Republic of Palau

2024

PALAU ECONOMIC REVIEW

Republic of Palau

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Graduate School USA

EconMAP

Abbreviations

CURRENCY EQUIVALENTS

Currency unit: United States dollar (US$)

ABBREVIATIONS

ADB	—	Asian Development Bank
ADSL	—	Asynchronous Digital Subscriber Line
AIFFP	—	Australian Infrastructure Financing Facility of the Pacific
AIP	—	Annual Implementation Plan
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
CNMI	—	Commonwealth of the Northern Marianas
COFA	—	Compact of Free Association
COTS	—	Commercial Off the Shelf
COVID	—	Corona Virus ID
CPI	—	Consumer Price Index
CPRO	—	Coronavirus Pandemic Relief Option
C-10	—	2010 Compact Review Agreement
C-23	—	2023 Compact Review Agreement
CROSS	—	Coronavirus Relief One-Stop Shop Act
CSPP	—	Civil Service Pension Plan
CTF	—	Compact Trust Fund
DFAT	—	Department of Foreign Affairs and Trade
DRP	—	Disaster Resilience Program
DSA	—	Debt Sustainability Analysis
EAG	—	Economic Advisory Group
FAS	—	Freely Associated States
FCC	—	Federal Communications Commission
FDI	—	Foreign Direct Investment
FDIC	—	Federal Deposit Insurance Corporation
FIC	—	Financial Institutions Commission
FMIS	—	Financial Management Information System
FPA	—	Fiscal Procedures Agreement
FRDMA	—	Fiscal Responsibility and Debt Management Act
FSM	—	Federated States of Micronesia
FTE	—	Full Time Equivalents
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
IMF	—	International Monetary Fund

JEMCO — Joint Economic Management Committee

JEMFAC — Joint Economic Management and Financial Accountability Committee

JICA — Japan International Cooperation Agency

KASP — Koror Airai Sanitation Project

KYC — Know Your Customer

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

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

PNCC — Palau National Communications Corporation

PPEF — Pristine Palau Environmental Fee

PPP — Private Public Partnership

PPUC — Palau Public Utilities Corporation

PSC — Palau Stable Coin

PSDI — Private Sector Development Initiative

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

RTPF — Responsible Tourism Policy Framework

RUS — Rural Utilities Service

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

SOE — State-Owned Enterprise

UCC — Universal Commercial Code

UNCTAD — United Nations Commission on Trade and Development

UNDP — United Nations Development Program

VAT — Value Added Tax

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 and opinions expressed in this Economic Review are those of the authors and reflect an independent analysis of Palau's economic performance. These views do not necessarily represent those of the Government of Palau, the Graduate School USA, the U.S. Department of the Interior, or any other organization, group, or individual, whether real or implied.

Foreword

This Economic Review, the seventh produced for the Republic of Palau (RoP), aims to support Palau in implementing the renewed economic assistance under the 2023 Amended Compact, agreed in May 2023 and enacted by separate legislation in the U.S. Congress in March 2024. The Review is also designed to assist the RoP in broader policy development and economic management. Prepared under contract with the U.S. Department of the Interior's Office of Insular Affairs and administered through the Graduate School USA's Pacific Islands Training Initiative, this Review evaluates Palau's economic performance and policy environment and provides a comprehensive set of economic data.

This Review was authored by Mark Sturton on behalf of Graduate School USA and EconMAP (Economic Monitoring and Analysis Program); the statistical data sheet was compiled by Glenn McKinlay and Michael Barsabal. Additional contributions were made by 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 from the Department of Planning and Statistics; and the many civil servants and business operators in Palau who contributed to the preparation of this Review and its statistical content.

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

Key Features in the Review

After a prolonged period of contraction due to COVID-19, the economy of Palau began to show signs of recovery in FY24, with projected growth of 8.3 percent. Unlike other South Pacific economies, tourism recovery in the Western Pacific has remained weak. Both FY22 and FY23 were challenging years for Palau, as the economy stagnated due to low visitor arrivals, a strong US dollar, and high inflation, which suppressed demand. However, in FY24, these factors began to dissipate, allowing the economy to strengthen as inflation dropped significantly, visitors started returning, and new infrastructure projects commenced. As a result, based on performance in the first half of FY24, the economy is expected to grow by 8.3 percent.

Although inflation in Palau has historically been low, FY22 and FY23 saw sharp increases in oil and food prices, driven by imported inflation and the introduction of the Palau Goods and Services Tax (PGST). Inflation averaged 13.2 percent in FY22, largely due to global supply shortages, expansionary fiscal policies, and the Ukraine war. As inflation began to ease globally in FY23, the introduction of the PGST caused a temporary spike in local inflation. While the impact of the PGST was a one-time occurrence, inflation remained high at 10.8 percent in FY23. For FY24, inflation is projected to decline to 4.2 percent as the PGST's effects work through the economy. By the start of 2023, inflation had largely stabilized, with a modest increase of 3.5 percent (Q1-24/Q2-23).

The recovery of Palau's tourism sector has been slow, with FY24 projected to reach only 30 percent of the FY18 level. Following the onset of COVID-19, the tourism industry collapsed, with visitor arrivals ceasing by March 2020 as the country closed its borders. Although Palau reopened its borders by the end of 2021 after a successful vaccination program, tourism did not show signs of recovery until mid-2023. The recovery remained sluggish, with 35,100 visitors recorded in FY23 and a projected 52,200 visitors in FY24, just 45 percent of the FY18 level. This slow recovery is comparable to that of other regional economies, such as Guam and the CNMI, and is compounded by a lack of flights from traditional markets like Japan and Korea, as well as the strong US dollar. Improvement in this sector is expected will only be accomplished over the medium-term.

In FY23, Palau successfully implemented a major tax reform initiative, introducing two new taxes: the Palau Goods and Services Tax (PGST) and the Business Profits Tax. The design of these reforms was thoroughly debated through public hearings and state-level town hall meetings, and an economic symposium was held in May 2021 with support from the Chamber of Commerce. The tax reform bill was passed into law in September. Revenues from the PGST exceeded expectations, helping restore fiscal balance in FY23 and reducing the need for deficit financing. However, the introduction of the PGST contributed to a significant increase in inflation, as businesses sought to recoup profits lost during the pandemic.

A breakdown of the recent inflation increases reveals several contributing factors. From Q1-2020, prior to the pandemic, to Q1-2024, overall inflation rose by 30.0 percent. Of this, 19.4 percent was attributed to rising domestic and imported inflation, while 10.6 percent resulted from the PGST's introduction. Within the 19.4 percent, food prices accounted for 7.5 percent, fuel and electricity for 6.7 percent, with the remainder driven by domestic factors. An analysis of the PGST's impact shows that

4.2 percent was due to discretionary changes in tax rates, and 6.4 percent to increased business margins.

During the COVID-19 crisis, the government required total financing equivalent to 24 percent of GDP to maintain operations. Historically, Palau has maintained conservative economic policies and fiscal balance. However, the pandemic led to a rapid deterioration in fiscal conditions, resulting in a record deficit of 13 percent of GDP in FY20. Tight fiscal controls reduced the deficit to 7.3 percent in FY21, and by FY22, it had largely been eliminated, falling to 0.6 percent. However, in FY23, the deficit rose to 2.9 percent due to increased expenditures in several areas, despite the positive effects of the PGST. Overall, Palau recorded a cumulative deficit equivalent to 24 percent of GDP during the COVID period (FY20-FY23).

With the passage of the 2023 Amended Compact (C-23) and strong revenue performance, Palau is projected to record a fiscal surplus of $7.6 million, or 2.5 percent of GDP, in FY24. In FY24, under the full implementation of the new tax regime, tax revenues are expected to increase by $12.3 million, or 21 percent, above FY23 levels. The C-23, agreed between the Republic of Palau and the United States in May 2023 and approved by the US Congress in March 2024, provided a series of new grant streams, including an additional $30 million in annual funding. However, with a 75-cent pay increase for civil servants and additional transfers to SOEs, the pensions system, and state governments, expenditures are also set to rise. Despite this, a fiscal surplus of $7.6 million, or 2.5 percent of GDP, is projected.

Palau needs to consider development of a debt management strategy to ensure that C-23 fiscal consolidation funds are used to reduce debt levels and avoid a fiscal cliff in FY30, when the C-23 funds are set to expire. The debt-to-GDP ratio rose rapidly, from 30 percent in FY18 to 70 percent in FY21, as Palau borrowed to finance government operations during the pandemic. Debt is estimated to have peaked at 79 percent of GDP in FY23, with a projected decline to 69 percent in FY24, and gradual reductions thereafter. Debt service costs have increased due to rising international interest rates, though they are expected to fall as global inflation comes under control. The six-year C-23 fiscal consolidation grant—providing $10 million annually—will significantly assist Palau in reducing its debt service costs. However, a comprehensive debt management strategy is needed to ensure the grant is effectively used to reduce debt levels and prevent a fiscal cliff when the C-23 funds expire in FY30.

Palau has launched three fintech innovations: the Palau Stable Coin (PSC), a Digital Residency program, and savings bonds. The PSC, effectively a Central Bank Digital Currency, underwent a trial with 168 participants and received favorable feedback. However, no bank in Palau or the US has agreed to act as an exchange, causing the project to lose momentum. A Digital Residency law was passed by the OEK, and digital IDs have been issued, with mailboxes to be made available for mail forwarding. Both initiatives have attracted attention, though concerns have been raised regarding Palau's capacity to regulate these innovations and ensure compliance with AML/CFT regulations. Additionally, the Ministry has initiated a program to issue savings bonds through a blockchain mobile app. Details such as interest rates, bond denominations, and the use of funds are still under development, but the project is expected to contribute to resource mobilization and financial diversification.

Palau's State-Owned Enterprise (SOE) sector has historically underperformed, but recent reforms, including full cost-recovery measures, aim to improve its performance and reduce fiscal risks. While Palau's SOE sector is smaller than those of other Micronesian economies, it has posed significant fiscal risks. Reforms at the Palau Public Utilities Corporation (PPUC) have introduced cost-recovery tariffs for power, water, and wastewater services, placing the PPUC on a more sustainable financial footing and reducing the burden on the national government. The PPUC has also entered a Power Purchase Agreement with a private company to supply solar-generated power, aimed at replacing up to 20 percent of Palau's fossil fuel generation. However, integration of this project into the national grid has faced challenges, and it has yet to reach its full potential.

Without reform, the Republic of Palau Social Security Administration (RoPSSA) is projected to collapse by FY34, at which point pensioners would receive only $0.74 per dollar of earned benefits. In November 2021, a participatory workshop proposed reforms to set RoPSSA on a sustainable trajectory, including a 2 percent increase in the contribution rate, modest benefit reductions, and benefit indexation. These proposals were drafted into law and submitted to the OEK, but as of now, no action has been taken.

Similarly, without reform, the Civil Service Pension Plan (CSPP) is projected to collapse by FY29, at which point beneficiaries would receive just $0.57 per dollar of earned benefits as the system defaults to a Pay-as-You-Go scheme. A workshop held in November 2022 proposed transitioning the CSPP to a defined-contribution system. Existing liabilities would be addressed through benefit reform, allocation of 3 percent of the civil service wage bill, and 1.5 percent of PGST revenues. After consultations with stakeholders, draft legislation will be prepared and transmitted to the OEK for consideration.

The terms of the second Compact Review Agreement (C-23), agreed by the US, passed by Congress, and signed into law in March 2024, provide substantial economic assistance to Palau. The major areas of support include:

1. Annual grants of $20 million for education, health, climate adaptation, environmental protection, justice, and public safety, with a 2 percent annual inflation adjustment.
2. $5 million in infrastructure grants, plus a 2 percent adjustment.
3. $5 million in infrastructure maintenance grants, plus a 2 percent adjustment.
4. Six annual grants of $10 million, starting in FY24, for fiscal consolidation of debt incurred before April 1, 2023.
5. Two $50 million tranches to be deposited in the Palau COFA Trust Fund.

The economy is projected to grow strongly, by 11.1 percent in FY25, and by an average of 4.1 percent annually over the remainder of the decade. In FY25, both the tourism and construction industries are expected to continue growing, with GDP projected to expand by 11.1 percent, bringing the economy back to the level reached in FY19. Through FY30, tourism is expected to fully recover, and annual growth is forecast to average 4.1 percent. In the labor market, Palauan employment is projected to return to full capacity by FY24, with any additional demand met by foreign labor.

The fiscal position is expected to tighten in FY25 before improving through the rest of the decade. In FY24, with the implementation of C-23, economic growth, and buoyant tax revenues, revenues grew strongly. In FY25, revenue growth is expected to slow to 8 percent as grants struggle to keep pace with inflation, though tax revenues are projected to increase by 17 percent as tourism recovers and PGST receipts grow. Expenses are anticipated to grow modestly by 5 percent, while capital outlays will increase sharply as C-23 infrastructure, donor, and military projects accelerate. Overall, a reduced fiscal surplus of 1.1 percent of GDP is expected in FY25. Over the remainder of the decade, continued economic expansion and a prudent policy to limit the real size of the public sector should improve the fiscal position, with a projected surplus of 4.9 percent by FY30.

The increase in funds from C-23 and tax reform raises important questions about how Palau should best utilize these resources. Economic projections assume Palau will refrain from borrowing from the COFA Trust Fund. Historically, Palau aimed to establish a perpetual fund under the Fiscal Responsibility and Debt Management Act (FRDMA). However, C-23 allows for the Compact to be renewed in 2043, potentially eliminating the need for a perpetual fund. This, coupled with the emergence of a structural surplus, raises the question of how to best use the available funds. Should Palau continue to save and build up the COFA Trust Fund, embark on self-financed infrastructure development, or utilize the funds for government operations?

Palau's accumulation of significant cash balances presents an opportunity to build up its Cyclical and Climate Resilience Reserves. During the COVID-19 period, Palau raised significant funds for deficit financing and mitigation. However, prudent financial management and revenue growth from tax reforms have resulted in significant cash balances in excess of cash management needs. The FRDMA requires contributions to both the Cyclical Reserve Fund and the Climate Resilience Reserve Fund, but these reserves remain underfunded and have been used for operational purposes, contrary to the FRDMA. The current cash balances would allow Palau to fully fund these reserves, bringing the country back into compliance with key fiscal responsibility laws.

1. Recent Economic Performance

Economic Performance

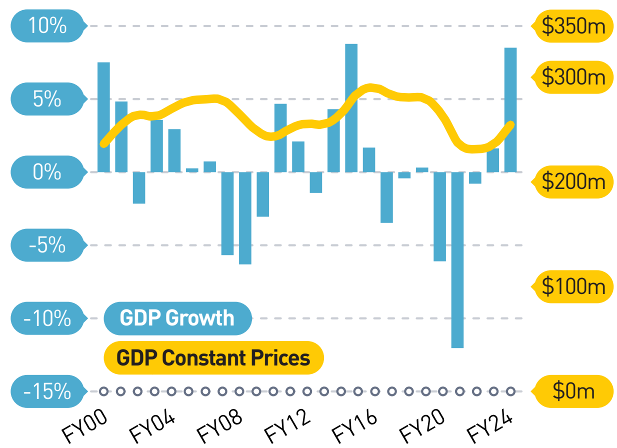
Palau's economic growth has been modest and characterized by significant volatility. From FY00 to FY19, economic growth in Palau averaged 0.5 percent per year[1], as shown in Figure 1. Growth during this period fluctuated between strong growth phases, driven by construction and tourism, and periods of substantial contraction. Palau's economy experienced four distinct cycles during this period: (i) early expansion with the construction of the Compact Road and growth in tourism; (ii) contraction during the Global Financial Crisis; (iii) a tourism boom fueled by an influx of Chinese tourists; and (iv) a contraction just before the COVID-19 pandemic.

Palau's economy is projected to have declined by 17 percent in FY23 compared to pre-pandemic levels in FY19. FY20 was expected to be a strong year for the Palau economy, with construction picking up pace and significant growth anticipated in the tourism industry. However, the onset of COVID-19 halted international travel, and no further visitors arrived. GDP is estimated to have contracted by 6.0 percent in FY20 and an additional 11.8 percent in FY21, as the full impact of the tourism sector collapse was felt. Figure 2 illustrates the sources of growth by demand component. In FY20, while tourism demand sharply declined, capital investment and government spending helped maintain some economic activity. By FY21,

1 Trends estimated using log-linear regression.

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

Palau economy faces massive drop in GDP, but recovery gets underway in FY24

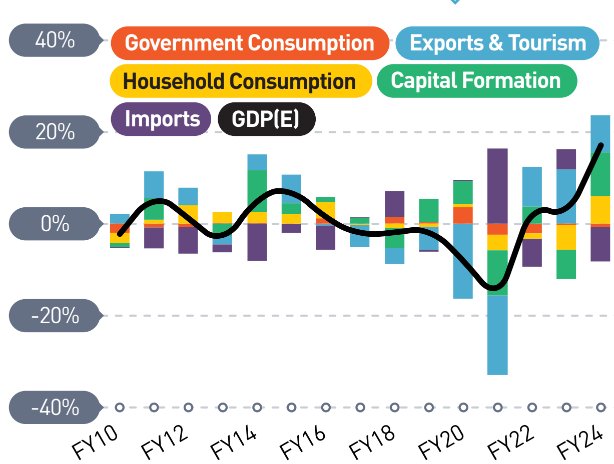


the economy saw a further drop in activity as visitor numbers remained virtually nonexistent, and construction also decreased significantly. However, the Cross Act and CARES Act mitigation programs helped support household incomes and expenditures, preventing a more dramatic decline.

In FY22, as tourism recovery failed to materialize, high inflation further reduced demand, leading to continued economic

Figure 2: GDE, contribution to growth

Tourism and investment are the main drivers of economic growth.



The Palau economy is estimated to have grown by 8.3 percent in FY24 as the recovery finally got underway.

contraction. Despite some improvement in tourism, largely due to longer stays by military personnel and ongoing construction projects, the economy contracted by 1.5 percent in FY22. Global supply chain constraints and expansionary fiscal policies led to sharp increases in inflation, further exacerbated by the war in Ukraine, which drove up oil and food prices. Palau experienced a 13.2 percent inflation surge, contributing to the overall economic decline.

The economy remained weak in FY23, despite a modest recovery in the tourism sector. It was anticipated that Palau's economy would be well on its way to recovery by FY23, similar to other South Pacific tourist destinations. However, Palau's key tourism markets in East Asia were slow to resume outbound travel, and visitor numbers only reached 35,000. Flights resumed from Taiwan and Macau in early 2023, accelerating recovery. Inflation remained high at 11 percent, driven by the introduction of the 10 percent Palau Goods and Services Tax (PGST) in January 2023. Although tourism and construction improved, the sharp rise in consumer prices weakened demand, limiting GDP growth to just 1.3 percent.

