notes the commitment made by Palau to development planning to ensure long-term stability and increasing self-reliance.

The major features of CRA-23 are outlined below:

Annual Economic Assistance

- Annual grants of $20 million for operations to be used for education, health, climate adaptation, the environment, and the administration of justice and public safety. The agreement allows for an annual 2 percent adjustor in lieu of inflation indexation.
- Infrastructure grants of $5 million plus the 2 percent adjustor to made available on a project-by-project basis and used exclusively for projects identified in the National Infrastructure Plan.
- Infrastructure maintenance grants of $5 million a year plus 2 percent adjustor to be used for projects originally constructed by the United States or Taiwan, if mutually agreed.
- CRA-23 includes an important clause that the US shall consider the continuation of

annual assistance after fiscal year 2043 subject to an agreement between the Signatory Governments. However, such an agreement is limited to the annual operational grants of $20 million and does not include either the infrastructure or infrastructure maintenance streams.

Fiscal Consolidation

- A series of 6 annual grants of $10 million beginning in FY24 for fiscal consolidation of debt incurred before April 1, 2023. The funds may be used to pay down debt owed to the ADB or Taiwan but are subject to US approval.

The COFA Trust Fund

- Two tranches of $50 million to be deposited in the Palau COFA Trust Fund. At the end of FY23 the funds stood at $270 million.
- Withdrawals of 4 percent or $15 million, whichever is greater, of the COFA Fund are permitted (3-year moving average). Funds can only be used for education, health, climate adaptation and the environment, or the administration of justice and public safety.
- Under extraordinary circumstances (agreed to by the parties) up to $5 million annually may be withdrawn between FY24-FY26. Thereafter, $5 million or 1.5 percent of the moving average of the last 3 years of the COFA Fund, whichever is the greater, may be withdrawn,. Again, the funds can only be used for extraordinary situations in the specified sectors.

Fiscal Management

The agreement specifies that to maintain economic stability, the government shall continue to undertake reform and shall give consideration to the recommendations of the IMF, ADB, PFTAC, and government of the US. Furthermore, Palau will adhere to the sound fiscal principles outlined in the Fiscal Responsibility and Debt Management Act.

Federal Programs and Services

The US government will continue to provide access to US Federal Programs and Services as agreed in the original Compact. In addition, other programs and services not included in the above agreement, but in existence during CRA-10, will continue to be provided.

Economic Advisory Group

The Economic Advisory Group, which was created under CRA-10, will continue in CRA-23 with the objective of contributing to the economic growth and sustainability of Palau by recommending economic, financial, and fiscal management measures. The EAG is to meet twice a year and provide a report to the parties by May 1 of each year. The EAG was originally organized in 2022, significantly behind the timeline intended in CRA-10, but conducted its first meeting in Palau in August 2022 with a second virtual meeting in December 2022. The EAG met again in Palau in August 2023.

Annual Economic Consultations

CRA-23 requires annual bilateral meetings to be held before August 30 of each year. Key features of the meeting include:

- The overall state of the bilateral economic relationship.
- Palau's economic situation.
- Status of the use of US funds, and audits.

- Implementation of the national development plan (PDP).
- Reports on economic and financial management of the EAG, IMF, ADB, and PFTAC.

Annual Implementation Plan

Palau needs to submit an annual implementation plan before the issuance of direct economic assistance grants. In the Fiscal Procedures section of CRA-23, the agreement outlines the need for an annual implementation plan. The implementation plan, required in July of each year and part of the annual budget process, must indicate the proposed purposes of each type of economic assistance, including operating grants, withdrawals from the COFA fund, or infrastructure maintenance. The proposed purposes must be in accord with the national development plan (PDP). The US may provide recommendations for modifications in the annual implementation plans within 30 days; it may also decline to issue funds if Palau is not in adherence with specific regulations.

CRA-23 does not require the submission of an annual performance report. In the case of Palau there have been no established procedures or formats for budgetary requests for direct economic assistance grants. In the case of the FSM and RMI, the two FAS submit annual budget requests (now also implementation plans) to their respective JEMCO and JEMFAC committees. The precise format of the implementation plans will need to be established and whether or not these plans will be included in the subject of the annual bilateral discussions held in August, which coincide with the start of the following fiscal period. In the case of Palau, CRA-23 does not require an annual performance report (unlike the requirements for FSM and RMI) regarding the use of direct economic assistance. While this will reduce the bureaucratic burden, it might be useful for Palau to undertake an annual performance analysis of all budgetary allocations, not just the use of Compact funds. This would be in accord with PFM improvement and best practice.

Issues relating to CRA-23

The design and funding available under CRA-23 must, in general, be seen as a credit to both parties and should assist Palau in its future development needs. This is particularly true as Palau recovers from of the consequences COVID-19, whereby the burden of the large debt incurred will be significantly reduced. However, the nature and structure of CRA-23 raises certain issues.

Perpetual COFA fund or source of revenue for government operations

Palau's Fiscal Strategy adopted the objective to establish a perpetual fund. The original COFA trust fund was designed as a sinking fund to provide a source of revenue for the duration of the economic provisions of the Compact. As part of the President's Fiscal Strategy issued in 2022 and required under the Fiscal Responsibility and Debt Management Act, the objective to establish a perpetual fund was declared. At the time the objective was to replace the level of annual drawdowns of $15 million in real terms in perpetuity with a high degree of confidence. With the funding levels of CRA-23 now established the objective would be reinterpreted to imply the replacement of the new levels of economic assistance on termination of CRA-23 in FY43.

CRA-23 is based on the assumption that a perpetual fund is no longer needed. The rationale of CRA-23, which permits drawdowns of COFA funds largely for operational purposes, is at odds with the objective to create a perpetual fund. In essence CRA-23 permits Palau to withdraw capital funds to support current levels of consumption. This is justified on the premise that CRA-23 now indicates under Article 1(h) that the US *shall consider the continuation of annual assistance after fiscal year 2043 on the basis provided for in subparagraphs (a) and (b) of this Article and subject to an agreement between the Signatory Governments*. CRA-23 thus indicates that the relationship between the US and Palau will exist in perpetuity and therefore obviates the need to establish a perpetual COFA fund. The policy question for Palau thus arises as to whether the nation wants to maintain its original intent to establish a perpetual fund for future generations or drawdown available funds for government operations and current consumption.

Use of COFA trust funds is restricted to the social, environmental, and public safety sectors rather than economic development. A justification for the withdrawal of funds from the COFA fund could be made on the basis that the return on the use of the funds in the local economy would be greater than investing in financial market instruments. While this argument provides a rationale for COFA fund withdrawals, CRA-23 does not permit the use of COFA fund resources for purposes other than use in the social, environmental, and public safety sectors. Ironically CRA-23 is biased toward using resources from a source of capital, that is, the COFA fund, for largely current needs and does not permit their use for investment in capital projects, other than in the social, but not economic, sectors.

Inflation adjustment

CRA-23 does not provide provision for annual inflation adjustment. CRA-23 incorporates a 2 percent annual adjustment in lieu of actual inflation adjustment. The rationale for this specification would appear to be to shift the risk of the cost of periods of high inflation onto Palau. Clearly, this would be much better borne by the US, where the costs would be relatively small, compared with Palau where the impact of a period of high inflation, like that recently experienced, could be very large and would significantly undermine the operation of government and jeopardize fiscal stability. Palau's CPI has risen on average by about 3 percent annually since 2000 and before the recent spike in international prices. The 2 percent adjustor is below this rate. Thus, Palau will need to prepare for an annual decrement in the real value of the Compact economic assistance of about 1 percent per annum as well as possible periodic spikes in inflation.

Infrastructure

The small allocation for infrastructure in CRA-23 is a major limitation. CRA-23 provision of infrastructure funds is low in comparison to the size of the package, that is, just $5 million (16.7 percent) of a total package of $30 million. This is considerably less than the 25 percent allocation in the FSM and RMI. Furthermore, the use of the COFA trust fund for this purpose is strongly restricted. In addition, CRA-23, as currently worded in Article 1(h), does not include the infrastructure or infrastructure maintenance grant for inclusion in continued annual assistance after FY43. The result of these various issues implies that CRA-23 will not have a large impact on developing Palau's infrastructure. This is unfortunate. As the EAG points out in their first report, the need for improved infrastructure and replacement of degrading capital stock is one of the priority needs of the nation.[22] In the absence of significant capital support in CRA-23, Palau will need to focus on other bilaterals, multilateral donors, PPPs, and other arrangements to fulfill its economic investment and development needs.

22 Palau Economic Advisory Group, ***First Annual Report of the Palau Economic Advisory Group, April 2023, See https://pitiviti.org/palau-eag***

11. The economic and fiscal outlook

Assumptions informing the outlook

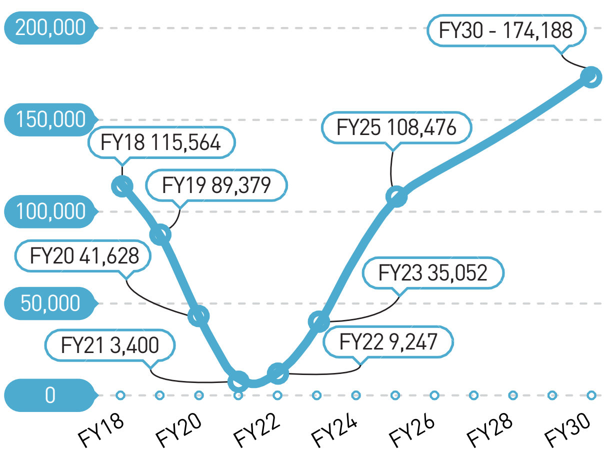
The projections of the economy take a conservative view of the recovery.[23] Earlier projections made by the GSUSA assumed that economic recovery would be well underway by mid-2022 and on a similar path to that experienced elsewhere in the South Pacific. However, the return of travel and recovery of the tourism industry in East Asia has been below expectations.

Tourism recovery, based on current flight arrivals, is projected to be well established in FY25. Summarizing the discussion in section 4 of the Review, the projections of the tourism recovery are based on the current flight pattern to Palau and those planned for 2024 for the near to medium-term. Based on a conservative estimate of seat occupancy rates of an average 36 percent in FY24, a total visitor count of 76,670 is projected, see Figure 15. For FY25 with the assumed return of flights from Japan and improved seat occupancy rates, a total of 108,476 visitors are projected. For FY26 and beyond, it is assumed Palau will slowly rebuild its tourism industry and that the new IHG hotel in Malakal and the new Four Seasons resort will start operating. Average hotel occupancy rates are assumed to increase from 42.5 percent in FY26 to 55 percent as profitability returns to minimum levels, and 174,000 visitors are projected for FY30.

Construction demand is projected to grow strongly in the medium-term. Construction has traditionally had a large impact on the economy. In the projections construction activity is derived from a series of sources: (i) on-budget capital-funded projects through CRA-23 and grants from Taiwan, (ii) a large source of off-budget funds from: the US military, the RUS grant to PNCC to install fiber to the home/premises, Japan capital projects, the ADB, and other donors, and (iii) private sector investment in new hotel projects, that is, the IHG project and new Four Season resort plus a general level of investment activity that is assumed to grow in line with the increase in the economy:

CRA-23 is assumed to be implemented in FY24, but the fiscal stance remains unaltered. While the CRA-23 has been agreed upon by the parties, it still requires action by the US Congress, and considerable risk exists that it will be delayed, possibly beyond the US election. In the Review it is assumed CRA-23 is passed into law and the funds are appropriated in FY24. The FY24 budget was passed by the OEK and is now law including

Figure 15: Visitor arrival projections: FY22-FY30
Tourism recovery is delayed until FY23 and only in FY25 is recovery well established.



23 The projections of the economy for the FY24-FY30 period are derived from an economic model, MTEF-mod, developed by the Graduate School USA. The projections form the basis for discussion and analysis of the economic outlook.

the 75¢ per hour pay increase for public servants. It is assumed that in FY25 there is an increase in use of goods and services to compensate the loss of purchasing power due to high inflation. The RoPSSA and CSPP reforms are not assumed to be acted on. CRA-23 debt consolidation funds are assumed to be applied to high cost COVID-19 related loans from the ADB plus KASP. It is also assumed that the cyclical and climate resilience funds are funded as required in CRA-23 and not used as a financing source for operations.

Outlook for the Economy

The economy is projected to continue the recovery commenced in FY23 and achieve full recovery by FY26. Based on the assumptions outlined, the economy is projected to grow by 13.5 percent in FY24, albeit from a low base, see Figure 16. However, this level of economic activity remains well below the level prevailing in FY18. The tourism recovery is expected to continue in FY25 when a level of 108,500 visitors is projected and with GDP increasing to a level 0.5 percent greater than that of FY18. After recouping the lost ground due to COVID-19, the economy is projected to grow by 2.8 percent per annum between FY25 and FY30 as capacity utilization and profitability levels return to normal.