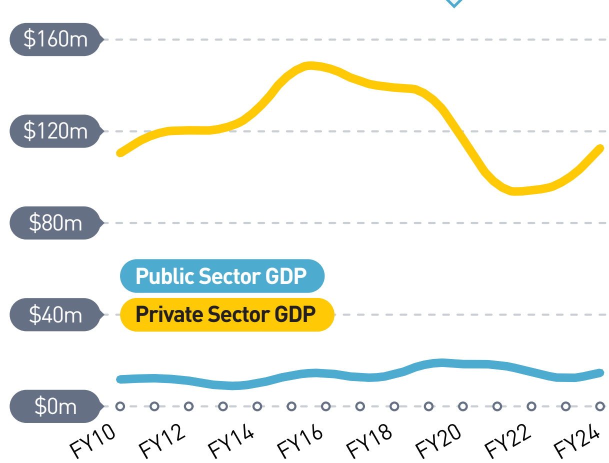
In FY24, the economy began to recover, with an estimated 8.3 percent growth[2]. Visitor arrivals are projected to have reached 52,000, a 49 percent increase over FY22 but still well below the pre-COVID level of 116,000 in FY18. Inflation moderated to an expected 4.6 percent as global inflation pressures eased, and the impact of the PGST worked through the system. Additionally, construction activity increased significantly with the start of new military projects.

After a steep decline during COVID-19, the private sector stagnated through FY23 before showing signs of recovery in FY24. Figure 3 highlights the impact of COVID-19 on the private sector. While the public sector remained stable, supported by government and donor financing, the private sector bore the brunt of the pandemic's effects. Between FY19 and FY21, private sector activity fell by 31 percent and showed no recovery over the next two years. However, in FY24, as inflation eased and tourism and construction picked up, the private sector grew by 16 percent, reaching activity levels last seen in FY10.

Gross National Income per Capita

Population growth in Palau has remained static, unlike the FSM and RMI which experienced significant out-migration. Palau's population consists of native Palauans and a sizable foreign workforce, primarily from the Philippines. Since 1986, the Palauan population has remained largely stable, growing by just 0.1 percent after accounting for external

Figure 3: Private and public sector GDP, constant prices, FY19
Private sector performance has been volatile and bore the brunt of COVID.



2 Data for FY24 has been estimated on performance in the 1st 6-9 months of the year.

migration, reaching 12,436 in FY20. The number of foreign residents, driven by demand in the tourism sector, has grown from 1,550 to 5,178 over the same period.

The World Bank reclassified Palau as a high-income country. While constant price GDP per capita grew in line with overall GDP during the pre-COVID period of FY00-FY19 at 0.5 percent, Gross National Income (GNI) per capita, the measure used by the World Bank to classify income levels, rose by 1.8 percent annually. Based on the World Bank's Atlas method[3], Palau achieved high-income country status before COVID-19. However, following the economic impact of the pandemic, Palau was reclassified as a middle-income country, which allowed greater access to donor funding. As of July 1, Palau has once again been reclassified as a high-income country.

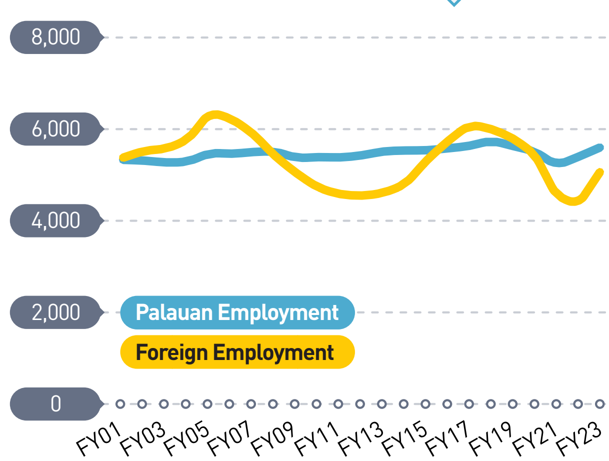
Employment

The labor market experienced fewer job losses during the pandemic than initially feared, with 1,710 jobs lost in FY21 compared to FY19. In FY19, Palau's labor market consisted of 5,641 Palauan workers and 5,800 foreign workers. In normal times, Palauan employment is near full capacity, with foreign workers making up for excess demand. Between FY00 and FY19, Palauan employment grew by an annual average of 0.3 percent, while foreign employment fluctuated with economic conditions, as shown in Figure 4. Early projections estimated job losses of up to 3,100, or 27 percent of the labor force, due to the pandemic. However, actual data for FY21 showed a loss of 1,710 jobs, or 15 percent of the FY19 workforce.

The impact of job losses was mitigated by employers retaining workers on reduced hours and government employment programs. In the private sector, 1,550 jobs were lost, representing a 24 percent decline between FY19 and FY21. However, these figures do not account for reduced working hours and pay, which many tourism operators implemented to cope with revenue shortfalls during the pandemic. On a full-time equivalent basis, the loss of private sector jobs was likely much higher. Overall, the impact of the pandemic on employment was less severe than expected, aided by employers' retention strategies and government support programs that helped sustain wage levels and reduce costs.

In FY23, employment grew strongly, particularly in the private sector, with rehiring of foreign workers. Employment levels remained steady in FY22, but by FY23, total employment grew by 915 jobs, or 9 percent, almost entirely in the private sector, which saw a 15 percent increase. Foreign employment grew by 16 percent, while Palauan employment increased by a modest 4 percent. The weak growth in the broader economy raises questions about the source of this employment growth. It is likely that the private sector rehired workers lost during the pandemic in anticipation of recovery and to address supply

Figure 4: Employment by Palauan and foreign workers
Employment of Palauans droped during COVID but has now returned to its former levels. Supply and demand for labor is met by changes in foreign worker participation.



3 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.

shortages. Data from the first two quarters of FY24 suggest these trends continued, with employment nearing the levels reached during the employment boom in 2017.

Inflation

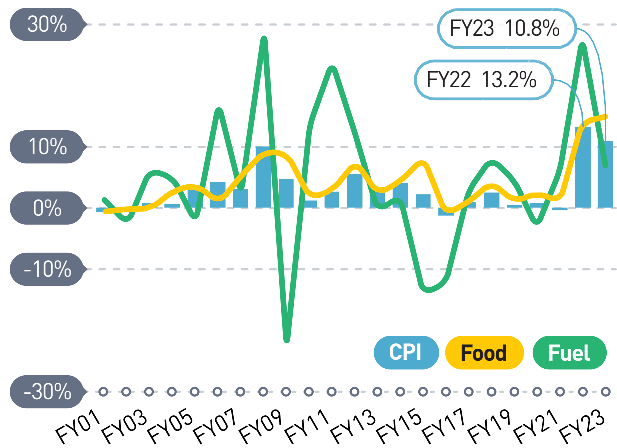
Inflation in Palau has historically been moderate, but recent global events have led to a rapid increase. Trend inflation in Palau averaged 2.8 percent between FY00 and FY21, though this figure masks significant volatility in fuel and food prices during periods of global instability, such as the financial crisis, as shown in Figure 5. In FY22, Palau experienced a surge in inflation due to the same forces affecting the rest of the world. Expansionary fiscal policies enacted during the COVID-19 pandemic, combined with supply shortages as the global economy reopened, drove inflation to levels not seen since the 1970s and 1980s. The Ukraine war further exacerbated the situation, with rapidly rising fuel and food prices pushing inflation in Palau to 13.2 percent in FY22.

The introduction of the PGST in FY23 led to a further increase in inflation, as businesses raised prices by 10 percent without offsetting reductions from the removal of legacy taxes. Inflation in FY23 remained high at 10.8 percent, despite the removal of import and gross receipts taxes. Businesses effectively added 10 percent to prices without adjusting for the repeal of these taxes, eroding household real incomes and increasing private sector profitability. This shift in the distribution of income was an unintended consequence of the PGST. By the end of Q1-24, prices had largely stabilized, rising by a modest 1.9 percent. Inflation for FY24 is projected at 4.6 percent, reflecting current trends and the residual effects of the PGST's introduction.

An analysis of recent inflation trends reveals several contributing factors. Between Q1-2020 and Q1-2024, overall inflation increased by 30 percent. Of this, 19.4 percent was due to rising domestic and imported inflation, while

Figure 5: Consumer price index

Inflation rose to 13 percent in FY22 due to rapid increases in fuel and food prices, and 11 percent in FY23 with the introduction of PGST.



10.6 percent was attributed to the PGST[4]. Within the 19.4 percent, 7.5 percent was driven by food price increases, 6.7 percent by fuel and electricity, and the remainder by other domestic factors. An analysis of the PGST's impact shows that 4.2 percent of the inflation spike was due to discretionary changes in tax rates, while 6.4 percent was due to increased business margins.

Wages

Real wages in both the private and public sectors have declined over the long term, with a considerable disparity between the two. Between FY10 and FY23, nominal wages grew by 2.1 percent annually in the private sector and 3.5 percent in the public sector, as shown in Figure 6. However, real wages declined by 0.3 percent in the private sector while growing by 1.1 percent in the public sector. In FY23, public sector wages were 120 percent higher

4 Of the total of 306 items priced in the CPI 276 are subjected to PGST. Of the 276 items 129 rose by exactly 10 percent (47 percent) and 179 (65 percent) rose by between 9.5 and 10.5 percent between January and February 2023 at the when PGST was implemented.

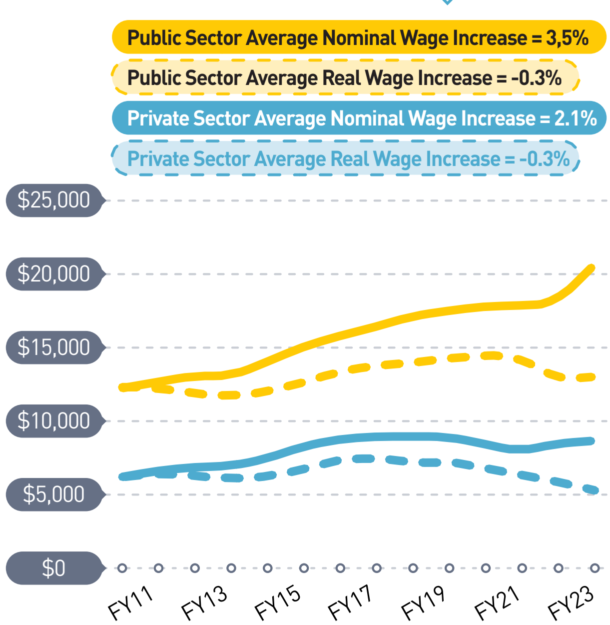
Inflation moderated to 4.6 percent in FY24 as global price impacts and the effect of the PGST eased.

than those in the private sector. Wages for Palauan workers were 59 percent higher than for non-Palauan workers, with most Palauans employed in the public sector and most non-Palauans in the private sector.

The recent surge in inflation had a significant negative impact on real wages, though public sector wage increases helped mitigate the impact. The sharp rise in inflation in FY22 resulted in a steep decline in real wages. Public sector nominal wages grew by just 0.6 percent, and the 13.2 percent inflation rate led to a corresponding drop in real wages. In FY23, public sector wages were increased by 75¢ per hour, resulting in a 12.6 percent nominal wage increase. After accounting for the ongoing inflation from the PGST, real wages rose by 1.5 percent. In FY24, a further 75¢ per hour increase in public sector wages is expected to help offset prior inflationary pressures. In the private sector, nominal wages rose by 5.8 percent in FY22, partially offsetting the inflation surge. However, nominal wages grew only marginally in FY23, resulting in a 13.8 percent decline in real wages compared to FY21. In mid-2024, the OEK passed legislation to raise the minimum wage for private sector workers by 75¢ in FY25 and another 75¢ in FY26, which should help alleviate some of the inflationary pressures on private sector wages.

Figure 6: Nominal and real wages, FY10 prices

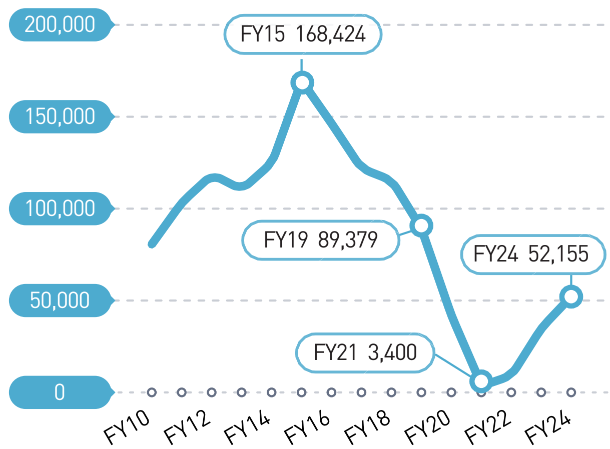
Real wages improved during the tourism boom due to low inflation but fell significantly post-COVID with rising inflation.



2. Tourism Developments and Policy

Figure 7: Visitor arrivals

After peaking in FY15 visitor arrivals declined to zero in FY22 due to the impact of COVID but is now on a slow road to recovery.



Tourism Developments

Visitor numbers boomed between FY10 and FY15 due to a large influx of package tourists, mainly from China. In FY15, annual visitor arrivals reached 168,484, an increase of 87,527 visitors, or 108 percent above the FY10 level (see Figure 7). However, from FY16 through FY19, visitor numbers declined each year, reaching a low of 89,379 in FY19. The original increase in visitors was driven by the availability of excess capacity in tourism facilities; occupancy rates rose from 40 percent in FY10 to 63 percent in FY15. Most of this growth occurred in middle- to lower-grade establishments, with a corresponding increase in package-tour visitors, predominantly from China.

The tourism boom encouraged new investment, but declining visitor numbers caused occupancy rates to plummet. From FY15 to FY19, the drop in arrivals was largely due to fewer Chinese visitors, caused by travel restrictions from Chinese authorities and limitations on charter flights imposed by Palau. Additionally, there was a significant reduction in higher-spending tourists from more traditional markets. As visitor numbers grew and occupancy rates improved in the mid-2010s, new hotel construction increased, just as the industry began to contract. By FY19, occupancy rates had dropped to 34 percent due to the decline in visitors and the addition of unoccupied facilities.

The increase in visitors had a positive impact on government revenues, but the economic benefit was limited. The fiscal gains from the increase in lower-spending visitors were smaller than those from higher-value tourists. As a result, the economic impact of the tourism boom was less than visitor numbers alone would suggest, and the decline in arrivals had a similarly muted effect. Despite the surge in visitors from lower-value tourists, the fiscal surplus rose significantly, reaching 5 percent of GDP in FY15, taking the government by surprise. This surplus was sustained through FY18, even as arrivals and occupancy rates declined, with government deposits increasing by $20 million.

Tourism collapsed with the onset of COVID-19 in early 2020, and signs of recovery only began to emerge in mid-2023. FY20 was expected to be a strong year, with 120,000 visitors projected, but by the end of March 2020, international arrivals had fallen to zero due to the pandemic, although 41,674 visitors were recorded for the fiscal year starting in October 2019. By mid-2021, Palau had completed a comprehensive vaccination program and reopened its borders in July. Despite expectations that Palau would follow other Pacific economies in recovering, this did not materialize. With countries such as Japan hesitant to resume travel, Palau's tourism sector remained largely dormant for nearly two years. Flights from Taiwan and charter services from Macau resumed in mid-2023, leading to the arrival of 35,052 visitors for the year.

The prolonged absence of tourism and slow recovery led to continual downward revisions of overly optimistic projections. Palau's tourism situation mirrors that of regional neighbors Guam and CNMI, where visitor numbers are also at around 50 percent of pre-COVID levels. Despite this, the nation remains optimistic, with confidence in the attractiveness of its tourism product. Two international hotel chains, IHG and Four Seasons, have begun construction, and a new hotel has been completed in Melekeok. However, a key constraint has been the lack of scheduled flights, along with the high value of the US dollar, which has made Palau and the region less competitive.

A gradual but slow recovery in tourism is projected for the medium term. Based on the first eight months of FY24, visitor arrivals are estimated at 52,000. While it may seem imprudent to make projections for an industry that has underperformed since COVID-19, the strong recovery in tourism elsewhere and Palau's attractive offerings suggest that recovery will eventually occur, even if the timing remains uncertain. The Review projects continued slow recovery through the medium term, with visitor arrivals increasing to 78,700 in FY25 and nearing pre-COVID levels at 93,700 in FY26, representing an occupancy rate of 35 percent—a rate that was considered disappointing in FY19. By FY30, visitor arrivals are projected to reach 147,200, representing a 50 percent occupancy rate, which is below the 60 percent rate considered the minimum return on investment by hotel operators[5].

Tourism recovery began in FY24, but visitor arrivals remained at only 45 percent of FY18 levels.

Tourism Policy

While the current focus is on reactivating the tourism industry, Palau lacks a long-term vision. Palau has adopted a policy aimed at attracting high-value tourists, but it lacks the resources to effectively implement this policy. As a result, tourism development has been virtually unconstrained, leading to significant volatility and large fluctuations in visitor numbers. In 2015, Palau requested support from the Asian Development Bank (ADB) to help rationalize the industry. The resulting report endorsed the concept of attracting high-value visitors and highlighted the need for a comprehensive tourism strategy or master plan. Under a grant from the U.S. Department of the Interior, Palau developed the Responsible Tourism Policy Framework[6] (RTPF). While the RTPF outlined important principles, it took a largely aspirational, community-based approach. It fell short of providing a comprehensive strategy with clearly defined actionable steps. Although current efforts are focused on reigniting the tourism industry, critical long-term questions—such as the size, location, and type of industry Palau wants to attract—remain unanswered. Until a comprehensive strategy or master plan is developed, Palau will continue to be vulnerable to market forces and the growth of an industry

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

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

that may not align with the principles of the RTPF.

Tourism Infrastructure

The need to extend Palau's international airport runway is questionable. Two major pieces of infrastructure have been considered important to tourism development in Palau: (i) extending the airport runway and (ii) redeveloping the Malakal dock. The argument for extending the runway is based on the claim that its current length of 7,200 feet is too short to accommodate flights from Japan and Korea. However, before COVID-19, direct flights from these countries operated regularly, with JAL and Delta flying from Japan and Asiana and Korean Air flying from Korea. While some Boeing 737 models have range limitations, it is unclear why this has only recently become an issue. Although a longer runway would allow larger planes to fly longer distances, Palau is already relatively close to its main tourism markets, so extending the flight range would not significantly increase tourist numbers. Larger planes could bring more tourists, but this could also lead to overcrowding—an issue Palau has faced in the past. Finally, due to the airport's geography, extending the runway would be very costly, with estimates as high as $300 million, making it unlikely to yield a positive return on investment.