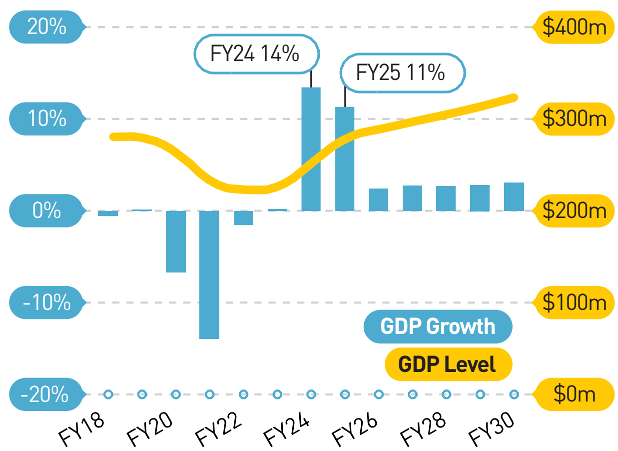
Employment

Demand for labor is anticipated to return with the recovery and to expand in the second half of the 2020s with favorable tourism and construction growth and Compact renewal.

> *The economic outlook for recovery now looks more favorable, and a return to prior visitor levels is projected by FY25.*

Figure 16: GDP level and growth: FY18-FY30

GDP is projected to recover strongly in FY24 and FY25.



The labor market in Palau is comprised of two segments: the Palauan and foreign worker components. The Palauan segment is largely fully employed with excess demand fulfilled by foreign workers. With the majority of the Palauan segment in the public sector, the impact of the pandemic on Palauan labor was less severe than for the labor market as a whole. The projections anticipate the Palauan segment will recover and return to full employment by FY24 and then will cease to grow unless strong incentives are provided to induce former migrants to return, see Figure 17. In the case of foreign workers, demand for labor is not anticipated to return to former levels until the second half of the 2020s. The growth and sustained recovery in the tourism sector plus increased construction activity should generate strong growth for foreign labor above the former peak attained in FY17.

Fiscal Impact

The impact of the economic recovery and growth in tourism coupled with implementation of CRA-23 results in a significant rise in revenues for FY24. With the projected recovery in the tourism sector, tax revenues are expected to rise by 27 percent.

Figure 17: Employment of Palauans and foreign workers, FY18-FY30
As the recovery gathers pace, full employment of Palauans is speedily achieved while demand for foreign labor grows steadily.

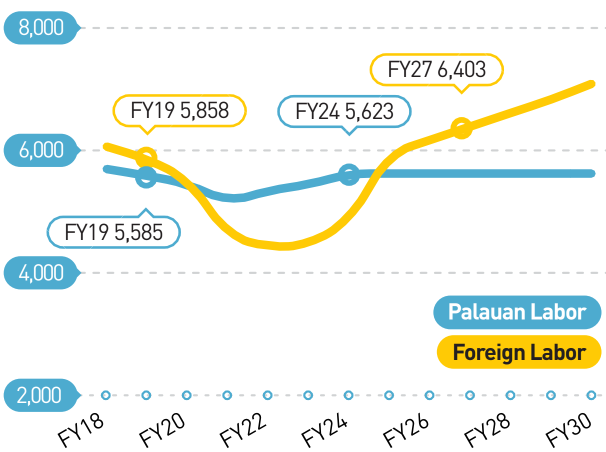
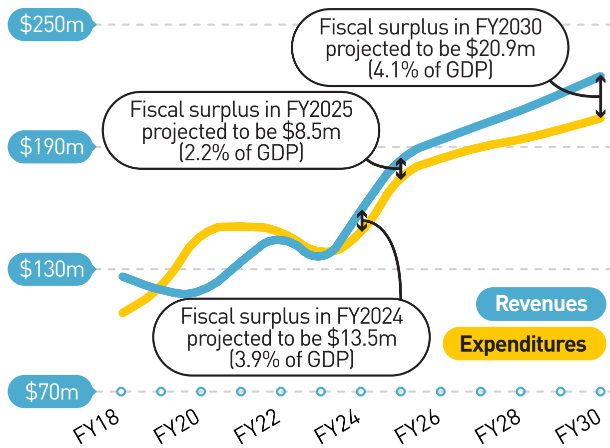


Figure 18: Government revenues and expenditures, FY19-FY30
Government is projected to run increasing levels of surplus after the recovery.



Reflecting a full year of PGST collections, revenues from this source are projected to rise by 67 percent, but will be offset by the reduction in BGRT, reduced revenues from the wages tax due to payment of refunds, and the repeal of the 3 percent general import tax. Overall, taxes are projected to rise by $15.7 million or 4.5 percent of GDP. With implementation during the year of CRA-23 Compact grants are set to rise by $20 million but be offset by a reduction of $15 million due to the absence of any drawdown from the COFA Trust Fund. Compact capital grants, infrastructure, and infrastructure maintenance of $10 million are projected to be delayed until FY25 due to the need for project identification and completion of architectural and engineering design. Overall revenues rise in FY24 by a large $30 million or 8.5 percent of GDP.

> *With the significant improvement in tax effort due to the tax reform and implementation of CRA-23, Palau's fiscal position is now projected to run surpluses and provides options for new initiatives.*

The fiscal position is expected to improve strongly in FY24 and to achieve a fiscal surplus of 3.0 percent of GDP; the first surplus since FY18. Expenditure policies in FY24 reflect the budget transmitted to the OEK including the civil servant wage increase of 75¢ an hour and transfers to the state governments to cover cost of the additional wage bill, estimated to be $5.4 million. Allowances are made for continuation of transfers to RoPSSA and CSPP of $1.8 million and $1.2 million respectively, together with transfers to households for power and water of $2.8 million. Interest payments on external debt are due to rise significantly, reflecting the recent rises in international rates. Overall, expenditures are projected to rise by $11.3 million. The results are that in FY24 the fiscal position improves strongly with a $13.5 million surplus or 3.9 percent of GDP,[24] see Figure 18.

Palau is projected to generate significant fiscal space through the end of the decade.

24 Receipt of the Compact debt consolidation grant stream is treated as a financing item and is not recorded as a capital grant. The fiscal position is thus below that which could be recorded under strict implementation of GFS classification rules.

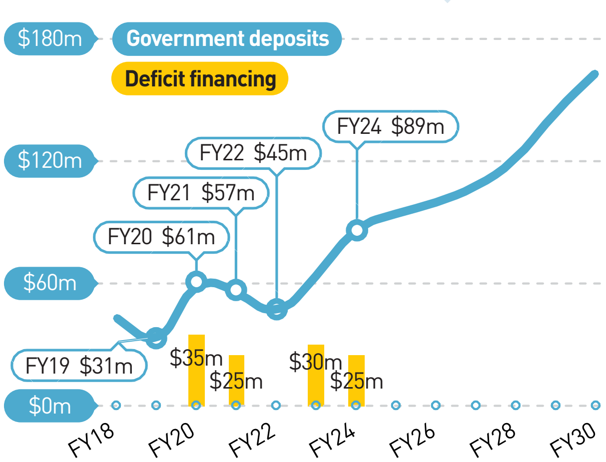
In FY25 a catchup for inflation between FY19 and FY24 is allocated to goods and services of 42 percent or $14.0 million. This additional expenditure results in a reduction in the fiscal position in FY25, although a surplus of 2.2 percent is achieved. Given the large increase in funds from CRA-23 and continuing growth in the economy, buoyancy of the reformed tax system coupled with largely static expenditures in real terms, the fiscal output is projected to generate large surpluses. After a period of rapid decline in the economy and fiscal restraint during COVID-19, the economy is now projected to enter a period with an entirely different fiscal profile.

Financing

National government cash reserves remained at healthy levels during COVID-19 and under the current policy scenario are projected to rise further with implementation of CR-23 and full recovery of the economy. Figure 19 indicates the level of government cash balances at the end of each fiscal year and the inflow of borrowed funds from the ADB for deficit financing. The figure indicates that during the FY20-FY23 period the government borrowed $90 million for budget support and deficit financing due to COVID-19. During FY24 the government is making provision for a further policy-based loan from the ADB of $25 million under the Sustainable Oceans and Resilience Strengthening Program. In FY24 cash reserves are projected to rise to $89 million with receipt of funds under CRA-23, and $25 million above that projected for the end of FY23. From this point forward as the recovery gathers momentum, cash balances are projected to rise further. This level of reserves indicates a likely trajectory based on current policy. However, it is probable and even desirable that the government will undergo reforms to the ailing pension system and invest in Palau-sourced development projects and infrastructure, which would imply that the actual output will be different to that represented in Figure 19.

Figure 19: Government deposits, FY19-FY30

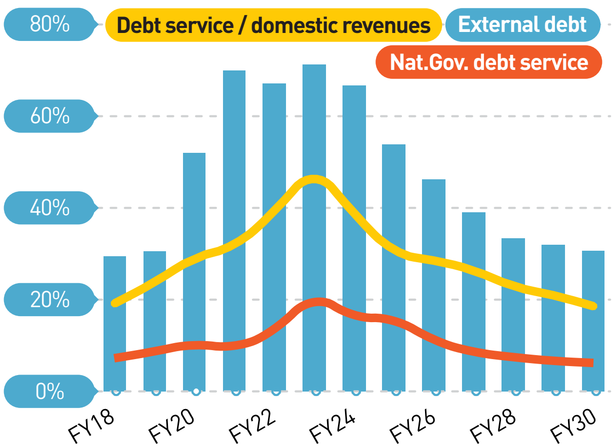
Government deposits remained at healthy levels during COVID-19 and are projected to rise further.



External debt

External debt/GDP ratio rose rapidly to 71 percent of GDP in FY21 stabilizing through FY24 and projected to decline gradually thereafter. As a result of the COVID-19 global pandemic the need for external borrowing has risen sharply, see Figure 20. External debt rose from a level of 30 percent to GDP in FY19 to 52 percent in FY20, to 71 percent by the end of FY21 and is projected to stabilize at that level through FY24. While the rise in the debt/GDP ratio has reached record levels, much of the increase is due to the decline in the denominator, GDP. With recovery now underway and benefit of the CRA-23 grant stream for debt consolidation, the debt/GDP ratio is projected to fall to 31 percent by FY30 (assuming Palau incurs no further external debt). While much of the rise in external debt, $115 million, is due to COVID-19, including $25 million of additional borrowing from the ADB in FY24, Palau has also borrowed or is committed to borrow for other purposes. In all, recent additional non-COVID-19 borrowing totals over $55.8 million.

Figure 20: External debt percent of GDP, and debt service percent of government revenues
Government deposits remained at healthy levels during External debt rises to high levels to GDP due to COVID-19 financing needs.



External debt service is projected to rise significantly but should not result in a high risk of debt stress. Debt service measured as a ratio of national government domestic revenues follows a similar pattern to the debt/GDP ratio. From representing 12 percent of domestic revenues before the crisis in FY18, debt service, including SOE debt service, rises to 23 percent in FY23. Then, with the benefit of the Compact debt consolidation grant, is projected to drop back to 10 percent by the end of FY30. After a period where debt service was a minor component of the national budget, it has risen to high levels after incurring additional borrowing for both new projects and deficit financing. The recent increases in international interest rates have added to debt service costs. However, if the CRA-23 grant stream for fiscal consolidation is strategically applied to pay down high-cost variable interest rate loans, it will assist significantly in keeping these at manageable levels. While the level of debt Palau has incurred is large by historical standards, it should not, given the concessional nature of the debt, pose a high risk of debt stress. However, future borrowing needs to be carefully evaluated as well as interest rate risk.

12. Policy Issues

The emergence of a structure surplus

With booming revenues from the tax reform and implementation of CRA-23 the emergence of a large fiscal surplus is projected. The post-pandemic emergence of the structural surplus reflects two factors: the strong performance of the tax reform and implementation of CRA-23. In FY18 and FY19 total tax collections from the legacy taxes, BGRT, and general import taxes were close to $16 million. These taxes were replaced by the PGST, which in FY23 collected $16.8 million in only 3 quarters of the year. Coupled with the recovery in the economy projected for FY24, this Review projects $28 million of PGST based on tax collections for the full year. In addition, the tax reform includes the introduction of the business profits tax, which is estimated to collect a further $7 million. While these estimates are subject to variation, the fundamental structure of the reformed tax regime infers the emergence of a significant surplus.

Emergence of structural surplus begs the question of allocation of the resources. The projections also assume CRA-23 is implemented and will also incur a significant addition in revenues: $5 million for operations ($20 million less $15 million prior drawdown from the COFA fund), $5 million for infrastructure, $5 million for infrastructure maintenance, and $10 million for debt consolidation. With current fiscal policy remaining conservative these developments imply the emergence of a significant surplus. Further they assume that no funds are withdrawn from the COFA trust fund as permissible under CRA-23 for operational purposes. The current analysis thus begs the question of what the best uses of the surplus are.