Redeveloping the Malakal port, currently operated by a private entity, would free up prime land for tourism development. The Malakal area is currently a mix of industrial and tourism-related activities, and much of it looks rundown, making it an unattractive environment. The site has significant potential for attracting brand-name hotels, condominiums, shopping centers, conference facilities, and restaurants. Denarau in Fiji is an example of a similar successful development. The current port requires significant repairs, and relocating it to a different part of Palau with a safe harbor and fewer alternative uses could have a significant impact on national development. While the current low level of tourism demand does not justify immediate redevelopment, careful consideration should be given to the future best use of the area before resources are allocated to an unsuitable location.

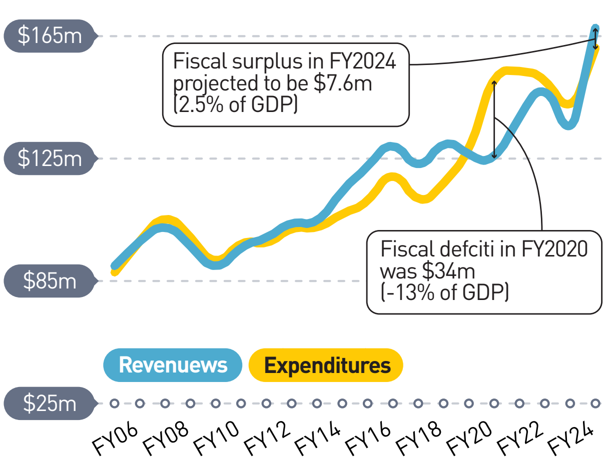
3. Fiscal Performance and Reform

Fiscal Outcomes

Palau has maintained a prudent fiscal policy and ran surpluses during the tourism boom years. After the global financial crisis, when Palau ran a series of fiscal deficits, the fiscal position improved between FY10 and FY13, with Palau recording a period of fiscal balance (see Figure 8). As a result of economic 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, up by $34 million from 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 percent of GDP, and cash deposits fell to $31 million. However, despite the reduction in reserves, fiscal prudence during the boom years established a significant cushion, which would prove crucial during the COVID-19 crisis.

Figure 8: Government revenues and expenditures

Palau generated large fiscal surpluses as tourism industry boomed, ran large fiscal deficits during COVID, but has now returned to fiscal balance.



Total financing needs of 24 percent of GDP were required to finance the fiscal deficit during the COVID-19 crisis (FY20–FY23). With the impact of COVID-19, Palau's fiscal position deteriorated rapidly. From a balanced position in FY19, the government incurred a large deficit of $33.7 million or 13.0 percent of GDP in FY20. A larger deficit had been anticipated for FY21, as the pandemic affected the entire fiscal period. However, rising grant levels to cover large mitigation programs helped reduce the deficit to $17.3 million or 7.3 percent of GDP. In FY22, despite the economy's continued deterioration, the fiscal position improved as grant levels further increased, and the deficit narrowed to $1.5 million or 0.6 percent of GDP. In FY23, the government implemented tax reforms that led to a $15 million increase in tax revenues, a 34 percent rise over FY22. However, expenditure growth also accelerated, driven by (i) a 75¢ pay award, (ii) increased use of goods and services, and (iii) growth in grants and subsidies. As a result, the deficit grew to $7.6 million or 2.5 percent of GDP. Over the COVID period, total financing needs amounted to $60 million, or 24 percent of GDP, 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 Asian Development Bank (ADB). A series of loans were initiated: (i) the Disaster Resilience Program (DRP), (ii) the

Total financing needs from COVID, to keep the government open and sustain mitigation programs, reached 24 percent of GDP.

COVID-19 Pandemic Relief Option (CPRO), and (iii) the Recovery through Improved Systems and Expenditure Support (RISES) program. The total available funds from the ADB amounted to $90 million, which, combined with Palau's own reserves from the tourism boom years, exceeded the $60 million needed to keep the government operational and maintain financial stability during the COVID-19 crisis. While the ADB funding was more than sufficient to cover the deficit, the strength of the tax reforms further reduced Palau's total financing needs.

Revenues in FY24 are expected to grow by 34 percent or $44 million, supported by new Compact grants and tax revenue growth. In FY24, with a full fiscal year under the new tax regime, tax revenues are projected to rise by $12 million, or 20 percent, above FY23 levels. Additionally, the 2023 Amended Compact (C-23), agreed between Palau and the United States in May 2023 and funded by the U.S. Congress in March 2024, provided new revenue streams. These included (i) $20 million in operational budgetary support, (ii) $5 million in infrastructure grants, (iii) a $5 million infrastructure maintenance grant, (iv) $10 million for fiscal consolidation, and (v) continued access to the COFA Trust Fund (CTF), with a drawdown of $15 million or 4 percent, whichever is greater[7].For FY24, it is assumed that Palau will draw the $20 million grant for operations, but due to timing issues, the infrastructure grant will not be utilized, while the entitled $15 million will be drawn from the CTF.

An overall surplus of $12.6 million or 4.1 percent of GDP is projected for FY24. While the C-23 Compact provides a significant increase in revenues, expenditure is also expected to rise. The implementation of a second 75¢ pay rise for civil servants and other provisions in the June supplemental PL11-34 will increase expenses. Grants to other layers of government are expected to rise by $7 million, or 33 percent, including subsidies and capital transfers to the Palau Public Utilities Corporation (PPUC) for operations and repayment of the Koror-Airai Sanitation Project (KASP) loan ($3 million). Block grants to state governments will increase by $3.5 million, along with additional transfers to the collapsing Social Security (SS) and Civil Service Pension Plan (CSPP) funds ($3.5 million). A further $3 million in wage tax refunds for Palauan citizens is also included. While additional Compact capital funds are available, it is assumed that these funds will not be fully utilized due to capacity constraints. After accounting for the additional revenues and expenditures, a $12.6 million surplus is anticipated, which is equivalent to 4.1 percent of GDP.

7 The new C-23 budget streams are discussed in greater detail in chapter 9.

Fiscal Responsibility and the RISES Program

Palau adopted a Fiscal Responsibility Framework supported by ADB technical assistance and a Policy-Based Loan known as the RISES Program[8]. Under an ADB-supported technical assistance project[9] in late 2018, a fiscal strategy was developed for Palau, with the core recommendation being the adoption of a fiscal responsibility framework for implementing fiscal policy. As part of the COVID-19 budgetary support program, the ADB executed the RISES Program (Recovery through Improved Systems and Expenditure Support), which includes the following elements:

1. Policy and legislative framework for public financial management:
    i. Fiscal Responsibility Law
2. Public sector reforms:

8 *Recovery through Improved Systems and Expenditure Support Program*, a Policy Based Loan, ADB, Manila, May 20212

9 *Toward a Medium-Term Fiscal Strategy for Sustainable Economic Development*, ADB TA-8581 REG: Strengthening Public Sector Management in the North Pacific, November 2018

ii. Tax reform

iii. Development of a fiscal strategy and preparation of the FY22 Economic and Fiscal Update

iv. National infrastructure plan

v. External debt management law and policy statement

vi. Social Security reform

3. Private sector reforms:

vii. Public-private partnership framework

viii. Arbitration law

ix. Corporations law and registry

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

The Fiscal Responsibility Law

Palau has adopted standard principles of fiscal responsibility, with extensions to suit its unique needs. Countries such as New Zealand and the Cook Islands have developed fiscal responsibility frameworks that focus on (i) maintaining expenditures within revenues, (ii) managing debt prudently, (iii) ensuring predictability in the tax regime, and (iv) managing risk prudently. In Palau, these principles were expanded to include additional critical features. In November 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 follows:

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 growth rate 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, ensuring equitable allocation of tax burdens and predictability over time.
5. Manage **reserves and insurance coverage** to offset cyclical volatility, natural disasters, and the impact of climate change.
6. Manage the non-primary government public sector prudently, ensuring that **State-Owned Enterprises (SOEs) and Public Financial Institutions** deliver services effectively and sustainably.
7. Manage **fiscal risks** and contingent liabilities prudently.

B. Notwithstanding subsection A, the government may depart from these principles of fiscal responsibility, provided that:

1. The departure is temporary.
2. The President states the reason for the departure.
3. The President specifies the period required to return to adherence to the principles.
4. If circumstances arise during the fiscal year that force a departure from these principles, they must be timely disclosed in accordance with the FRDMA.

The Fiscal and Economic Update

The FRDMA requires the preparation of an Economic and Fiscal Update as part of the annual budget cycle to assess the economic and fiscal health of the nation. The update provides key information on the fiscal envelope to ensure fiscal stability and sustainability over the medium term. It also assesses the government's adherence to the principles of fiscal responsibility. Economic and fiscal updates were completed in June 2022 and September 2023. Although the FY24 version has not yet been completed, an initial assessment indicates the following:

1. **Fiscal balance**: In adherence; the fiscal balance deteriorated in FY23, but the entry into force of the 2023 Amended Compact (C-23) restored fiscal balance in FY24.
2. **Net National Wealth**: Not in adherence; net national wealth declined significantly during COVID-19. However, with the improved fiscal position resulting from C-23, net national wealth is expected to increase as debt is repaid and public investment grows.
3. **Debt**: Not in adherence; the debt-to-GDP ratio has risen rapidly due to significant borrowing during COVID-19 and new loan drawdowns in FY24. Scheduled debt repayments and nominal GDP growth should return external debt to sustainable levels in the medium term. Use of the Compact debt consolidation fund for accelerated principal repayment should further reduce debt-to-GDP.
4. **Revenue regime**: In adherence, following the implementation of the tax reform in January 2023.
5. **Reserves and insurance coverage**: Not in adherence; reserve funds are below target and were used to fund FY23 and FY24 supplemental budgets without meeting withdrawal conditions.
6. **SOEs and pension funds**: The SOE sector is in adherence after adopting full cost-recovery tariffs. However, the RoPSSA and CSPP funds are not in adherence and are operating under unsustainable financial policies.
7. **Fiscal Risk**: A formal analysis of fiscal risk has not yet been undertaken.

Palau adopts a Fiscal Responsibility and Debt Management framework.

Tax Reform

The tax reform bill was passed into law in September 2021, after years of efforts to modernize Palau's tax regime. As part of the RISES program, Palau prioritized tax reform. An earlier version of the Palau Goods and Services Tax (PGST) bill, originally proposed in 2018, was revised to include a business profits tax, and the bill was reintroduced in January 2021. The bill was widely debated through hearings and town hall meetings. An economic symposium, supported by the Chamber of Commerce, was held in May 2021, and the bill was passed into law in September 2021. The main features of the new law are:

1. A 10 percent Palau **Goods and Services Tax** (PGST).
2. Excise taxes to replace former import duties.
3. A 12 percent **Business Profits Tax** (BPT).
4. Medium-sized businesses will remain under the Business Gross Receipts Tax (BGRT), while small businesses will pay an annual fee.
5. Reform of the Wages Tax, with a 0 percent rate for Palauans earning less than $15,000, a standard rate of 10 percent, and 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 program was implemented rapidly over one year, it is considered a large success. Implementation included training in administration, the development of new IT systems, public outreach, and a major symposium on the program. The program was launched on January 1, 2023, and, after an initial adjustment period, is now well established. Support came from donors such as the IMF, Pacific Financial Technical Assistance Centre (PFTAC), and the Australian Tax Office (ATO). Despite Palau's limited resources, the program is viewed as 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 competitive forces exert themselves profit margins will revert to normal levels. After the initial price shock, inflation has been low and may indicate that some of the subsequent increase in inflation may have been absorbed by vendors. The increase in prices was a one-time shock and abated rapidly after the start of 2023.

New initiatives are underway:

1. An **evaluation of the tax reform program** is being conducted to identify areas for improvement. While the tax reform replaced inefficient legacy taxes (BGRT and import tax), the current system does not include a general personal income tax, which could be part of a second phase of reforms.

2. An **evaluation of the Tax Information System** is in progress, with a needs assessment being prepared to support the selection of a modern, risk-based Commercial Off-the-Shelf (COTS) IT system.

3. **Reforms to the Customs Act** are also underway, aimed at improving border coordination and trade facilitation with support from UNCTAD and UNDP. The Asycuda system, a modern, risk-based IT customs system developed by UNCTAD, was operationalized in early 2024 and integrated into the tax reform process.

The introduction of tax reform and the Palau Goods and Services Tax marks a milestone in Palau's economic and financial development.

4. External Debt

Palau incurred significant debt to finance the nation during COVID-19. To support the country through the crisis, Palau took out a series of loans from the Asian Development Bank (ADB), including (i) a $15 million facility under the Disaster Resilience Program, (ii) $20 million under the COVID Pandemic Relief Option, and (iii) a $55 million policy-based loan under the RISES program, consisting of two subprograms of $25 million and $30 million. The conditions for the release of funds under Subprogram 1 were met by early 2021, with the second set of conditions for Subprogram 2 completed by the end of FY22.

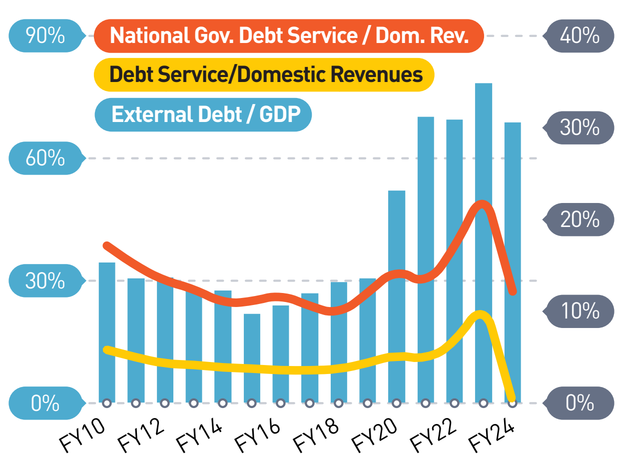
A further policy-based loan was arranged through the ADB despite considerable improvement in the fiscal position. During 2023 while the outlook for recovery remained uncertain Palau arranged a further policy-based loan comprised of two sub-programs of $12.5 million under the Sustainable Oceans and Resilience Strengthening Program for contingency financing. In FY24, with additional financing from the 2023 Amended Compact (C-23), the fiscal outlook improved significantly, but the government continued processing the loan, which was arranged on favorable concessional terms. The first subprogram funds were received in the third quarter of 2024. In total, Palau incurred $115 million in debt in response to COVID-19.

While COVID-19 was the primary cause of Palau's rapid debt increase, the nation also incurred debt for other purposes. In addition to the $115 million in debt for deficit financing during the pandemic, Palau has borrowed, or is committed to borrowing, for other purposes. These include the $15 million Taiwan HLDP loan in FY20 and a $5 million loan from Taiwan for Women and Youth Entrepreneurs and MSMEs re-lending in FY21. Additional borrowing includes an ADB policy-based loan of $10 million for the Palau Public Utilities Corporation (PPUC) in two subprograms in FY22 and FY23, $15.8 million from Australia and JBIC for the second internet fiber project in FY23, and a planned $15 million loan from Saudi Arabia for the National Development Bank of Palau (NDBP) for land subdivision and housing in FY25. In total, recent non-COVID borrowing amounts to over $60.8 million.

The external debt-to-GDP ratio rose rapidly to 79 percent of GDP in FY23. Due to the global pandemic and other funding needs, Palau's external debt surged (see Figure 9). External debt increased from 30 percent of GDP in FY19 to 52 percent in FY20, and then to 70 percent in FY21. While the debt level plateaued in FY22, it reached a record high of 79 percent in FY23. However, much of this increase was due to the decline in GDP (the denominator). As the economy began to recover in FY24 and GDP grew significantly, the debt-to-GDP ratio fell to 69 percent.

Figure 9: External debt and debt service, percent GDP

External debt rose to alarming levels due to financing needs related to COVID.



External debt service has also risen significantly, but with the benefit of the C-23 consolidation grant, it fell to 12 percent of national government revenues in FY24. Debt service, measured as a percentage of national government domestic revenues, followed a similar trend as the debt-to-GDP ratio. It was 12 percent of domestic revenues before the crisis in FY18, including State-Owned Enterprise (SOE) debt service, but rose to 22 percent in FY23. Excluding SOE debt service (including on-lent loans), national government debt service was projected to peak at 10 percent of general fund revenues in FY23. With the availability of the C-23 debt consolidation grant, debt service is expected to fall to 12 percent of national government revenues in FY24, with national government debt service alone largely disappearing.

Recent increases in international interest rates have added to debt service costs. While the level of debt Palau has incurred is historically high, the concessional nature of the loans (i.e., more favorable terms than market loans) should limit the risk of debt distress. Recent IMF Article IV consultations with Palau support this view[10]. However, future borrowing and interest rate risk must be carefully evaluated.

Palau temporarily ceased debt service on the Koror-Airai Sanitation Project (KASP), but repayments have since resumed. As part of the FY24 budget, the OEK legislated that the government should cease further payments on the ADB KASP project until the President and the ADB addressed disputes related to loan repayments for the unfinished project. Following discussions between the Administration, OEK, and ADB, Palau agreed to resume repayments. While the issue appears to have been resolved, it was contentious and suggests that the use of the new C-23 debt consolidation fund could be prioritized to rapidly pay down outstanding debt under this loan.

External debt rose to 79 percent of GDP in FY23 but is projected to fall below 61 percent by FY25.

The Fiscal Responsibility and Debt Management Act (FRDMA) provides a framework for managing external debt. The passage of the FRDMA has established a framework and institutional capacity for managing external debt. This includes monitoring and assessing new debt, conducting periodic debt sustainability analyses (DSAs), and issuing a debt management policy statement. A debt management unit has been created to:

1. Provide technical reviews of all proposed borrowings and sovereign guarantees, particularly assessing the associated risks, terms, conditions, and debt-servicing strategies.
2. Assist the Minister of Finance in developing and maintaining a debt management policy for consideration by the President.
3. Develop and implement a project appraisal and approval framework for assessing loan-financed projects and providing advice to the Minister of Finance.
4. Undertake periodic DSAs to support the debt management component of the Annual Economic and Fiscal Update, as set forth in the FRDMA, and provide opinions or advice to the Minister.