Use of Fiscal Surplus. Clearly the range of options for the allocation of the fiscal surplus are large and there would be a variety of different advocacy groups. This Review outlines a few options:

1. Fiscal catch-up. Fiscal policy in Palau has been conducted on a conservative basis. During the COVID-19 period and subsequent weak recovery, as Palau experiences high rates of inflation, fiscal policy was highly contractionary in real terms. It is thus desirable, as fiscal space emerges, to adopt a more expansionary policy, especially in the use of goods and services, to prevent bottlenecks in the delivery of services.
2. Pension reform. As this Review makes clear, the major fiscal risk and need for reform is in the Pension system, both SS and CSPP. In the case of SS, the reforms do not envisage transfers from government, but in the case of CSPP the reforms assume hypothecation of a portion of PGST collections to pay down the accrued liability and maintain pension levels.
3. Government services. The PDP places a high priority on funding government operations and social policy, which is reflected in its ranking system for the use of funds, rather than for economic development and infrastructure. This implies implementation of the PDP would incur an increase in resources to fund consumption with improvements in health, education, social welfare, etcetera. CRA-23 also expresses an implicit bias for the funding consumption.
4. Infrastructure. The EAG and this Review emphasize the need for funds for infrastructure and long-term growth. The NIIP provides a list of projects including critical but large projects in health, port redevelopment, and possible airport extension. Palau has not in the past adopted a policy of using domestic resources to fund the capital budget, preferring to rely on donor sources. However, the emergence of a fiscal surplus now permits Palau to rethink this policy.

The impact of a minimum wage increase

OEK is considering increasing the minimum wage. During 2023 the OEK Senate passed a bill to raise the minimum wage to $5.00 an hour, a $1.50 increase over the existing level. This followed a similar increase granted to public servants of 75¢ at the start of FY23 and a further 75¢ at the start of FY24, that is, a total increase of $1.50. At the start of 2024 the House of Delegates is considering a bill to also increase the minimum wage to $8.54 an hour, a very large increase of over $5.00 an hour.

Minimum wage policy. While Palau has a minimum wage, there is no formal procedure or framework within which minimum wages are determined. The ILO indicates the minimum wage policy should be guided by a variety of factors:[25]

> *The purpose of a minimum wage is to protect workers against unduly low pay. They help ensure a just and equitable share of the fruits of progress to all, and a minimum living wage to all who are employed and in need of such protection. Minimum wages can also be one element of a policy to overcome poverty and reduce inequality, including that between men and women, by promoting the*

25 ILO, Minimum Wage Policy Guide, Geneva. See *https://www.ilo.org/global/topics/wages/minimum-wages/lang--en/index.htm*

right to equal remuneration for work of equal value.

In Palau it is clear that there is a strong social commitment to ensure the minimum wage is sufficient to support a minimum living standard to enable participation in Palauan society and be above the poverty line. President Surangel Whipps has adopted a major component of his administration to raise the minimum wage a level that would limit the outflow of Palauans to the US and even to encourage some to return. All of these policy objectives are beyond the scope of this Review. However, the Review can place the proposals being considered by the OEK within the context of the basic needs poverty line and examine their economic impact.

Estimation of a Basic Needs Poverty Line in today's prices. In 2016 the UNDP prepared a study on estimating poverty lines for Palau[26] based on the 2014 Household and Income Survey.[27] The study found that to maintain the average household above a basic poverty line, a weekly income of $67.46 per person was required or $255.30 per household. Since that time the average price level has risen 37.2 percent (average rise in the price level between 2014 and 2023q3) based on a basket of food and nonfood items. Based on current census data conducted in 2020, the average household had 3.5 persons with an average of 1.7 wage earners. Multiplying out these figures the minimum wage required (on a 40-hour week basis) for a household of average size with an average number of wage earners is in today's prices equal to $4.63 an hour. Alternatively, if the policy objective is to provide a wage sufficient for the average household with only one wage earner, the hourly wage would need to be raised to $8.06. The decision of whether either of these parameters is an appropriate anchor for the minimum wage policy or some other metric should be used is clearly a political decision. However, the two figures provide a yardstick with which to evaluate the current proposals.

> *Minimum wage policies under consideration by the OEK require dovetailing with the phase of the economic cycle to avoid impacting the nascent recovery.*

The impact of the proposed minimum wage increases of the Senate and House of Delegates are simulated. The economic model is used to simulate the impact of two versions of the minimum wage increase: (i) for the Senate version the wage increase is only applicable to the private sector, (ii) for the House it is assumed the minimum wage for the private sector increases from $3.50 to $8.50 an hour and for the public sector from $5.00 to $8.50. It is assumed that all wage earners, regardless of wage level, benefit from the increase in both private and public sectors. Four major economic forces have been modeled:

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

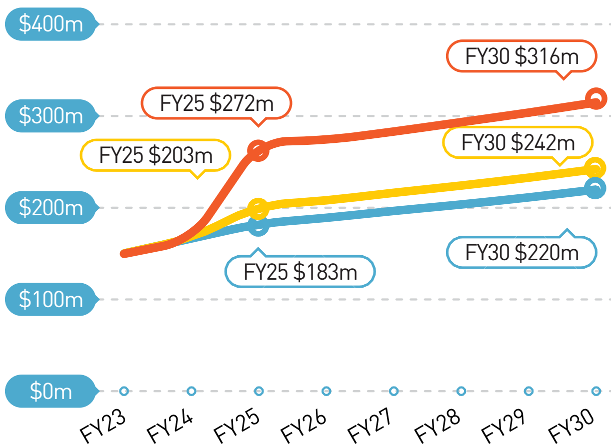
The wage bill is estimated to rise by 11 percent in FY25 under the Senate version and 48 percent under the House version. The increase in cost under the House version is very large and would impose a significant burden on operating costs, see Figure 21. These increases in wages will in turn increase the prices of items consumed and the cost of tourism. In the case of consumers, the

26 UNDP (David Abbott), Estimating National Poverty Lines for Palau, 2016.

27 Republic of Palau, 2014 Household Income and Expenditure Survey, Palau.

Figure 21: Total Wage bill before and after minimum wage increase: FY22-FY30

Total wage bill increases by 11 percent currently??? and by 48 percent in FY25 under the Senate and House bills, respectively.