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

5. Public Financial Management

Palau conducts a PEFA assessment and adopts a Roadmap for PFM reform.

Public Expenditure and Financial Accountability

The PEFA is a framework for the assessment of public financial management. The Public Expenditure and Financial Accountability (PEFA) framework, developed by the World Bank and a group of international donors, is an assessment tool used to evaluate the quality of public financial management (PFM). It has been implemented in many countries and provides an objective benchmark by which nations can assess and improve their PFM performance. The framework consists of seven 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 conducted a PEFA in late 2022. In March 2013, Palau invited the Pacific Financial Technical Assistance Center (PFTAC) to assist in preparing a PEFA self-assessment. Although a formal external assessment was planned for 2019, it was delayed due to COVID-19. A reduced yet comprehensive version of the PEFA, known as the "agile PEFA," was completed in late 2022[11]. While the PEFA included assessments on various PFM elements, the report lacked an overall perspective of PFM in Palau. The primary value of the report lies in its analysis of individual PFM elements rather than a holistic overview. The assessment identified good performance in areas such as transparency (item 2), asset management (item 3), and policy-based fiscal strategy (item 4). Budget reliability (item 1) scored relatively low, except for the dimension related to contingency reserves, while predictability and control in budget execution (item 5) showed mixed results. Due to the delayed completion of audits, accounting and reporting (item 6) scored poorly.

With the PEFA completed, Palau requested PFTAC assistance for a roadmap. Following the completion of the agile PEFA assessment, Palau requested PFTAC to assist in developing a PFM roadmap to enhance PFM performance. The roadmap was completed and approved by the government in November 2023[12], providing a comprehensive assessment of PFM in Palau. Rather than addressing all PEFA elements, the roadmap focuses on prioritizing and sequencing activities suitable to Palau's context, considering staffing capacity and resource constraints. Key areas of focus include:

- Macroeconomic and fiscal forecasting
- Planning and budgeting

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

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

- Financial reporting
- Public investment management
- Internal audit
- Procurement
- Asset management
- SOE oversight
- Fiscal risk management
- FMIS rollout
- Strengthening general transparency
- Revenue reforms
- Debt management
- Budget execution
- Strengthening PFM in state governments

During the COVID-19 period, Palau initiated PFM reforms ahead of the PEFA assessment and roadmap. These reforms included many elements from the ADB RISES program, such as the Fiscal Responsibility and Debt Management Act, the Fiscal Strategy and Economic and Fiscal Update, tax reform, the national infrastructure plan, and reforms to the RoPSSA and CSPP social security and pension schemes. Palau also adopted a modern Financial Management Information System (FMIS), providing a framework for sound financial management. The timing of the PEFA and PFM roadmap was fortuitous, as they allowed for an assessment of these reforms and provided a path forward to maintain momentum.

PEFA serves as a tool to demonstrate Palau's financial soundness to investors and donors. As Palau transitions from developing country status to high-income status, it must demonstrate to financiers and donors that it is a financially sound and well-managed nation. The PEFA assessment and PFM roadmap offer an objective method for evaluating reform efforts, which Palau can present to investors and rating agencies.

The Palau Development Plan - 2023

Palau has conducted several development planning exercises to promote economic growth and development. The major national planning initiatives include the Palau 2020 National Master Development Plan (NMDP) from 1993 and the Medium-Term Development Strategy (MTDS) from 2009. These earlier plans followed a traditional economic development model, focusing on optimizing economic growth given limited resources while balancing social, cultural, and environmental factors. These plans addressed the classic economic challenge of maximizing returns from scarce resources under specific constraints.

The Palau Development Plan (PDP) defines five pillars of development: social, culture, environment, economic, and governance. Departing from traditional economic allocation models, the PDP's long-term vision is to "substantially enhance the quality of life for current and future generations of Palauans." The plan defines five pillars:

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

The target for the PDP is to have well-established processes and programs in place for each of the five pillars by 2026. The PDP focuses on developing these pillars, with only one being directly economic.

The PDP has two dimensions: five pillars and two geographies—national and community. The plan is structured into two major parts:

a discussion of the status of development across the five pillars and an outline of sector development programs and strategies. It considers development priorities at both the national and community levels (urban, rural, and outer island), creating a two-dimensional structure that integrates five pillars and two geographies, all with equal ranking.

The core of the PDP lies in 16 development sectors aligned with government ministries, bureaus, and agencies. Each sector follows a standard format: (i) sector goals, (ii) status and trends, (iii) strategy, and (iv) priorities, programs, and projects. A monitoring matrix at the end of each chapter tracks sector performance, national impact, outcomes, and outputs, and provides a budget for sector activities. These matrices form the core of the plan and guide resource allocation during the annual budget process. The PDP is well-constructed to meet C-23 requirements, guiding the use of Compact funds and serving as a key element in annual bilateral economic consultations on PDP implementation progress.

The PDP includes a Multi-Criteria Analysis (MCA) for capital expenditure (Capex) and priority recurrent expenditure selection. The PDP outlines a five-step process for selecting capital expenditures from the National Infrastructure Investment Plan (NIIP):

1. Compile a list of 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 ready for appraisal and prioritize them
5. Seek funding

The Palau Development Plan establishes a framework for budget preparation.

Each project is evaluated based on its contribution to the five pillars, with equal weighting for each pillar. Economic projects undergo a simple cost-benefit analysis, while MCA scores (ranging from -1 to 3) are applied to the pillars to rank projects. A similar process is used to prioritize new recurrent initiatives. Most projects are selected based on their social, cultural, and environmental impact rather than traditional cost-benefit analysis.

A key omission in the PDP is the lack of a macroeconomic framework. A macroeconomic framework is critical to assessing the financial viability of the plan and ensuring that sector operations and projects are financially viable. The PDP includes a chapter on financing, but it primarily discusses different funding sources without evaluating the plan's financial feasibility. This raises concerns about domestic resource mobilization and fiscal policy. Palau has traditionally funded capital projects through external grants and loans, but with its reclassification as a high-income economy, generating domestic savings through fiscal and financial sector policies is now a pressing issue. While the PDP plays an important role in annual budget formulation, it does not adequately address strategies for domestic and external resource mobilization.

Financial Management Information Systems (FMIS)

The new FMIS has been successfully implemented, but delays in audits persist. Palau replaced its previous FMIS with the Tyler-Munis system, funded by the Compact of Free Association (C-10). Widely used by U.S. government agencies, this system meets U.S. government accounting standards and federal program requirements. The system includes a broad range of reporting tools, which finance staff are gradually mastering. The system was successfully deployed in mid-2020, though data migration and COVID-19-related delays postponed the audit. The FY20 audit was completed on April 24, 2023, nearly three years behind schedule. The departure of Deloitte and Touche from the region further delayed audit preparation, which has now been contracted to Ernst and Young (E&Y). E&Y is responsible for conducting the FY21 audit and implementing a program to bring audits up to date within nine months of the fiscal year's end. However, the FY21 and subsequent audits remain incomplete.

The new FMIS does not fully integrate with GFS or performance budgeting management reports. The original intent was for the FMIS to produce data compatible with the IMF's Government Finance Statistics (GFS) to support fiscal policy design. While some improvements were made to the chart of accounts and account codes were mapped to GFS categories, the standard account codes do not provide sufficient information to generate GFS reports of the required quality. GFS statistics can be compiled from the FMIS, but this requires additional data extraction, correspondence tables, and coding of individual transactions. Additionally, the system does not integrate output/performance budgeting, limiting its ability to meet modern budgeting requirements. While the system has been successfully implemented, it lacks integration with key fiscal reporting and budgeting functions.

Public Sector Payroll

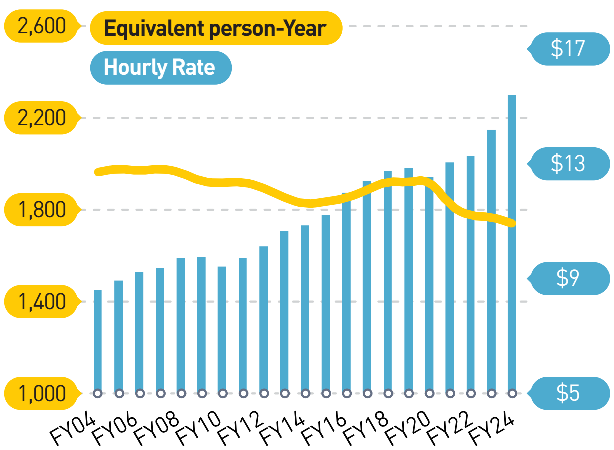
Palau has maintained good control over civil service size and payroll costs. An essential component of PFM and fiscal policy is the control of payroll costs. Between FY04 and FY19, the number of Full-Time Equivalents (FTEs) decreased slightly by 0.2 percent per year, while hourly pay rates (including benefits) rose from $8.60 to $12.84, an average annual growth of 2.7 percent, see Figure 10. However, adjusted for inflation, real government wages stagnated, declining by an average of 0.5 percent. The global financial crisis in 2008–2009 led to reductions in both employment and wage rates, including cuts in working hours and overtime.

Despite two across-the-board increases of 75¢ each, real civil service wages fell by 4.1 percent. The COVID-19 era presented different challenges. FTEs declined by 10.2 percent between FY20 and FY24, reaching the lowest levels recorded. This was partly due to increased out-migration, as Palau's borders remained closed for an extended period during COVID-19, while labor shortages in the U.S. led to active recruitment in Palau. The civil service experienced contraction, although it remains unclear whether this trend will continue. During this period, hourly wages increased by 22.7 percent due to two 75¢ wage increases in FY23 and FY24. However, inflation during this period rose by 28 percent, meaning that despite the wage increases, real wages fell by 4.1 percent.

The IMF provides technical assistance (TA) for wage bill analysis and enhancing civil service efficiency. In November 2023 and again in May 2024, the IMF provided TA to help Palau analyze and forecast its wage bill. The analytical tool developed breaks down the factors driving the government's wage bill to improve civil service effectiveness, recruitment, and compensation. The model considers remuneration rates, workforce numbers, age cohorts, functions (e.g., education, health), reasons for departure, and more. Preliminary analysis indicated that Palau's civil service suffers from wage compression, where the wage gap between higher and lower earners is reduced, which discourages retention and recruitment. The model also highlighted the potential of recruiting foreign workers to address labor shortages.

Figure 10: Government payroll: full-time equivalents and hourly wages

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



6. State-Owned Enterprise Reform

The SOE Sector

The SOE sector in Palau is small but poses significant fiscal risks. Compared to other Micronesian economies, Palau's state-owned enterprise (SOE) sector is relatively smaller. The four major SOEs are the Palau National Communications Corporation (PNCC), the Palau Public Utilities Corporation (PPUC), the National Development Bank of Palau (NDBP), and the more recent Belau Submarine Cable Company (BSCC). Airport operations and the Post Office are managed as government departments, while the port is owned by Koror State and operated by a private company under a 25-year concession. The operation and upgrade of the airport terminal have been restructured under a joint venture involving the government, JICA, and a private Japanese corporation.

The SOE sector has been inefficient, especially in the power and water sectors. A 2017 assessment[13] revealed several weaknesses in the management and operations of Palau's SOEs. The report identified the absence of a legal framework to support commercial operations, leading to underperformance. Board members were frequently political appointees, often lacking relevant experience. SOEs were not required to operate on a commercial basis, and pricing was set at "affordable" rather than market

13 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.

rates. As a result, maintenance was often deferred, leading to service disruptions and higher long-term capital costs.

Legislation to support the commercial operation of SOEs has not yet been enacted. In 2014, the president issued an SOE policy aimed at enabling SOEs to operate commercially and recover all costs, including capital. The policy included principles such as specifying community service obligations (CSOs), appointing qualified directors (excluding political appointees), preparing annual business plans, and implementing performance monitoring. Although this policy was included in the administration's Fiscal Strategy, draft legislation to formalize it has not yet been submitted to the OEK. Replacing political involvement with a rules-based, efficient system grounded in best practices will be challenging.

Reforms in the utilities sector

Power Generation and Distribution

PPUC engages with the ADB for a policy-based loan to avoid insolvency. The Palau Public Utilities Corporation (PPUC) is responsible for power generation and distribution, as well as water and wastewater services since 2013. Until recently, PPUC operated on a cash-flow basis that was well below cost-recovery levels, leading to weak management results and deferred maintenance of the plant. By 2020, PPUC was reported to be insolvent. To address the emerging crisis, the ADB was engaged to support a series of reforms through the Palau Public Utilities Corporation Reform Program, a policy-based loan[14]. Subprogram 1 of the loan, which provided $5 million in financing, focused on four key areas: (i) tariff reform and adoption of cost recovery measures, including subsidies for low-income households, (ii) financial management improvements, (iii) corporate governance reforms, and (iv) market access for private sector participation in renewable energy development.

PPUC petitions for a new cost-recovery tariff, which is approved by the Palau Energy and Water Administration. While there were delays in processing Subprogram 1 due to compliance issues in corporate governance, the program was launched in 2021. The Palau Energy and Water Administration (PEWA), the regulatory body overseeing energy and water services, approved guidelines for (i) a tariff petition procedure by PPUC and (ii) a method for estimating full cost-recovery electricity tariffs. Subsequently, PPUC's petition for a cost-recovery tariff was adopted and approved by PEWA.

Palau executes its first public-private partnership for solar voltaic power but has yet to achieve its full potential. A Power Purchase Agreement (PPA) was established between PPUC and Solar Pacific, a private company, for the supply of solar voltaic electricity. The project received $22 million in funding through the Australian Infrastructure Financing Facility of the Pacific (AIFFP), with $18 million provided as a loan and $4 million as grants. This PPP was Palau's first of its kind and plays a key role in reducing the country's reliance on fossil fuels. Initially, the project was designed to replace 20 percent of Palau's power needs. However, while the solar power generation has met expectations, issues with grid integration have limited its effectiveness.

Grid upgrades and further investments are needed to fully realize the potential of solar energy. A series of upgrades are required before the new solar system can operate at full capacity. Currently, JICA is funding two major power projects: $17 million for grid upgrades and $15 million for grid transition. Additionally, further funding is needed for battery storage systems to supply power during the night and adverse weather conditions. While solar energy has significant potential for helping Palau achieve its renewable energy goals,

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

The SOE sector has underperformed, but full-cost-recovery tariffs in power, water, and wastewater should lead to a sustainable future.

complementary investments are essential to meet these targets.

The current electricity subsidy for residential customers is inefficient and encourages carbon emissions. Due to the large increase in global fuel prices in 2022, the OEK approved a $2.55 million subsidy in the FY22 budget to offset rising electricity costs for consumers. In the FY23-FY25 budgets, the subsidy was reduced to $1.6 million and limited to residential customers, providing 10¢ per kWh for the first 500 units consumed. However, this across-the-board subsidy is inefficient, as it benefits households outside the intended low-income group and encourages the use of carbon-emitting processes. The recommended policy is to target subsidies to low-income and disadvantaged households, allowing them to allocate the benefits where needed most. Palau should establish an effective social welfare program to properly identify and assist low-income households.

Water and wastewater services

Water and wastewater services have operated at a significant loss and well below full cost recovery. In 2010, Palau initiated the Water Sector Improvement Program (WSIP) with $15 million in funding from the ADB. The program aimed to: (i) establish a legal and policy framework for water sector improvements, (ii) create an independent corporation for enhanced water services, (iii) achieve full cost recovery, and (iv) provide effective public consultation. Although the ADB recommended that water services be managed as a new SOE, the delivery of water services—previously handled by a government department—was merged with PPUC. This merger was partly intended to avoid cross-subsidization, but while direct cross-subsidization was prohibited, Water and Wastewater Operations (WWO) failed to pay for power, effectively resulting in a transfer. Although the WSIP program included increases in water tariffs, they were insufficient to achieve full cost recovery, and PPUC continued to record large operating losses. Based on unaudited FY23 data, operating revenues covered only 57 percent of total operating costs.

Subprogram 2 of the PPUC policy-based loan (PBL) focused on achieving full cost recovery for water services. In mid-2022, the original ADB-funded PPUC Reform Program was extended through Subprogram 2, which specifically focused on WWO. This policy-based loan, which provided an additional $5 million in funding, was intended to improve water services while continuing support for corporate and financial management. Key reforms included: (i) the adoption of cost recovery measures for WWO, along with a system of subsidies for low-income households, (ii) enhanced financial management, (iii) improved corporate governance incorporating many of the reforms outlined in the SOE policy framework, and (iv) the establishment of procedures for public-private partnerships (PPPs) to build market confidence that power purchase agreements (PPAs) are based on transparent and justifiable criteria.

A new full cost recovery tariff was implemented for WWO, with large increases for residential customers, offset by OEK subsidies. In 2023, PPUC petitioned PEWA for the adoption of a full cost recovery tariff for the water sector, and public hearings were held. While the new tariff involved significant increases for residential customers, the tariffs for the commercial and government sectors remained largely unchanged. After the hearings, PEWA approved the new tariffs. However, in the FY24 budget, the OEK implemented subsidies for the residential sector similar to those provided for electricity. Specifically, the OEK legislated that the first 2,500 gallons of water would be free of charge, allocating $960,000 in the FY24 budget to cover these costs. As with the power subsidy, this policy is inefficient and lacks a targeted approach for assisting low-income households.

Additional funding is required to complete the problematic Koror-Airai Sanitation Project (KASP). The second ADB-supported program in the water and wastewater sector, the Koror-Airai Sanitation Project (KASP), initially allocated $28 million for upgrading infrastructure, including expanding capacity for the growing tourism industry. However, after years of delays and contractual issues, most of the funds have been exhausted, and the project remains incomplete. An additional $5 million is needed to finish the project.

ICT Reforms

Laying of a new fiber optic cable has significantly improved internet access in Palau. Reforms in the telecom sector have progressed with the creation of the Palau Submarine Cable Company (BSCC), an SOE established with an ADB loan to manage a new fiber-optic link to the internet backbone. Palau has partnered with the SEA-US cable project, which links Indonesia, the Philippines, Palau, and Yap to Guam, Honolulu, and the U.S. mainland. The laying of the cable was completed in 2017, and the system has now been operational for several years. Previously, Palau's ICT services were among the most expensive in the Pacific region. The introduction of the SEA-US cable represented a significant change, improving both the economic and social fabric of Palau.

The moratorium on competition in the ICT market has been extended through June 2025, with a further three-year extension under consideration. A key element of the ICT reforms was the passage of a telecom reform bill in 2017, supported by the World Bank. The law introduced competition into the market and removed the monopoly held by existing providers, including the Palau National Communications Corporation (PNCC). It also created a new regulatory body, the Bureau of Communications, under the Ministry of Infrastructure, Industries, and Commerce, responsible for regulating the sector and issuing licenses to new entrants. The law initially imposed a moratorium of up to three years on new entrants, which has since been extended through June 2025. A further three-year extension is under consideration.

Palau embarks on a second fiber project (PC2) to ensure system redundancy in case of failure. In addition to the original cable project (PC1), BSCC is working on implementing PC2, a second fiber project designed to guarantee connectivity and provide redundancy in case of a failure or break in the initial cable. The PC2 project involves a 110-km link with a large-capacity submarine optical cable that connects Southeast Asia and the U.S. mainland. The main cable system, known as the Echo subsea cable system, has been laid and is jointly owned by subsidiaries of Meta and Google. While the construction of Palau's spur to the Echo system is complete, it has yet to be spliced into the main cable system due to delays in regulatory approvals in Singapore and pending FCC approval. It is anticipated that Palau will have access to the Echo system by mid-2025. The project is financed by Japan ($8 million in loans), Australia ($7.75 million in soft loans), and U.S. Compact and other grants totaling $11.8 million.

A successful application to the RUS ReConnect program will extend fiber connectivity to homes and premises. While Palau's two fiber projects provide high-speed access to the internet, this connectivity is only available to major telecom hubs and has not yet been extended to homes and businesses. The current infrastructure relies on outdated copper systems that are insufficient for modern ICT needs. PNCC applied for a grant under the RUS ReConnect Loan and Grant Program to replace the existing copper infrastructure with fiber-to-the-home/

premises. The application was successful, with Palau awarded a $34.9 million grant. This will enable nearly all parts of the nation to have high-speed coverage. A communications engineering firm has been contracted to prepare tender documents for the project, with construction set to begin in September 2024. Most of the work will be outsourced, and project completion is expected by early 2027.

A further project to modernize Palau's mobile network will introduce 5G services. In addition to the ReConnect project, Palau has initiated a Mobile Network Modernization project with support from the U.S. Trade and Development Agency[15] (USTDA). A $870,000 grant was awarded to PNCC for technical assistance to modernize the national mobile network, expand connectivity, and prepare for 5G rollout. The technical assistance provided designs and implementation plans to replace the existing Huawei-based network with secure technology. An RFP for the project was issued in July, with tenders due by August, and the contract is expected to be awarded by November 2024. Construction is set to begin in early 2025, with completion expected by the end of the year. This will mark the first commercial deployment of Open Radio Access Network (Open RAN) technology in the Pacific Islands, allowing equipment interoperability and avoiding dependency on a single supplier. The project is funded by unused COVID-19 tracing funds ($1.9 million), the U.S. Coronavirus Capital Projects Fund ($14.2 million), and a grant from Australia ($A3.5 million).

A major policy issue in the ICT sector concerns pricing. When the original fiber optic cable was introduced, internet service prices dropped significantly. However, prices have remained high by international standards—currently at $120 per month for a 20/1 Mbps ADSL connection. A condition of the RUS $35 million grant is that internet prices be made affordable for households. International benchmarks suggest that basic internet service (25 Mbps) should cost around 2 percent of GNI per capita, which for Palau equates to about $25 per month. Achieving this price point will be challenging for PNCC.

ICT services have greatly improved, and with RUS financing for fiber-to-the-home and mobile network modernization, Palau is completing its modern IT infrastructure.

Starlink offers competitive broadband internet to remote areas at affordable prices. The recent introduction of Starlink, a network of low-orbit satellites offering high-speed internet for $90-$120 per month (25-220 Mbps), has had a significant impact in the Pacific. In the FSM, the telecom regulator has licensed the service despite opposition from local providers. In Palau, however, the regulator has banned Starlink, a move widely seen as anti-competitive. Although licensing Starlink would likely have minimal impact on PNCC's residential customer base, it could significantly affect its commercial revenues. During the implementation of the RUS fiber-to-the-home/premises project and the Mobile Network Modernization project, some justification exists for the ban. However, once these projects are complete, the moratorium on competition should be lifted, allowing Starlink and other providers to enter the Palau market if they wish to compete.

15 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.

7. The Financial Sector

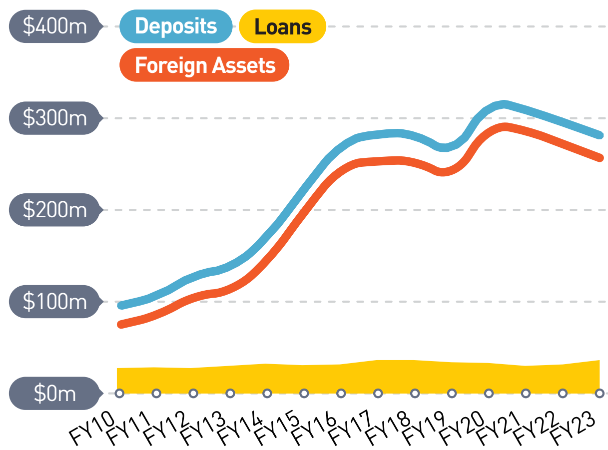
Banking

Deposits grew rapidly in Palau during the tourism boom years and surged again during COVID. The deposit base in Palau's banking system ($280.9 million in FY23) expanded significantly during the tourism boom from FY11 to FY16, driven by a booming economy, foreign direct investment, and land-lease purchases (see Figure 11). After peaking in FY15, the deposit base stagnated and contracted in FY19 due to the weakening economy. However, deposits grew rapidly across all sectors in FY20. Government deposits reached high levels, reflecting unspent COVID-related borrowing, while both the private and household sectors recorded growth in deposits despite the massive contraction of the tourism industry.

Household deposits mirrored trends observed in other countries during the pandemic, as unemployment benefits and limited consumption opportunities led to increased savings. However, from FY21 through FY23, the deposit base contracted as institutions ran down their COVID-era savings. Household deposits fell by 6 percent, though business deposits remained largely stagnant.

The national government built reserves during COVID, while Koror State's deposits fell significantly. Government deposits in the Palau banking system decreased by $16 million between FY20 and FY24 (a 30 percent drop), but this decline should not be taken as a reflection of the overall fiscal outcome. The

Figure 11: Commercial bank deposits, lending and net foreign assets
Commercial bank lending remains weak with funds invested offshore; deposit growth picked up during COVID, but as since fallen



government took advantage of rising Fed funds rates by placing significant funds offshore in Time Certificates of Deposit (TCDs). Over this period, the government's cash flow position strengthened considerably.

Prior to COVID, Koror State had built up reserves of $26 million, providing a critical buffer to maintain state operations when its primary revenue source—tourism—dried up during the pandemic. By the end of FY23, these reserves had dwindled to $9 million. Despite a modest recovery in tourism, Koror State sought a $10 million loan from the national government to rebuild its depleted reserves.

Private sector credit remained low during COVID, as businesses struggled with fixed costs and diminished sales. Despite the rapid growth in deposits, lending to the private sector remained weak. In FY19, lending to the private sector totaled $33.7 million, only 12.8 percent of the deposit base, likely the lowest rate in the region. Even as the tourism sector suffered during the pandemic, credit to tourism operators remained subdued, reflecting caution from both lenders and borrowers. Private sector credit contracted further in FY21 but showed slight improvement by FY23, with the loans-to-deposits ratio rising to 12.9 percent. The gap between the large deposit base and low lending levels has resulted in $257 million in commercial bank foreign assets being invested offshore by FY23.

Structural weaknesses have hindered commercial lending in Palau, though tax reforms may enable greater access to credit. The low rate of domestic lending reflects high perceived risk and a persistent lack of "bankable projects." Businesses in Palau often struggle to prepare credible business plans and financial statements, and the lack of collateral, limited ability of foreign banks to use land as security, and absence of a credit bureau have further hampered financial sector development. Additionally, the current usury law, which caps lending rates, restricts viable commercial lending. The law sets a limit of 4 percent above the prime rate, which, at present, translates to a cap of 12.5 percent.[16] By comparison, lending rates to small and medium-sized enterprises (SMEs) in the United States range from 11.5 to 16.5 percent.

Given the higher risk environment in Palau, it is unsurprising that commercial bank lending remains weak. The recent tax reform, which requires businesses to prepare financial statements for tax filings, may help generate the necessary financial data to support loan applications. However, in the absence of sufficient domestic lending opportunities, foreign commercial banks regulated by the FDIC have opted to invest their assets in less risky and more secure offshore markets.

National Development Bank of Palau

The NDBP plays a significant role in Palau's financial sector. Established in 1982, the National Development Bank of Palau (NDBP) is wholly owned by the government. It plays a more substantial role in Palau's financial system than similar institutions in most Pacific Island economies, largely due to the modest role of commercial banks. The size of its lending portfolio is comparable to that of commercial banks. Six members of the NDBP Board are appointed by the President of Palau with the advice and consent of the OEK. The remaining board member is also the CEO, selected by the Board.

A new CEO was recently appointed, and while the Bank's objectives remain the same, there is now a focused emphasis on:

1. **Financial market diversification** – addressing systemic weaknesses in the financial sector, such as the limited range of financial products and poor lending performance by commercial banks.
2. **Development** – supporting business incubation and the growth of SMEs.
3. **Industrial policy** – encouraging diversification in non-traditional sectors of the economy.

While housing loans have grown dramatically, business credit has stagnated. In FY23, unaudited data indicated that the Bank's loan portfolio amounted to $33.5 million. Of this, 70 percent ($23.5 million) was allocated to homeownership loans, while $7.4 million (22 percent) supported the commercial sector. Smaller projects in agriculture ($1.0 million), fisheries ($0.5 million), and home solar projects ($1.2 million) were also funded. Housing loans have nearly doubled from $12.2 million in FY18 to the current $23.5 million, while lending to commercial activities stagnated, particularly during the COVID period. Despite the significant social need for increased housing in Palau, NDBP's role in financing the commercial sector has been relatively limited.

The financial position of NDBP remains strong, reflecting sound management. Approximately 26 percent of its assets are held in cash or cash equivalents, with $33.5

16 https://www.bankrate.com/loans/small-business/sba-loan-rates/

million (72 percent) provided in lending to the Bank's clients. Non-performing loans rose to 15 percent during COVID but have since dropped to 5.7 percent after write-offs. NDBP has borrowed funds from RoPSSA ($1 million), on-lent loans from Taiwan guaranteed by the government for agribusiness ($3.6 million) and Women and Youth Entrepreneurs and MSMEs ($4.9 million). NDBP also participated in the ADB solar project ($2.5 million) and managed several other minor debt liabilities.

During COVID, NDBP received $1.5 million in grants in FY20 and $0.5 million in FY22 to support the private sector through the CROSS Act. Additionally, NDBP was the beneficiary of $9 million in government grants, which had originally been intended as a loan to be shared with the Palau Housing Authority but was converted into a grant by the OEK.

NDBP considers entering a joint venture with state governments to expand housing availability. NDBP is developing a new project in partnership with state governments to support housing subdivision and development. A $15 million loan from Saudi Arabia's Public Investment Fund is under consideration. State governments would provide land access, and NDBP would provide funds for housing development. Proceeds from housing sales or rentals would be used to repay the loan. However, issues remain regarding the lender's request for exemptions from Palau's open government law and local taxation. The loan, currently pending approval in the OEK, would be denominated in Saudi riyals, presenting potential exchange rate risks. The loan terms include a fixed 2.5 percent interest rate with a 5-year grace period and 15-year repayment.

The Development Bank plays a key role in home loans and SME financing and is implementing new initiatives.

A major issue confronting NDBP is deposit taking. The Bank is authorized to accept deposits but has yet to do so. Several issues arise with deposit-taking: the majority of NDBP's portfolio consists of long-term assets (68 percent of loans have durations over three years), whereas deposits are typically short-term and highly liquid. Although the Bank could structure its portfolio to accept large institutional deposits, its current structure is not well-suited for deposit-taking.

Moreover, NDBP would need to acquire a banking license from the Financial Institutions Commission (FIC). This would involve meeting regulatory requirements that could conflict with the Bank's developmental and nonprofit mission. The process of obtaining a license and adhering to deposit-taking regulations could fundamentally alter the Bank's structure and operations. In March 2024, NDBP applied for a banking license. The FIC must assess the competence of the Board and ensure the Bank's procedures align with regulatory requirements before proceeding. Additionally, NDBP is seeking reform of the NDBP Act to align with FIC requirements and provide a sovereign guarantee if the Bank takes deposits or issues debt instruments. The Bank is also looking to come under the provisions of the Usury Law.

Under new management, NDBP is adopting a more proactive approach to developing both the economy and the financial sector. These new initiatives are welcome, provided they are pursued cautiously to avoid undermining the Bank's core traditional functions.

Financial sector digital innovations

Palau adopts fintech to diversify its economy. Palau has recently embraced financial technology (fintech) through three innovative projects: (i) the creation of a Palau Stable Coin (PSC), (ii) the establishment of a digital residency program, and (iii) the issuance of savings bonds using blockchain technology.

New Fintech innovations have raised concerns and will require enhanced regulatory capacity.

These projects are aimed at diversifying 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:[17]

> *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.*

The PSC is intended to function as a central bank digital currency (CBDC) and serve as legal tender in Palau. While a pilot project was conducted over a three-month period with 168 government employees spending 100 PSC at three participating retailers, the project has not yet been adopted into law. Both the volunteers and retailers are reported to have responded positively to their experience using the PSC.

Challenges remain before a full launch of the PSC. Many regulatory, capacity, and institutional issues must be resolved before the PSC can be fully implemented. No commercial bank operating in Palau, or any US-based financial institution, has been willing to accept PSC transactions or serve as an exchange intermediary. In the absence of a financial institution, the Ministry of Finance would need to fulfill this role—something it is not equipped to do. Additionally, Palau's regulatory bodies, particularly the Financial Institutions Commission, lack the capacity and expertise required to oversee the PSC and ensure compliance with AML/CFT and KYC standards. Although still an active government project, momentum for the PSC has slowed, and the project appears to be on the back burner.

Digital Residence

Palau enacts the Digital Residency Program in November 2021[18]. Modeled on Estonia's digital residency program, Palau's Digital Residency Program allows individuals to establish a digital identity, but unlike Estonia's program, it does not confer legal residency rights. However, digital residents are now entitled to reside in Palau for up to 180 days. Palau's financial institutions do not accept digital residency as proof of identity for opening bank accounts, and it cannot be used to obtain a local driver's license.

A Digital Residency Office was established within the Ministry of Finance. The office oversees the program and contracts service providers for its operations. Each digital residency application requires a $50 fee and includes KYC information for AML/CFT compliance. Upon approval, the resident is issued an ID card containing personal details, such as legal name, date of birth, and a photo. The digital resident pays $100 annually, with 5- and 10-year subscriptions also available.

Additional services for digital residents have been introduced. Regulations now allow digital residents to lease mailboxes from Palau's Postal Service, which can receive and forward mail. However, approval from the postmaster general and the US Postal Service is required before PO Boxes can be issued to digital

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

18 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.

residents. A virtual phone number service is also under consideration.

The digital residency program has raised close to $4 million, but renewal rates suggest declining interest. As of a recent fintech conference, Palau had 23,000 digital residents, with fees collected increasing from $0.1 million in 2022 to $2.5 million in 2023. However, only 2,045 residents have renewed their licenses, suggesting limited ongoing utility of the program. Despite this, the program has generated nearly $4 million in revenue for the government.

Concerns have arisen around mail forwarding and the name change provision. The ability to forward mail using a US zip code raises concerns about bypassing US regulations, while the provision for name changes in the program could obscure beneficial ownership. During recent IMF Article IV consultations, the IMF Board cautioned Palau to strengthen its regulatory frameworks before further expanding fintech initiatives. They emphasized the need to close existing gaps in regulation and governance, and to enhance the AML/CFT framework, concluding:[19]

> *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.*

Savings Bonds

The Ministry of Finance is developing a Savings Bond program using blockchain technology. Palau's Ministry of Finance has partnered with Soramitsu, a Japanese fintech firm, to develop a digital savings bond system. This system will be built on the Hyperledger Iroha blockchain platform, which is designed for business and financial applications. A mobile app is under development to support the program, allowing small-denomination savings bonds to be held in digital wallets. While the specific terms and interest rates of the bonds are still being determined, the use of funds and details of the issuance process are also yet to be established.

Social Security Sustainability

An actuarial evaluation based on FY20 data projected fund collapse by FY42. An earlier actuarial assessment[20] at the end of FY18 had presented a relatively optimistic outlook for RoPSSA, with a funded ratio of 35.4 percent and a stable cash-flow balance projected over the medium to long term. However, a subsequent evaluation[21] using FY20 data indicated a different scenario. The funded ratio had fallen to 20.3 percent, and the fund was now projected to collapse by FY42. The deterioration was attributed primarily to changes in assumptions, including a lower investment return (accounting for 9 percent of the difference), increased longevity (3 percent), and other factors (3 percent).

Supplemental benefits further erode the viability of RoPSSA, advancing the projected fund collapse to FY35. In addition to these changes, prior evaluations had not factored in three supplemental benefits of $50 per month awarded to pensioners. The first was granted in October 2014, the second in October 2017, and the third in April 2020. While the second award was absorbed into the system and accompanied by an increase in the contribution rate from 6 to 7 percent, the other two

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

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

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

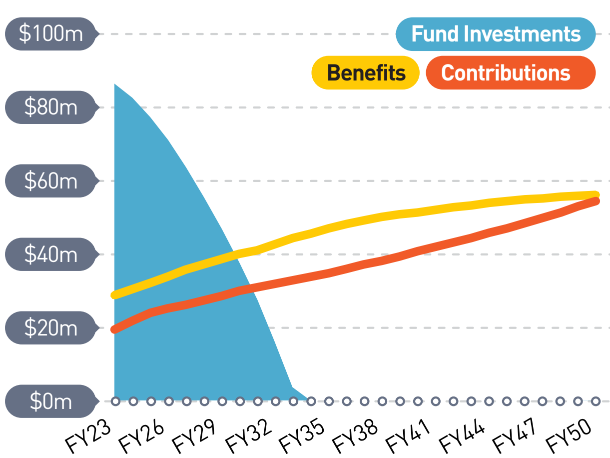
benefits were unfunded and required annual appropriations from the national treasury.