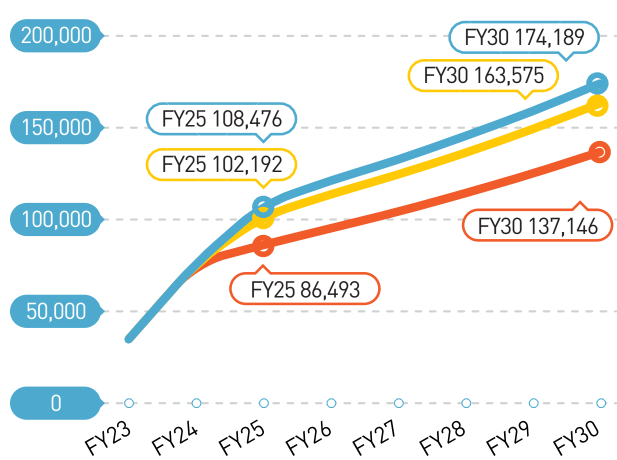
model projects that consumer prices will rise by 5.3 percent and 18.2 percent under the two OEK versions, respectively. In the case of tourism, the price impact of the two policies is estimated to be larger at 9.5 percent and 33.2 percent, respectively. The difference between the impact on consumers and the tourism sector reflects the use of labor in production and domestically supplied items in expenditure. Clearly, the greater the use of labor, the greater will be the impact on inflation. The model further assumes that producers pass on the cost of inflation,[28] which amplifies the impact of wage inflation on prices. The model also draws on an investigation of the impact of price increases on tourism demand in the South Pacific nations of Fiji, Cook Islands, Samoa, Tonga, and Vanuatu.[29] The study estimates that for every 1 percent increase in prices, visitor arrivals will fall 0.61 percent. This price elasticity of demand is used in the current impact estimates, although the tourist markets for Palau will be different from those in other areas of the South Pacific.

GDP is projected to fall by 1.0 or 3.3 percent and visitor arrivals by 5.8 or 15.4 percent, respectively due to the increase in minimum wage policies. Figure 22 indicates the impact on visitor arrivals and suggests that by FY25 visitor arrivals will be 5.8 or 15.4 percent lower and 6,284 or 21,983 less than before implementation of the policy changes. The impact of the reduction in visitors plus other macroeconomic effects, (including additional demand due to higher wages but offset by the impact of inflation) suggest the economy is likely to contract by 1.0 or 3.3 percent after implementation of the wage policies, respectively.

In the House version out of the 42 percent increase in nominal wages, disposable incomes rise just 22 percent. While average nominal wages are projected to rise by 10 and 42 percent in FY25, under the two versions, the benefit from higher wages will be offset in a series of increases in taxes, social contributions, reductions in overseas remittances of foreign workers,

Figure 22: Visitor arrival projections with and without minimum wage increase: FY22-FY30

Visitor arrivals fall by 6 percent and 15 percent in FY25 under the Senate and House bills, respectively.



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

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

and inflation. Figure 23 indicates the share of the increase in minimum wages allocated to these categories under the House version: 6.9 percent of the benefit is paid on taxes and social costs, -0.7 percent on remittances, and a large 14.0 percent is eroded by inflation. Due to the projected contraction in the economy, the demand for foreign workers falls and more than offsets the increase in outward remittances due to higher wages. After deduction of these costs wage earners are left with an increase of 22 percent in disposable income out of the original increase in the minimum wage of 42 percent.

Impact on fiscal position under both scenarios is positive and especially large under the House variant. The impact of the minimum wage increase on the fiscal deficit is shown in Figure 24. The impact of the two versions of the minimum wage increase is different. Under the Senate version it is only the private sector that is subjected to higher wage costs. Out of the increase, wage taxes rise and the fiscal surplus grows, in this case by $1.9 million or 0.5 percent of GDP. Under the House proposal the wage bills of both the private and public sectors rise. While Government's payroll costs rise by $14.1 million, this is offset by an even larger rise in taxes of $20.9 million, resulting in an increased fiscal surplus of $8.2 million (2.1 percent of GDP). The distributional impact of the two minimum wage policies is thus divergent. Under both policies both households and government benefit from the increase in minimum wages. However, the result is wholly negative on the economy and private sector as the introduction of higher wages will raise the cost of vacationing in Palau resulting in fewer visitors.

Policy implications. A series of implications arise out of the foregoing analysis:

1. The analysis of the impact of inflation on the Basic Needs Policy Line suggests that an increase in minimum wage to $5.00 is warranted.

2. The impact of wage increases on inflation is large at 5 and 18 percent under the two policies, respectively. After the recent impact of a 20 percent increase in the CPI due to imported food and fuel prices, coupled with the 10 percent increase in PGST, a further inflationary shock would be adverse.

3. The potential impact of higher prices on tourism demand, and the negative

Figure 23: Allocation of benefit of minimum wage increase, FY25

After allowance for taxes, SS, CSPP, remittances, and inflation, households are left with 22 percent of the original 42 percent gain in nominal wages.

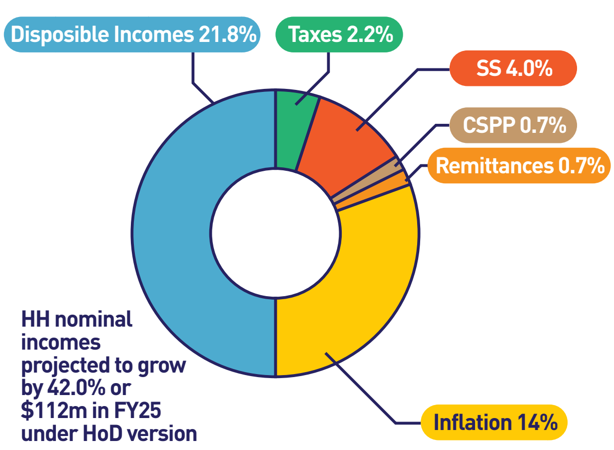
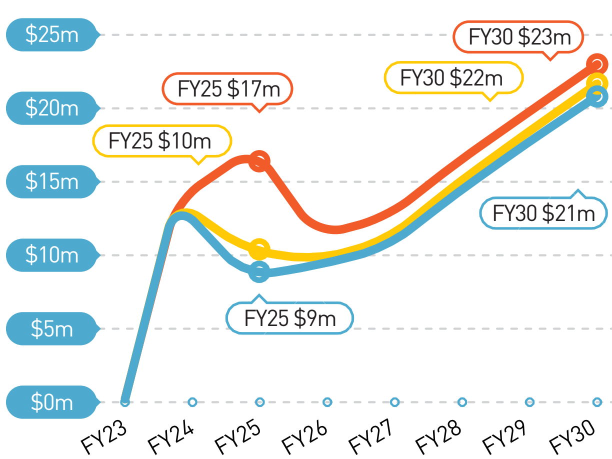


Figure 24: Fiscal deficit with and without minimum wage increase: FY22-FY30

Impact of minimum wage bills on public funds is a wash.



consequences for the private sector and the nascent recovery would be undesirable.

4. The trade-off between supporting the needs of private sector workers and a fragile economy is not an easy choice. In a previous presentation the GSUSA proposed that increases in the minimum wage should be staged after the recovery is well established. This argument would seem to remain valid; minimum wage increases should be postponed till after the recovery is well advanced when the economy and private sector would be able to bear the increased costs.

13. Statistical Issues

Statistical systems

Palau's administrative statistical systems have provided a sound base for fiscal and economic monitoring. Statistical availability in Palau can be accorded a high score compared with regional standards. After a period of weak and deteriorating availability of macroeconomic data, Palau now has a comprehensive range of economic statistics for monitoring economic performance, including: GDP by production and expenditure in current and constant prices, employment, wages, consumer prices, banking, balance of payments, and GFS statistics. An initial set of economic statistics is available by the end of March of the following fiscal year and final estimates are available after completion of the annual audits at the end of June. Currently the audit process is running two years behind schedule and while this has not delayed compilation of a preliminary set of estimates, final estimates have been considerably delayed. Weaknesses have existed in the lack of: i. a comprehensive business survey to estimate private sector value added and ii. provision of producer prices to estimate the constant price series. Efforts to integrate the statistical system through database management has considerably improved data integrity and consistency.

The tax reform initiative has the potential to significantly improve Palau's economic statistics. Implementation of the Palau Goods and Services Tax is now generating a monthly set of data that will considerably enhance the coverage and accuracy of Palau's economic statistics. The prior value-added series were based on business gross receipts times a coefficient of value added that was derived from a set of annual corporate returns of several prior years. New systems are under development and will replace the former series with a set of direct estimates of value added and intermediate consumption. On the expenditure side the PGST will also provide estimates of major elements of demand, that is, business investment and imported services. The annual business profits tax will provide additional information on intermediates, inventories, and investment, reducing the need for a separate business survey. The main remaining weakness will be the lack of a producer price series on which the constant price series is derived. Finally, Palau will be able to produce a regular series of quarterly estimates.

Palau summary economic indicators, FY2016-FY2022

	FY16	FY17	FY18	FY19	FY20	FY21	FY22
Per Capita Income measures							
GDP current prices, $ million	305.4	292.3	288.1	281.8	261.1	229.8	242.3
Population	17,653	17,645	17,637	17,630	17,622	17,614	17,606
GDP per capita $	17,300	16,568	16,338	15,986	14,821	13,050	13,764
GNI per capita $	16,408	16,235	15,908	15,865	15,158	13,599	13,931
GNDI per capita $	18,232	17,915	18,520	17,311	16,852	16,467	17,271
National accounts							
GDP, at constant FY2019 prices, $ million (ave. GDP(P) and GDP(E))	**284.3**	**274.2**	**276.0**	**278.5**	**257.4**	**221.0**	**220.2**
GDP, % growth	**0.9%**	**-3.5%**	**0.6%**	**0.9%**	**-7.6%**	**-14.2%**	**-0.4%**
Prices (annual percent change)							
Consumer price index	-1.3%	0.9%	2.5%	0.4%	0.7%	-0.5%	13.2%
Employment and Wages							
Number of employees	**11,352**	**11,738**	**11,770**	**11,443**	**10,986**	**9,760**	**9,772**
% change	4.3%	3.4%	0.3%	-2.8%	-4.0%	-11.2%	0.1%
Private sector	6,623	6,856	6,897	6,598	6,091	5,013	5,078
% change	7.0%	3.5%	0.6%	-4.3%	-7.7%	-17.7%	1.3%
Public sector	3,770	3,877	3,900	3,895	3,969	3,883	3,871
% change	2.6%	2.9%	0.6%	-0.1%	1.9%	-2.1%	-0.3%
Other	959	1.005	974	950	926	864	823
Palau citizens	5,540	5,578	5,705	5,585	5,455	5,159	5,355
Foreign workers	5,811	6,160	6,065	5,858	5,531	4,601	4,418
Average annual wage	**10,919**	**11,200**	**11,468**	**11,679**	**11,735**	**11,832**	**12,171**
% change	5.2%	2.6%	2.4%	1.8%	0.5%	0.8%	2.9%
Private sector	9,145	9,305	9,293	9,309	8,856	8,350	8,833
% change	5.3%	1.8%	-0.1%	0.2%	-4.9%	-5.7%	5.8%
Public sector	15,580	16,145	16,800	17,159	17,467	17,521	17,619
% change	4.5%	3.6%	4.1%	2.1%	1.8%	0.3%	0.6%
Palau citizens	13,321	13,925	14,083	14,284	14,551	14,487	14,509
Foreign workers	8,630	8,732	9,009	9,196	8,957	8,856	9,337
Average annual real wage (less inflation)	**11,335**	**11,524**	**11,518**	**11,679**	**11,653**	**11,806**	**10,731**
% change	6.6%	1.7%	-0.1%	1.4%	-0.2%	1.3%	-9.1%
Government Finance Statistics, ($ million)							
Revenue	**124.7**	**115.0**	**126.7**	**119.4**	**117.0**	**134.5**	**149.8**
Tax revenue	59.1	56.9	60.5	51.8	47.3	41.0	43.5
Grants	49.3	37.3	49.4	50.3	55.9	75.5	89.1
Other revenue	16.3	20.7	16.9	17.3	13.9	18.0	17.1
Expense	**-97.2**	**-92.8**	**-102.3**	**-103.6**	**-134.3**	**-132.3**	**-129.5**
Compensation of employees	-41.0	-42.9	-44.6	-45.5	-48.4	-46.4	-45.3
Use of goods and services	-25.9	-25.1	-26.6	-27.1	-26.8	-26.8	-29.3
Other expense	-30.4	-24.8	-31.1	-30.9	-59.0	-59.0	-54.9
Net Worth and its Changes	**-27.5**	**-22.2**	**-24.4**	**-15.8**	**17.2**	**-2.3**	**-20.3**
Nonfinancial assets	-16.8	-8.4	-6.6	-16.9	-16.5	-19.5	-20.8
Financial assets	-27.8	-18.4	-29.3	-3.3	-28.8	-14.3	-27.2
Financial liabilities	17.2	4.6	11.4	4.4	62.5	31.5	27.7
Overall fiscal balance	10.7	13.8	17.8	-1.0	-33.7	-17.3	-0.5
(In percent of GDP)							
Revenue	**40.8%**	**39.3%**	**44.0%**	**42.4%**	**44.8%**	**58.5%**	**61.8%**
Taxes	19.4%	19.5%	21.0%	18.4%	18.1%	17.8%	18.0%
Domestic revenues	16.1%	12.8%	17.1%	17.8%	21.4%	32.9%	36.8%
Grants	5.3%	7.1%	5.9%	6.2%	5.3%	7.8%	7.1%
Expense	**-31.8%**	**-31.7%**	**-35.5%**	**-36.8%**	**-51.4%**	**-57.5%**	**-53.4%**
Compensation of employees	-13.4%	-14.7%	-15.5%	-16.2%	-18.5%	-20.2%	-18.7%
Use of goods and services	-8.5%	-8.6%	-9.2%	-9.6%	-10.3%	-11.7%	-12.1%
Non Financial Assets	**-5.5%**	**-2.9%**	**-2.3%**	**-6.0%**	**-6.3%**	**-8.5%**	**-8.6%**
Overall fiscal balance	**3.5%**	**4.7%**	**6.2%**	**-0.4%**	**-12.9%**	**-7.5%**	**-0.2%**