The first two supplements were awarded to all pensioners, both current and future, while the third was granted only to existing pensioners and the disabled. Once these supplemental benefits were included as liabilities, the FY20 evaluation showed the funded ratio had fallen to 17.5 percent, and the system was projected to collapse by FY35. Figure 12 illustrates that in FY35, pensioners would receive only 74¢ on the dollar. Furthermore, the government would be obligated to fill the gap, estimated at $13 million, or 2.2 percent of projected PGST revenue at the time.

A participatory process was initiated to develop reforms aimed at placing RoPSSA on a sustainable path. As part of the ADB RISES program, which provided budget support to Palau during COVID, a condition was included requiring an evaluation of the social security system alongside reform recommendations. After the FY20 evaluation, a pension working group was formed to develop suitable reform options for broader discussion. In November 2021, a national consultative process was held, attended by key members of Palau's

Figure 12: Social Security without reform

Without reform, by FY33 pensioners would only receive $0.74 on the dollar.



leadership, private sector representatives, and other stakeholders. The group developed a set of reforms, which were consolidated into a consensus during the plenary session.

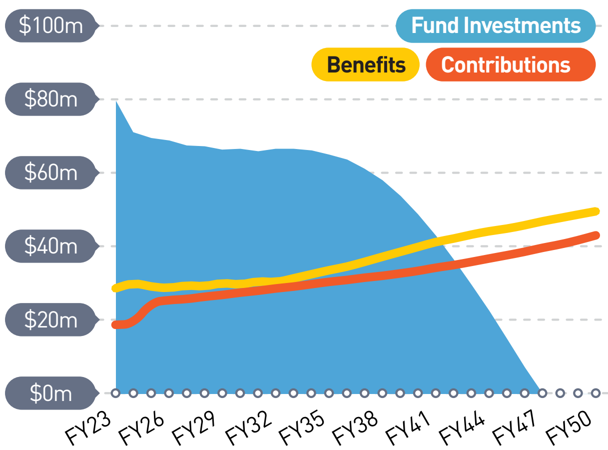
The OEK has yet to act on a presidential bill that proposes reforms developed during the participatory workshop and reviewed by the IMF. The consensus recommendations included increasing the contribution rate from 7 percent to 9 percent, raising the retirement age to 65, and ensuring full benefits after 35 years of service. Pension benefits would be adjusted for inflation but would rise slightly less than the full increase in average wage rates. It was also agreed that the social security system should operate independently, without subsidies.

IMF recommends prompt enactment of the SS reform bill. Younger participants emphasized that increasing the contribution rate was key to the system's financial stability, although it was noted this would increase costs for the private sector. These proposals, along with adjustments to spousal and dependent benefits, were drafted into a reform bill and transmitted to the OEK for consideration. However, no action has been taken by the OEK to date. During recent IMF Article IV consultations, the IMF reviewed the proposed reforms and, in a hearing before the Ways and Means Committee, recommended their prompt enactment. Figure 13 shows that with these reforms, the stability of the social security system should be assured for many years, although further adjustments may be needed depending on financial market and demographic factors.

Civil Service Pension Plan

Milliman report indicates CSPP is at imminent risk of collapse between 2023 and 2025. In 2019, the government of Palau commissioned an actuarial assessment of the Civil Service Pension Plan (CSPP) through the Milliman

Figure 13: Social Security with reform
With reform, SS remains stable for 15 years before further adjustments might be needed.



report.[22] The report found that while the original design of the Plan was sufficient to support the accrual of benefits in the long term, the decision to award benefits to employees for service prior to the start of contributions created a persistent funding shortfall. As a result, the Fund has always required significant additional funding. The Milliman report indicated that the ratio of assets to liabilities was only 16 percent, with the Fund projected to collapse between 2023 and 2025.

Milliman report proposed a series of reforms, none of which made a significant contribution to sustainability. Several reform options were considered, including: (i) extending the retirement age to 65 over 25 years, (ii) reducing the 2 percent crediting ratio to 1 percent, (iii) establishing a defined contribution (DC) scheme with private sector participation, and (iv) providing an additional government subvention of $2 million per annum. The reform package assumed that pensioners in retirement or over age 55 would continue receiving pensions at their current rate. However, even with these changes, the reforms had little effect on the long-term sustainability of the CSPP, only delaying the collapse date to 2030 at best.

A recent actuarial evaluation of Social Security shows a risk of collapse, but proposed reforms could ensure long-term financial sustainability.

Callund report affirms Milliman report, with collapse now projected during FY26. In December 2023, a new actuarial assessment of the CSPP was conducted, known as the Callund report.[23] The findings confirmed the conclusions of the Milliman report, stating that without reforms or a cash injection, the CSPP would collapse by FY26. The report indicated that pensioners would only receive 57¢ on the dollar without additional government support (see Figure 14). The Callund assessment also revealed that CSPP had an accrued pension liability of $232.9 million, with plan assets of only $23.5 million—representing a mere 10 percent of liabilities. Although the OEK transferred $13.3 million to the CSPP over the FY19-FY24 budgets to provide temporary relief, these funds have not altered the underlying trajectory toward collapse.

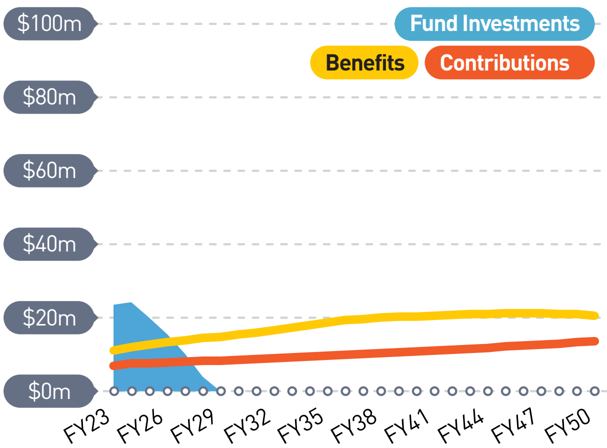
Reform Taskforce adopts objective to find a long-term sustainable solution. Following the pension reforms initiated during the ADB RISES program, the ADB provided further technical assistance (TA) to maintain momentum. The pension reform task force was directed to collaborate with TA consultants to develop solutions for the Civil Service Pension Plan (CSPP). Given the imminent collapse of the CSPP and the limited impact of earlier reforms proposed in the Milliman report, a long-term, sustainable solution was sought. The task force recommended terminating the

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

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

Figure 14: Civil Service Pension Plan without reform

Without reform, by FY27 civil servants would only receive $0.57 on the dollar.



existing Defined Benefit (DB) scheme, with future contributions directed to a new Defined Contribution (DC) scheme. Existing pensioners would continue receiving benefits, while current employees with accrued pension rights would either receive a cash payout or modified future benefits.

Participatory workshop crafts reforms that provide a long-term sustainable solution. In November 2022, a participatory workshop similar to that used for RoPSSA was convened to explore sustainable solutions for meeting future pension obligations. The workshop was divided into two groups, each tasked with developing equitable and financially viable reform options. Differences between the groups were resolved in a plenary session, and the following reforms were adopted:

1. The normal retirement age would be set at 63 years.
2. Unvested civil servants with less than five years of service would receive a cash payout equivalent to their contributions (without earnings), impacting 1,044 members.
3. Vested civil servants with five to 15 years of service would retain their existing pension rights, with pensions based on the average of their three highest salary years at the time of reform, affecting 1,229 members.
4. Vested civil servants with more than 15 years of service would see their crediting rate reduced from 2 percent to 1.5 percent, based on the average of their three highest salary years at the time of reform, impacting 883 members.
5. Current retirees would not be subject to the reforms.
6. The new DC scheme would require a 6 percent employee contribution and a 3 percent employer contribution. The remaining 3 percent difference from the old scheme would support the legacy DB scheme.
7. Two percent of the new PGST (set at 10 percent) would be allocated to fund the legacy DB scheme.

Financing the closure of the DB scheme will involve a long-term process requiring government funding until all liabilities are met. Figure 15 illustrates the projected closure of the DB scheme. Pensions will continue to be paid to eligible civil servants under the old DB scheme, albeit with some reductions. The payment needs are expected to remain stable until FY37, after which they will gradually decline. To cover the costs of the DB scheme's closure, three revenue streams are proposed: (i) an allocation from PGST collections (which can now be reduced to 1.5 percent due to the buoyancy of the tax), (ii) the 3 percent payroll contribution, and (iii) a 12.5 percent allocation from the PPEF to support CSPP. These sources will increase until FY46, when further funding will no longer be required, as sufficient reserves will have accumulated to cover all remaining benefit claims. CSPP investments are expected to decline until FY28, then begin rising until FY44, at which point they should

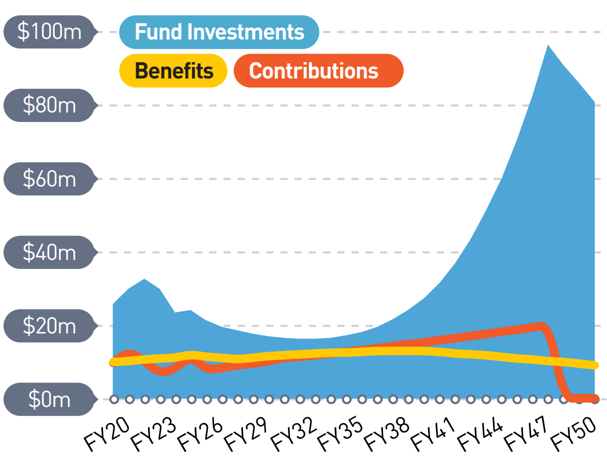
The CSPP is also at risk of imminent collapse, but reforms have been designed to close the DB scheme and introduce a new DC scheme.

be sufficient to cover remaining liabilities. After that, investments will gradually decrease as the number of remaining DB scheme pensioners diminishes.

Draft legislation will be prepared for submission to the OEK in October 2024 but is unlikely to be actively considered until after the upcoming elections and the formation of a new OEK. Since the CSPP participatory workshop, the pension task force has finalized the design of the new DC scheme. At the November 2023 Development Symposium, a presentation outlined the status of CSPP and the new DC scheme's structure. Several anomalies in the CSPP reforms were identified: (i) the retirement age difference between SS (65) and CSPP (63), (ii) discrepancies in benefits for employees with five to 15 years of service compared to those with more than 15 years, and (iii) the relative disadvantage for retirees with over 15 years of service.

Two significant developments have since occurred: (i) the introduction of the PGST, which has generated higher-than-anticipated tax revenue, reducing the need for additional funding, and (ii) substantial inflation and wage increases for civil servants. In September 2024, further information and planning sessions took place to prepare draft legislation for submission to the OEK in October. While it is not expected that the OEK will actively consider the bill before the November election, the draft legislation will be available for immediate discussion once the new OEK is formed in early 2025.

Figure 15: CSPP reform: DB closure contributions and benefits
Benefits gradually decline in the long term, funded by PGST, payroll, and PPEF; need for additional revenue ends in FY46.



8. Private Sector Development[24]

Reforms in the private sector, including new Corporation and Arbitration laws, will create a more secure environment for business development.

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.[25] However, the survey provided a useful broad indicator and yardstick for assessing the attractiveness of the business environment. The 2020 survey indicated Palau ranked in the bottom third, suggesting room for improvement. Palau's ranking of 145 out of 190 countries, while better than the FSM (158) and RMI (153), was significantly lower than most South Pacific nations. Palau scored poorly in several areas, including starting a business, dealing with construction permits, getting electricity, protecting investors, trading across borders, and resolving bankruptcy.

World Bank to replace Doing Business Survey with a new survey, B-READY. Although the discontinuation of the survey was unfortunate, it is expected to be replaced in October by a new survey called B-READY, which will measure the business and investment climate of 180 countries annually. This replacement survey will allow Palau to compare its performance with peers and form the basis 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 ownership is restricted to Palauan citizens and is held by individuals, clans, and the government. A specific challenge arises because foreign-owned financial institutions cannot secure mortgages on land or land leases in case of default, as they are not entitled to ownership. As a result, the only institution that can issue mortgages against land or land leases is the National Development Bank of Palau. Although lease terms can be issued for up to 99 years, which is generally not an issue, the lack of effective land-use planning in Palau remains a significant weakness. This is particularly problematic in a tourism-based economy, where land-use planning is crucial to implementing policies and achieving high-value tourism goals.

The Regulatory Environment

The reformed Companies Act has been passed by the OEK, and the establishment of an electronic Corporations Registry is underway. Palau's regulatory framework is shaped by its constitution, customary law, and U.S. common law, but lacks a Uniform Commercial Code

24 This Chapter is largely similar to that in the 2022 and 2023 Economic Review, but the material remains relevant and is repeated in the current version.

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

(UCC) or equivalent. An ADB Private Sector Assessment highlighted that the previous Companies Act was outdated and ineffective for modern commerce, with a poorly functioning company registry. As part of the ADB RISES program, Palau developed new legislation, culminating in the passage of a reformed Companies Bill in September 2021, designed to create a modern electronic framework. The reforms were supported by the Private Sector Development Initiative (PSDI), and the key features of the new law include:

1. A standardized set of forms for online filing by corporations, streamlining the process and eliminating outdated bureaucratic formalities that caused delays in incorporation.
2. Compliance with global anti-money laundering and counter-terrorism financing (AML/CFT) obligations.
3. An online public registry providing current, accurate corporate information.
4. More robust provisions for foreign corporations seeking to do business in Palau.
5. A new framework for classifying nonprofits into (i) charitable organizations for public good, (ii) religious organizations, and (iii) member-benefit entities like chambers of commerce.

Creation of a centralized "one-stop shop" will assist in streamlining private sector applications to operate businesses. Numerous permits, licenses, and approvals are currently required for businesses in Palau. Centralizing these functions into a "one-stop shop," a method widely adopted in other jurisdictions, is expected to reduce this complexity. The former finance buildings in Koror are being redeveloped for this purpose. Integrating the new electronic corporate registry with a consolidated administrative office for different approval agencies will greatly simplify the process. Additionally, Palau currently lacks a bankruptcy statute, which neither protects debtors nor creditors. The absence of an efficient system for discharging debts and the lengthy, complex proof-of-debt process further hinders the business environment.

Palau accedes to the New York Convention on the Recognition and Enforcement of Arbitral Awards. This accession provides Palau with access to a recognized mechanism for neutral dispute resolution and the enforcement of arbitral awards in the courts of other signatory countries. In April 2021, Palau enacted the International Arbitration Law, enabling commercial arbitration between local and foreign parties who agree to arbitration in writing. The law outlines the conduct of arbitration in Palau and defines its relationship with Palau's court system. These reforms, supported by PSDI, were complemented by stakeholder information sessions involving the business, legal, and judicial communities.

Foreign Direct Investment

Palau operates an outdated foreign-investment-board model, imposing numerous bureaucratic restrictions on FDI. The Foreign Investment Act was amended in March 2016 to address the issue of "front" businesses, where Palauan-owned companies are operated by noncitizens. The law gave the board broader powers to address this issue. However, despite these enhanced powers, the prevalence of front businesses remains unchanged, and the Act has not improved the quality or quantity of foreign investment. The stricter regulations appear to have exacerbated issues, restricting the introduction of modern, efficient legislation. A more balanced approach with better monitoring could prove more beneficial than the current ineffective regulations.

Private Public Partnerships (PPP)

Designation as a high-income nation requires Palau to explore new avenues for

A Private Public Partnership policy and framework will provide crucial financing for infrastructure projects and their maintenance.

infrastructure financing. Historically, Palau has relied on government funding, bilateral aid, and multilateral loans for public infrastructure projects, including utilities managed by state-owned enterprises (SOEs). However, as a high-income nation, Palau must develop alternative mechanisms for financing and operating its infrastructure. In response, Palau developed a PPP policy statement with PSDI's support. The adoption of this policy by the president was a key element of the RISES program.

A new PPP unit will be created within the Ministry of Finance to identify and develop PPP projects. While formally established, the unit is not yet operational. Its role will include developing a PPP framework to guide project development and procurement. The PPP unit will work alongside the debt management unit, ensuring alignment with the Fiscal Responsibility Framework. Once potential PPP projects are identified, they will be reviewed by a ministerial PPP project committee, followed by feasibility assessments. Approved projects will then proceed to the president and the OEK for final approval. The PPP unit will also monitor project delivery to ensure compliance with agreed terms.

9. Compact Renewal

Background

The second Compact Review was agreed upon by the US and Palau in May 2023 and passed by the US Congress in March 2024. 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 a referendum in 1993. The Compact, which became effective in 1995 for a 15-year period, provided annual economic assistance grants and established a Compact Trust Fund, known in Palau as the COFA Fund. The original agreement included provisions for reviews in the 15th, 30th, and 40th years. The first review (C-10) was completed in September 2010, extending the economic assistance grants and adding funds to the COFA Fund to address overly optimistic original projections. However, while C-10 was submitted to Congress for approval, it was not finally approved until 2018, eight years later. In May 2023, the second Compact Review (C-23) was completed, and a 20-year extension for FY24-FY43 was agreed upon. C-23 was approved by Congress and signed into law in March 2024.

Compact Review Agreement 2023

C-23 outlines key objectives and commitments made by Palau. The preamble to the agreement highlights several important aspects that will be part of the annual review process. These include Palau's progress in adopting the Fiscal Responsibility and Debt

Management Act, the impact of COVID on the economy, challenges related to climate change and sea-level rise, and Palau's commitment to long-term development planning to ensure stability and self-reliance.

Key features of C-23 include:

Annual Economic Assistance

- Annual grants of $20 million for operations, allocated for education, health, climate adaptation, the environment, justice administration, public safety, and audit-related expenses. A 2 percent annual adjustor replaces inflation indexation.
- $5 million in infrastructure grants, with a 2 percent adjustor, allocated on a project-by-project basis for projects identified in the National Infrastructure Plan.
- $5 million in infrastructure maintenance grants, with a 2 percent adjustor, for projects originally constructed by the US or Taiwan, subject to mutual agreement.
- A clause allows for the consideration of continued annual assistance after FY43, limited to the $20 million operational grants, excluding infrastructure and maintenance.

Fiscal Consolidation

- Six annual grants of $10 million, starting in FY24, for fiscal consolidation of debt incurred before April 1, 2023. Funds may be used to repay debt owed to the ADB or Taiwan, subject to US approval.

> *The 2023 Amended Compact introduces significant new initiatives and grant streams.*

The COFA Trust Fund

- Two tranches of $50 million are to be deposited into the Palau COFA Trust Fund. After the first tranche, the Fund stood at $355 million as of June 2024.
- Withdrawals of 4 percent or $15 million, whichever is greater (based on a 3-year moving average), are permitted. These funds can only be used for education, health, climate adaptation, the environment, justice, and public safety.
- Under extraordinary circumstances, withdrawals of up to $5 million are allowed annually between FY24 and FY26, with similar provisions extending beyond FY26.