Palau summary economic indicators, FY2016-FY2022 cont'd

	FY16	FY17	FY18	FY19	FY20	FY21	FY22
Depositiory Coporations Survey ($ million)							
Net foreign assets	**249.1**	**253.3**	**254.2**	**238.5**	**290.5**	**286.3**	**271.1**
Domestic claims	**-3.8**	**-6.9**	**-6.4**	**2.7**	**-27.9**	**-26.3**	**-13.7**
Net claims on national government	-35.6	-43.2	-42.9	-31.0	-60.7	-56.5	-45.3
Claims on other sectors	31.8	36.3	36.5	33.7	32.8	30.2	31.6
Private non-financial corporations	1.2	6.5	8.4	5.4	5.2	4.8	7.0
Individuals	30.6	29.8	28.1	28.2	27.6	25.4	24.6
Broad money liabilities	**236.4**	**237.1**	**237.9**	**230.3**	**254.1**	**251.0**	**248.6**
Demand deposits	106.1	96.8	91.0	99.4	115.4	120.5	123.3
Other deposits	130.3	140.4	146.9	130.9	138.7	130.4	125.3
Capital and other accounts	**8.8**	**9.6**	**11.2**	**10.7**	**6.3**	**6.8**	**7.0**
Loans to deposit ratio, %	13.4%	15.3%	15.4%	14.6%	12.9%	12.0%	12.7%
Memo: item: National Development Bank of Palau lending	18,2	19,3	n.a.	n.a.	n.a.	n.a.	n.a.
Balance of Payments $ million							
Trade balance	-15.5	-16.1	-23.4	-26.4	-21.2	-22.1	-35.2
Service balance	102.2	82.1	73.2	59.4	25.2	-15.8	0.4
Primary Income balance	-1.1	-1.7	-1.7	-1.3	-0.4	0.0	0.0
Secondary Income balance	-63.2	-68.3	-62.9	-64.5	-54.7	-43.5	-61.6
Current Account, balance	-48.0	-65.7	-54.1	-86.3	-113.5	-96.1	-122.3
Capital Account, balance	24.4	20.6	82.6	34.9	26.8	20.7	21.8
Financial account balance	26.4	48.3	-10.3	75.0	48.1	67.6	104.0
International Investment Position (IIP), $ million							
Total stocks, net	-97.5	-108.3	-62.2	-134.2	-170.4	-171.9	-377.8
Direct investment, net	584.3	624.7	711.1	684.7	741.3	800.9	672.8
Portfolio investment, net	681.9	733.0	773.3	818.9	911.8	972.8	1,050.5
Other investment, net	421.4	447.7	465.1	490.1	515.8	528.7	568.1
memo: COFA Trust Fund	196.8	219.5	297.5	286.4	280.0	323.4	246.6
External Debt, $ million							
Gross External Debt, total	72.0	78.0	85.1	86.0	134.9	164.4	168.5
National Government	40.6	50.3	59.9	63.3	114.1	146.3	152.7
Public Enterprises	31.5	27.7	25.2	22.7	20.8	18.1	15.8
Gross External debt as % of GDP	23.6%	26.7%	29.5%	30.5%	51.6%	71.5%	69.5%
Debt Service	8.7	7.9	7.2	8.0	8.8	9.0	11.6
Debt service as % of national government revenues	7.0%	6.9%	5.7%	6.7%	7.5%	6.7%	7.7%
Tourism							
Total Tourism receipts, $ million	**127.4**	**111.1**	**105.0**	**86.6**	**48.5**	**6.1**	**25.1**
Tourist nights	**684,901**	**589,533**	**564,757**	**460,615**	**231,021**	**22,427**	**82,027**
Receipts per visitor, $	871	913	909	969	1,164	1,783	2,713
Receipts per visitor night, $	186	189	186	188	210	270	306
Direct value added per visitor night, $ million	103.9	102.0	93.6	97.7	94.2	46.4	93.2
Average length of stay, nights	**4.7**	**4.8**	**4.9**	**5.2**	**5.5**	**6.6**	**8.9**
Tourism arrivals	**146,268**	**121,670**	**115,564**	**89,379**	**41,628**	**3,400**	**9,247**
Japan	30,546	25,777	24,384	19,585	10,623	80	762
South Korea	12,480	13,419	12,833	11,541	6,211	12	136
Taiwan	15,436	9,422	11,296	14,024	6,258	1,912	892
China	70,637	55,358	50,063	28,368	9,721	33	57
USA	8,459	8,490	8,378	7,804	4,009	1,191	5,687
Europe	4,248	4,962	4,447	3,753	2,535	19	563
Other	4,462	4,242	4,163	4,304	2,271	153	1,150
Hotel occupancy rate	65.2%	46.6%	43.5%	36.3%	17.1%	1.7%	7.1%
Number of Hotel rooms, yearly average	**1,656**	**1,788**	**1,812**	**1,753**	**1,812**	**1,702**	**1,682**
Tourism Direct Value Added, $ million	71.2	60.1	52.8	45.0	21.8	1.0	7.6
% change							
Tourism receipts	-5.9%	-12.8%	-5.5%	-17.5%	-44.0%	-87.5%	313.7%
Tourism arrivals	-13.2%	-16.8%	-5.0%	-22.7%	-53.4%	-91.8%	172.0%
Tourism nights	-10.4%	-13.9%	-4.2%	-18.4%	-49.8%	-90.3%	265.7%
Tourism receipts per visitor	8.4%	4.8%	-0.5%	6.6%	20.2%	53.2%	52.1%
Tourism receipts per visitor night	5.0%	1.3%	-1.4%	1.1%	11.6%	28.9%	13.1%

PALAU
ECONOMIC REVIEW 2023

Republic of Palau

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

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