Fiscal Management

Palau is required to continue fiscal reforms and take into consideration recommendations from the IMF, ADB, PFTAC, and the US government. Palau must also adhere to the principles in the Fiscal Responsibility and Debt Management Act.

Federal Programs and Services

The US will continue providing access to federal programs and services as agreed in the original Compact. Other programs not included in the original agreement but available during C-10 will continue to be provided.

Economic Advisory Group

The Economic Advisory Group (EAG), established under C-10, will continue its role

under C-23 with the objective of supporting Palau's economic growth and sustainability by providing recommendations on economic, financial, and fiscal management. The EAG is required to meet twice a year and submit a report to both parties by May 1 each year. Although the EAG was initially delayed and not organized until 2022, it held its first meeting in Palau in August 2022, followed by a virtual meeting in December 2022. The group met again in Palau in August 2023, with another visit to Palau in September 2024.

Annual Economic Consultations

C-23 mandates annual bilateral meetings to be held before August 30 each year. Key features of these meetings 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.

After a prolonged absence, bilateral meetings resumed in June 2023 and again in June 2024, marking the first such meetings under C-23.

Annual Implementation Plan

Palau is required to submit an annual implementation plan before the issuance of direct economic assistance grants. The Fiscal Procedures section of C-23 outlines the need for this plan, which is due each July as part of the annual budget process. The plan must specify the intended purposes for each type of economic assistance, including operating grants, withdrawals from the COFA fund, and infrastructure maintenance. These purposes must align with the National Development Plan (PDP). The U.S. may provide recommendations for modifications within 30 days and may decline to issue funds if Palau is not in compliance with specific regulations.

> *The C-23 agreement includes a provision for Compact extension, suggesting a Perpetual COFA Fund may no longer be needed.*

Palau prepared its first AIP for FY24 and FY25, though submission was delayed until July/August 2024. Palau had no established procedures or formats for budgetary requests for direct economic assistance grants. In contrast, the FSM and RMI submit annual budget requests (now also implementation plans) to their respective JEMCO and JEMFAC committees. In line with the Fiscal Procedures Agreement (FPA), Palau submitted its first AIP for the ongoing FY24 period and the upcoming FY25 fiscal year in mid-2024. The delayed approval of C-23 and the need to develop a new format for the plan contributed to the delay. At the time of writing, the U.S. is reviewing the documents.

C-23 does not require Palau to submit an annual performance report. Unlike FSM and RMI, Palau is not obligated to provide a performance report on the use of direct economic assistance. While this reduces administrative burdens, it may be beneficial for Palau to conduct an annual performance review of all budgetary allocations, including Compact funds, in line with public financial management (PFM) improvements and best practices.

Issues relating to C-23

The design and funding provided under C-23 should be viewed as a positive achievement

for both parties and will support Palau in meeting its future development needs. This is especially important as Palau recovers from the economic impact of COVID-19, which resulted in a significant debt burden. However, certain aspects of C-23's structure and provisions raise important considerations.

Perpetual COFA fund or source of revenue for government operations

Palau's Fiscal Strategy adopted the principle of establishing a perpetual fund. The original COFA trust fund was designed as a sinking fund to provide revenue for the duration of the Compact's economic provisions. As part of the President's Fiscal Strategy, issued in 2022 under the Fiscal Responsibility and Debt Management Act, the goal of establishing a perpetual fund was declared. The initial objective was to build the CTF corpus until it was large enough to replace annual drawdowns of $15 million in real terms, ensuring sustainability in perpetuity. With the new funding levels established under C-23, this objective could be reinterpreted to replace the level of economic assistance set to end in FY43.

C-23 implies that a perpetual fund may no longer be necessary. C-23 permits drawdowns from the COFA fund for operational purposes, which contrasts with the original intent to create a perpetual fund. In effect, C-23 allows Palau to withdraw capital resources to support current consumption levels. Under Article 1(h) of C-23, the US agrees to consider continuing annual assistance after FY43, subject to an agreement between the signatory governments. This provision enables a potentially ongoing relationship between the US and Palau, which could eliminate the need to establish a perpetual COFA fund. This raises a policy question for Palau: should it maintain its original goal of building a perpetual fund for future generations, or rely on the provisions of C-23, drawing down resources for current government operations and public consumption?

The use of COFA trust funds for permitted sectors conflicts with fiscal responsibility principles. Principle No. 2 of the FRDMA encourages increasing national wealth. Using CTF resources for investment or infrastructure could support this objective, especially for projects where the return on local investment exceeds returns from financial markets. However, while this rationale might justify COFA fund withdrawals, C-23 restricts their use to social, environmental, and public safety sectors. Ironically, this framework directs capital resources, such as the COFA fund, toward current needs and limits their use for capital investment projects.

Inflation adjustment

C-23 does not provide for annual inflation adjustment. Instead, it incorporates a fixed 2 percent annual adjustment, which falls short of actual inflation rates. This approach appears to shift the burden of inflation risk onto Palau. While the US could more easily absorb these costs, periods of high inflation, like those recently experienced, could severely undermine Palau's government operations and fiscal stability. Palau's Consumer Price Index (CPI) has risen by close to 3 percent annually since 2000, before the recent surge in global prices. The 2 percent adjustor falls below this rate, meaning Palau will need to prepare for a gradual decline in the real value of Compact economic assistance, approximately 1 percent per year, alongside potential inflation spikes.

Infrastructure

The limited allocation for infrastructure in C-23 is a significant drawback. The infrastructure funds provided under C-23 amount to just $5 million annually, representing 16.7 percent of the total $30 million in annual grants. This is much lower than the 25 percent allocated for infrastructure in the FSM and RMI. Additionally, the use of the

COFA trust fund for infrastructure is heavily restricted. C-23, as currently worded in Article 1(h), excludes infrastructure or infrastructure maintenance grants from consideration for continued annual assistance after FY43. These limitations mean that C-23 will have minimal impact on Palau's infrastructure development. As the EAG emphasized in its first report, improving infrastructure and replacing aging capital stock is a priority for the nation[26]. Without substantial capital support from C-23, Palau will need to mobilize its own resources or seek funding from bilateral agreements, multilateral donors, public-private partnerships (PPPs), and other sources to meet its economic investment and development goals.

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

10. The economic and fiscal outlook

Assumptions informing the outlook

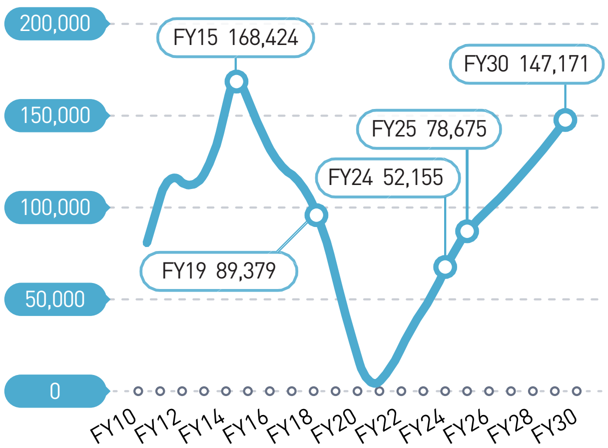
The projections assume a gradual recovery in the economy without being overly optimistic.[27] Earlier projections made by the GSUSA assumed that economic recovery would be well underway by mid-2022 and would follow a similar path to that experienced elsewhere in the South Pacific. However, the return of travel and the recovery of the tourism industry in East Asia have been below expectations, leading the GSUSA to continually make downward revisions. The current projections, therefore, presume a gradual recovery without a quick return to normal occupancy levels that would be possible given Palau's hotel capacity.

Tourism recovery is based on current flight arrivals and some additions expected in 2025. As outlined in Chapter 4 of the Review, projections for the tourism economy in FY24 estimate a total of close to 52,200 visitors (see Figure 16). For FY25, with the assumed return of flights from Japan and improved seat occupancy rates, the number of visitors is projected to rise to 78,700. For FY26 and beyond, Palau is expected to slowly rebuild its tourism industry, aided by the opening of the new IHG hotel in Malakal and the Four Seasons resort. Average hotel occupancy rates are expected to increase from 35 percent in FY26 to 50 percent by FY30, with 147,200 visitors

27 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.

Figure 16: Visitor arrival projections: FY10-FY30

Tourism recovery is delayed and not projected to be fully achieved untill FY30



projected for that year. This level approaches the average seen during the FY14–FY16 period.

Construction demand is projected to grow strongly in the medium term. Historically, construction has had a large impact on the economy. The projections anticipate construction activity from several sources: (i) on-budget capital projects funded through C-23 and grants from Taiwan; (ii) significant off-budget funding from sources such as the U.S. military, the RUS grant to PNCC for fiber installation, U.S. grants for the Mobile Network Modernization project, Japanese capital projects, the ADB, and other donors; and (iii) private sector investment in new hotel projects, including the IHG project and the Four Seasons resort, alongside a general increase in investment activities as the economy expands.

C-23 came into force in FY24 but is not expected to significantly impact operations in FY24 beyond the recent supplemental budget. C-23 was passed into law in March 2024, and Palau submitted its first Annual Implementation Plan (AIP) to the U.S. in July 2024. The FY24 AIP is awaiting U.S. approval but is expected to be agreed upon with only minor alterations. A supplemental budget, passed by the OEK in June 2024, included significant changes, along with the earlier 75¢ per hour wage increase for public servants. These have been factored into the projections. It is assumed that in FY25, there will be an increase in spending on goods and services to compensate for the loss of purchasing power due to high inflation. Furthermore, minimum wage increases of 75¢ per hour for the private sector in FY25 and FY26 are also reflected in the projections.

The RoPSSA and CSPP reforms are not assumed to be implemented. C-23 debt consolidation funds are assumed to be used for normal debt service to maximize fiscal space for current operations, rather than to pay down the principal on high-cost loans. Contrary to recent practice, it is also assumed that the cyclical and climate resilience funds required by C-23 will be fully funded and not used as financing for operations.

Outlook for the Economy

The economy is projected to continue strong growth in FY25 as tourism and construction activity improve. Based on the assumptions outlined, the economy is expected to grow by 11.1 percent in FY25, with visitor arrivals reaching 78,700 and construction activity increasing by 18 percent (see Figure 17). The tourism recovery is anticipated to continue into FY26, with visitor numbers projected to rise to 93,700. At that point, GDP growth is expected to moderate to 4.2 percent, reaching a level 5 percent higher than that of FY18. After regaining much of the ground lost due to COVID, the economy is projected to grow at a rate of 4.1 percent per annum between FY26 and FY30, as capacity utilization and profitability levels normalize.

Employment

The labor market is expected to return to previous levels in FY25, with growth driving demand for foreign workers. Palau's labor

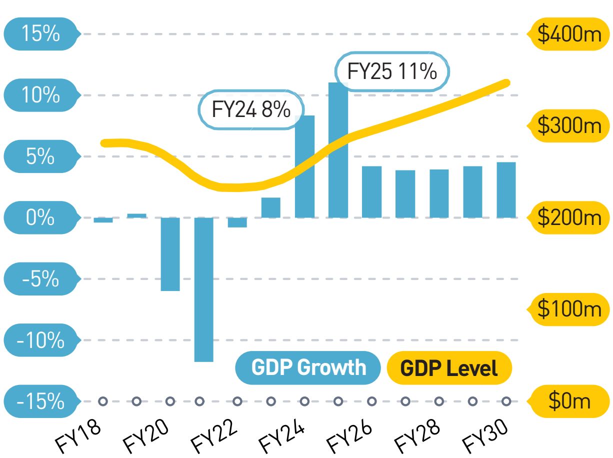
The economic outlook has improved, with a return to pre-COVID levels expected by FY25 and continued growth through FY30.

market consists of two segments: Palauan workers and foreign workers. The Palauan segment is generally at full employment, with additional labor demand fulfilled by foreign workers. Since most Palauan workers are employed in the public sector, the pandemic had less of an impact on them compared to the overall labor market. Projections suggest that Palauan employment largely recovered to pre-pandemic levels by FY24, and further expansion is unlikely unless strong incentives are introduced to encourage former migrants to return (see Figure 18).

For foreign workers, labor demand is expected to return to its FY17 peak by FY25, with an average annual growth rate of 3.5 percent in the latter half of the 2020s. Growth in the tourism sector and increased construction activity are expected to drive strong demand for foreign labor. Overall, the labor market is projected to grow at an average rate of 1.9 percent per annum from FY25 to FY30.

Figure 17: GDP level and growth: FY18-FY30

GDP is projected to recover strongly in FY24 and FY25.

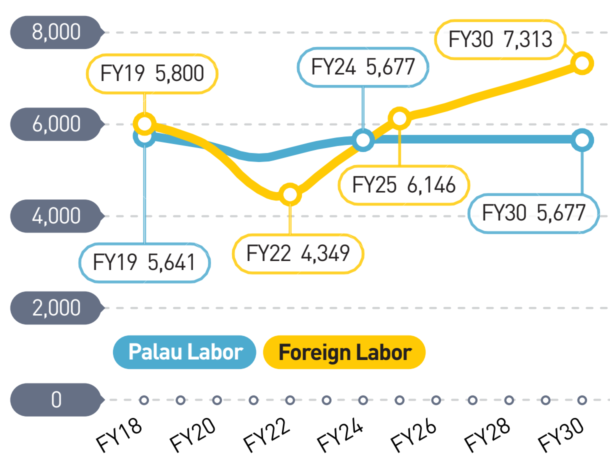


Fiscal Impact

After strong revenue performance in FY24, revenue growth will moderate in FY25, with tax revenue remaining buoyant through the end of the decade. Following the significant growth in tax revenues in FY24, the rate of increase is expected to slow in FY25 but remain favorable, reflecting overall economic growth. Revenues are projected to rise by 5 percent. PGST revenue is forecasted to grow strongly, increasing by 19 percent due to the tourism recovery, with similar growth expected in hotel room and departure taxes (PPEF). Grants are projected to remain largely unchanged as Palau refrains from drawing on the COFA fund, while fully utilizing infrastructure grant funds. Other revenue streams are expected to remain stable. These trends are anticipated to continue through the decade, with overall revenues growing by 3.3 percent per annum. Tax performance will remain strong due to tourism growth, while grants and non-tax revenues are expected to remain stagnant.

Figure 18: Employment of Palauans and foreign workers, FY18-FY30

As recovery gathers pace, full employment of Palauans is achieved, while demand for foreign labor grows steadily.



The fiscal position is expected to remain favorable in FY25, achieving a fiscal surplus of 1.1 percent of GDP. Following the payroll growth in FY23 and FY24, due to the 75¢ per hour wage increase, payroll costs in FY25 are expected to revert to a trend growth of approximately 3 percent per annum through the rest of the decade. Spending on goods and services, accounting for inflationary catch-up from FY19 to FY25, is projected to grow by 19 percent, after which it will return to trend. Interest payments on debt are expected to decline as US interest rates fall by 1 percent. In the absence of reforms, transfers to RoPSSA and CSPP are expected to continue at $1.8 million and $3.0 million respectively, with additional transfers to households for power and water at $2.8 million. State block grants are anticipated to remain high at over $13.1 million. Overall, expenditures are expected to rise by $3.9 million, resulting in a favorable fiscal position with a $6.9 million surplus, or 1.9 percent of GDP (see Figure 19).

The fiscal position is projected to gradually improve through the end of the decade. As the economy stabilizes after the upheavals caused by COVID, the tax reform, and the 2023 amended Compact, the fiscal outlook is expected to improve. Tax revenues are anticipated to remain buoyant, while grants and non-tax revenues stagnate. On the expenditure side, prudent fiscal policies are expected to keep most items under control. By FY30, the fiscal position is projected to record a surplus of 3.4 percent of GDP. Notably, these projections do not account for potential COFA Trust Fund drawdowns. This raises the question of how best to use these funds: should they be saved to create a perpetual fund for future generations, used to augment the limited Compact funds for infrastructure investment, or applied to increase government operations and consumption?

Financing

National government cash reserves remained at healthy levels during COVID and are projected to rise further under the current policy scenario with the implementation of C-23 and full recovery of the economy. Figure 20 shows the level of government cash balances at the end of each fiscal year, as well as the inflow of borrowed funds from the ADB for deficit financing. During the FY20–FY23 period, the government borrowed $90 million

Figure 19: Government revenues and expenditures, FY19-FY30
Government is projected to run increasing surpluses after the recovery.

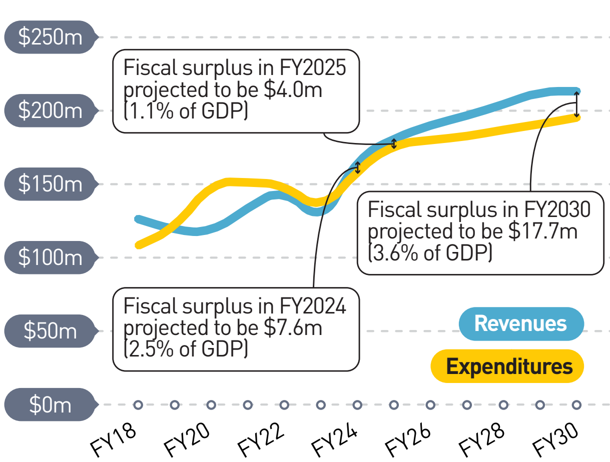
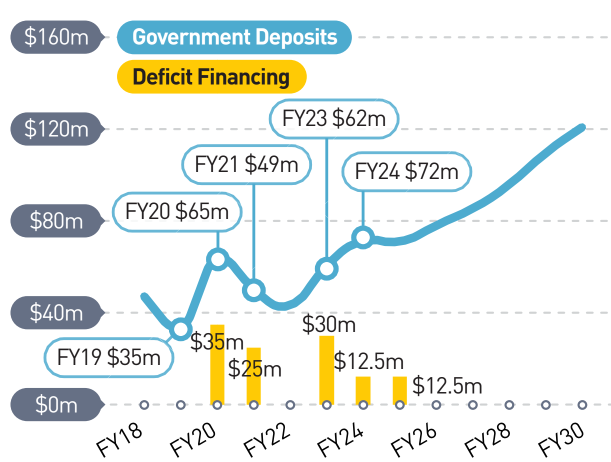


Figure 20: Government deposits, FY19-FY30
Government deposits remained healthy during COVID and are projected to rise further.



for budget support and deficit financing due to COVID. In FY24, the government drew down the first of two sub-programs, each valued at $12.5 million, under the ADB's Sustainable Oceans and Resilience Strengthening Program, with a similar drawdown scheduled for FY25.

In FY24, cash reserves are projected to rise to $77 million with the receipt of funds under C-23, $15 million higher than the levels at the end of FY23. After a slight decline in FY25, cash balances are projected to reach $131 million by FY30 as the economy continues to recover. This healthy reserve trajectory is based on current policy assumptions. However, it is likely that the government will implement reforms to address the ailing pension system and invest in Palau-sourced development projects and infrastructure, which may result in actual cash reserve outcomes differing from those projected in Figure 19.

External debt

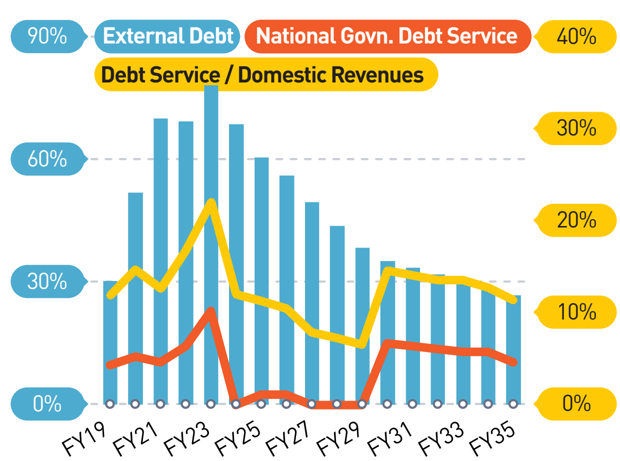
C-23 debt consolidation grants are used to pay debt service rather than reducing principal. The external debt and debt service projections in this review reflect the strategy adopted in the FY24 and FY25 budgets: to use C-23 debt consolidation funds to maximize fiscal space for operational purposes. This strategy applies the funds to meet existing debt service obligations without reducing the principal debt. Consequently, the debt-to-GDP ratio follows the same trajectory as if Palau had not received the consolidation funds. The debt-to-GDP ratio is projected to decline gradually from 69 percent in FY24 to 35 percent by FY30, assuming Palau does not incur further external debt beyond known pipeline loans, as illustrated in Figure 21.

Palau faces a $10 million fiscal cliff in FY30 when C-23 debt consolidation funds are depleted. The C-23 consolidation funds significantly reduce Palau's debt service obligations, cutting debt service from 22 percent in FY23 to 11 percent in FY24, and further reducing it by 6 percent through FY29. Since the C-23 funds are earmarked for national government debt service, annual charges on national government debt effectively drop to zero during this period. However, as the principal has not been reduced, debt service charges are projected to rise sharply in FY30 when the debt consolidation grant expires, creating a $10 million fiscal cliff.

With stronger tax collection and C-23 implementation, Palau's fiscal position is projected to run surpluses, offering opportunities for new initiatives.

While external debt has risen to historically high levels, it should not pose a significant risk of debt stress if prudently managed. Debt service costs rose sharply after Palau borrowed significantly to cover COVID-related deficits and new projects. Rising global interest rates have also increased debt service costs, though these are expected to decrease as

Figure 21: External debt percent GDP, and debt service percent government revenues
External debt rose to high levels relative to GDP due to COVID financing needs.



interest rates normalize globally. Despite the large increase in debt, its concessional nature means that the risk of debt stress remains low. However, future borrowing decisions must be carefully evaluated, particularly with regard to interest rate risk.

11. Policy Issues

The emergence of a structure surplus

With strong revenue performance from the tax reform and the implementation of C-23, a significant fiscal surplus is projected. The post-pandemic emergence of this structural surplus is driven by two main factors: the robust performance of the tax reform and the implementation of C-23. In FY19, total tax collections from legacy taxes, such as the BGRT and general import taxes, were around $16 million. These taxes were replaced by the PGST, which is projected to collect $27 million in FY24, based on the first six months of data. Additionally, the tax reform introduced a business profits tax, estimated to generate an additional $6.2 million. While these figures are subject to adjustment once final data is available, the reformed tax regime points to a significant surplus. From FY23 to FY25, total revenues, including taxes and new Compact grants, are projected to increase by 40 percent.

The emergence of a structural surplus raises the question of how to allocate the resources. On the expenditure side, expenses are projected to grow by 23 percent between FY23 and FY25 due to the FY24 supplemental budget and the FY25 budget. This growth reflects recent increases in civil servant wages, anticipated inflation adjustments, and additional transfers to other levels of government, including state governments and pensions. From FY25 onwards, assuming conservative fiscal policy and continued economic recovery, a significant surplus of 3.4

percent of GDP, or $16.5 million, is projected by FY30. Furthermore, it is assumed that no funds will be withdrawn from the COFA trust fund for operational purposes, as permitted under C-23. This situation prompts important questions about the best use of the surplus.

The options for allocating the fiscal surplus are broad, and various advocacy groups will likely have differing opinions. This Review outlines a few potential options:

6. **Strategic Use of C-23 Debt Consolidation Funds**: This Review suggests that the current use of C-23 debt consolidation funds maximizes fiscal space. A more strategic approach would involve using the funds to pay down debt principal. While this would reduce short-term fiscal space, it would decrease the present value of external debt liabilities and help avoid the fiscal cliff projected for FY30. This option is explored further below.

7. **Pension Reform**: As outlined in this Review, the most significant fiscal risk and reform need lies in the pension system, including both SS and CSPP. In the case of SS, reforms do not anticipate government transfers. However, for CSPP, reforms assume the allocation of a portion of PGST collections to reduce accrued liabilities and sustain pension levels. The implications of SS and CSPP reform are explored in subsequent sections.

8. **Government Services**: The Palau Development Plan (PDP) prioritizes funding for government operations and social policy, favoring the use of funds for consumption over economic development and infrastructure. This suggests that implementing the PDP would require additional resources for health, education, social welfare, and other public services. C-23 also implies a preference for funding consumption.

9. Infrastructure: Both the EAG and this Review emphasize the need for infrastructure investment to support long-term growth. The National Infrastructure Investment Plan (NIIP) lists critical projects, including major initiatives in health, port redevelopment, and potential airport expansion. Historically, Palau has relied on donor funding for capital projects, rather than domestic resources. However, the emergence of a fiscal surplus presents an opportunity to reconsider this approach and potentially use domestic funds for capital investment.

Debt consolidation

Current use of C-23 fiscal consolidation funds has been to maximize fiscal space to fund expenditures. The projections provided in this review reflect the strategy outlined in the FY24 and FY25 budgets: using C-23 debt consolidation funds to maximize fiscal space for operational purposes. An alternative strategy would be to accelerate the repayment of loan principal, prioritizing loans with shorter durations and those with interest payments based on market rates. This approach would reduce fiscal space in the short term but lower the debt-to-GDP ratio and alleviate future debt stress.

Current use of fiscal consolidation funds will incur a large fiscal cliff and contraction in FY30. Figure 22 illustrates the profile of debt service costs through FY40. Without the use of C-23 funds, debt service remains high, representing 22 percent of domestic revenues in FY23, falling to 9 percent by FY35. Under the current scenario adopted in the FY24 and FY25 budgets, the C-23 consolidation funds are not used for accelerated debt repayment but instead to maximize fiscal space for operations. Debt service drops rapidly in FY24 to 12 percent of general fund revenues, gradually falling to 6 percent by FY29. However, it rises again to 13 percent in FY30 as the

Figure 22: Debt service without and with debt consolidation strategy, $'m
Strategic use of consolidation funds smooths debt service and avoids fiscal cliff.

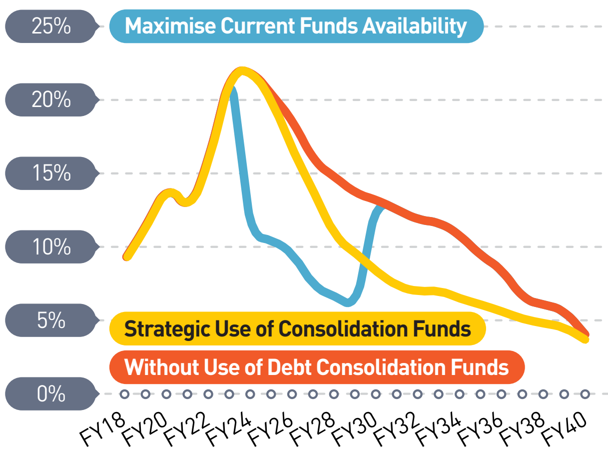
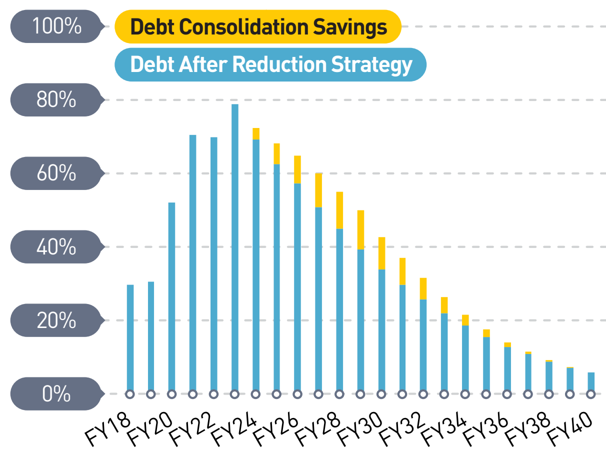


Figure 23: Reduction in debt due to adoption of debt consolidation strategy, $'m
External debt declines more rapidly with strategic use of debt conslidaiton funds.



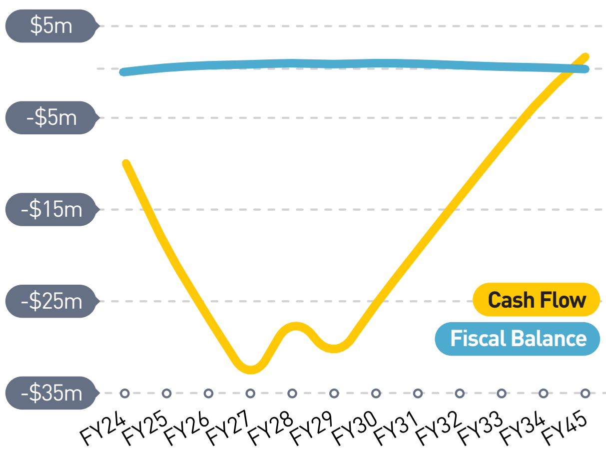
C-23 fiscal consolidation funds are depleted. This rapid increase in debt service costs in FY30, amounting to $10 million, would necessitate significant fiscal consolidation to maintain balance.

Adoption of a debt management strategy would enable a more efficient use of the C-23 consolidation grant, albeit at the cost of reduced space for operations in the near term. Alternatively, the government could adopt a strategy to deploy C-23 funds for accelerated debt repayment. Under this approach, debt service would decline gradually through FY29 and continue to fall through FY35 without incurring a fiscal cliff or requiring a large fiscal contraction. Figure 23 demonstrates the impact on the debt-to-GDP ratio under two scenarios. Strategic use of C-23 funds would reduce the debt-to-GDP ratio from 50 percent to 39 percent, an 11 percent reduction. This strategy would alleviate debt stress and allow for greater borrowing capacity in the future. However, it would come at the cost of reducing the operating budget in the near term. Given the increased grant availability from C-23 and the buoyancy of tax reform, there is scope for a more efficient use of the C-23 debt consolidation fund, aligning with its original purpose.

While the government's cash flow position will deteriorate in the near term, it will improve in the long term. Figure 24 illustrates the effect of adopting a debt consolidation strategy on the fiscal balance and cash flow position (difference between baseline fiscal projection and consolidation scenario). Under this strategy, the fiscal balance improves as the repayment of principal reduces interest charges compared to the baseline. However, using the C-23 consolidation grant for early principal repayment, a "below the line" financing item, leads to a temporary cash flow reduction of $33 million by FY27. From this point onward, cash reserves steadily improve, exceeding the baseline by FY35. Given the government's current strong cash

Compact fiscal consolidation requires a debt management strategy to accelerate repayment of high-cost loans.

Figure 24: Difference in fiscal balance and cash flow positions after adoption of debt management strategy
Cash flow deteriorates with adotpion of debt mangement starategy but rebounds as debt is paid down.



reserve position, which is projected to exceed $70 million in FY24, this temporary reduction in reserves should not lead to fiscal stress. As noted in Chapter 4, a debt management unit has been established within the Ministry of Finance, although it has yet to be fully operationalized. Now would be an opportune time to do so.

Reserve Management

The Fiscal Responsibility and Debt Management Act establishes Cyclical Reserve and Climate Resilience funds. As part of the FRDMA, Palau created two reserve funds: the Cyclical Reserve and the Climate Resilience Reserve Fund. The Cyclical Reserve is targeted to reach the equivalent of three months of general fund revenues, while the target for the Climate Resilience Fund will be set by regulation. Contributions of 2 percent and 1 percent of local revenues, respectively, are to be made to these funds until they reach their targets. The Cyclical Reserve allows withdrawals if revenues in any year fall below 5 percent of projected levels, while the Climate Resilience Fund may be accessed if the President declares a state of emergency. Both funds have been established, and initial contributions have been made.

Accumulation of significant cash balances presents an opportunity to build Palau's Cyclical and Climate Resilience Reserves. During the COVID-19 period, Palau raised substantial funds for deficit financing and mitigation efforts. However, prudent use of these funds, along with increased revenues from the tax reform, has led to significant cash balances that exceed the government's immediate cash management needs. Currently, the reserve funds are underfunded and have been utilized for operational expenses, which is not in compliance with the FRDMA. With available cash balances exceeding $70 million, Palau is in a position to fund these reserves to their target levels and bring the government back into compliance with the law and C-23 requirements.

12. Statistical Developments

Palau's administrative statistical systems have provided a sound base for fiscal and economic monitoring. Statistical availability in Palau ranks highly compared to regional standards. After a period of weak and deteriorating macroeconomic data, Palau now has a comprehensive range of economic statistics to monitor performance. This includes GDP by production and expenditure (in current and constant prices), employment, wages, consumer prices, banking, balance of payments, and government finance statistics (GFS). Initial estimates for the fiscal year are typically available by the end of March, with final estimates following the completion of annual audits by the end of June. However, the audit process is currently three years behind schedule. While this delay has not affected the preliminary estimates, final estimates have been significantly delayed. Key areas of weakness include the absence of (i) a comprehensive business survey to estimate private sector value-added, and (ii) producer prices to estimate the constant price series. Recent efforts to integrate the statistical system through better database management have improved data integrity and consistency.

The tax reform initiative will significantly improve Palau's economic statistics. The introduction of the Palau Goods and Services Tax (PGST) is generating a monthly data set that will enhance the accuracy and coverage of economic statistics. Previously, value-added series were based on business gross receipts multiplied by a coefficient derived from corporate returns filed in previous years. For FY23, GDP estimation continued to rely on this methodology. However, starting in FY24, new systems will replace the former series with direct estimates of value-added and intermediate consumption. On the expenditure side, the PGST will provide data on key demand elements, such as business investment and imported services. The annual business profits tax will offer further insight into intermediates, inventories, and investment, reducing the need for a separate business survey. One remaining challenge is the lack of a producer price series, which is essential for estimating constant price series. With these reforms, Palau will also be able to produce a regular series of quarterly estimates.

Palau summary economic indicators, FY2017-FY2023

	FY17	FY18	FY19	FY20	FY21	FY22	FY23
Per Capita Income measures							
GDP current prices, $ million	292.1	288.0	282.1	261.7	230.7	242.1	267.7
Population	17,645	17,637	17,630	17,622	17,614	17,606	17,598
GDP per capita $	16,555	16,328	16,000	14,851	13,097	13,752	15,214
GNI per capita $	16,222	15,905	15,888	15,191	13,648	13,930	14,316
GNDI per capita $	17,921	18,536	17,353	16,905	16,591	17,457	15,712
National accounts							
GDP, at constant FY2019 prices, $ million (ave. GDP(P) and GDP(E))	**276.9**	**275.6**	**278.6**	**258.6**	**224.5**	**224.7**	**226.1**
GDP, % growth	**-3.6%**	**-0.5%**	**1.1%**	**-7.2%**	**-13.2%**	**0.1%**	**0.6%**
GDP by Production, at constant 2019 prices, $ million	**277.0**	**277.9**	**281.9**	**265.0**	**234.4**	**230.9**	**232.3**
Agriculture and fisheries	10.5	10.1	9.6	8.6	8.3	8.3	8.3
Manufacturing, utilities, construction	25.0	24.6	31.7	30.4	30.5	24.6	20.0
Wholesale and retail trade	43.1	43.6	41.0	39.0	36.9	36.8	31.3
Accomodation, restaurants and transport	51.7	48.4	42.6	28.0	11.0	15.6	26.1
Public admin, Health and education	63.4	65.2	65.4	66.1	64.8	61.7	62.7
Other services	56.8	58.1	62.4	64.6	58.9	59.9	61.6
Taxes less subsidies on products	31.4	30.5	29.2	28.3	23.2	24.4	24.1
GDP by Expenditure, at constant 2019 prices, $ million	**290.6**	**284.7**	**282.2**	**260.2**	**222.0**	**229.1**	**231.6**
Final consumption expenditure, government	90.5	94.6	95.2	105.2	99.0	94.2	93.6
Final consumption expenditure, households	204.0	201.0	198.8	200.7	191.9	189.5	176.9
Gross fixed capital formation	95.5	83.1	97.9	112.2	86.4	94.6	79.9
Gross domestic expenditure	**391.0**	**378.7**	**391.8**	**415.4**	**380.0**	**381.2**	**346.5**
Exports	132.4	122.2	108.1	61.6	16.3	35.7	62.9
Less Imports	232.8	216.2	217.6	216.8	174.3	187.9	177.7
GDP by Income, $ million (current prices)	**290.0**	**288.2**	**281.9**	**259.0**	**235.7**	**246.1**	**269.5**
Of which							
Compensation of employees	155.8	161.2	160.8	158.4	143.4	142.6	159.3
Operating surplus and Mixed income	84.2	79.4	74.8	59.0	51.8	63.5	56.5
Taxes, less subsidies	33.9	31.5	29.2	23.6	25.8	25.7	34.1
Monetary	*272.6*	*270.4*	*263.9*	*240.0*	*216.2*	*226.2*	*247.9*
Non-Monetary (household subsistence, own dwellings)	*17.3*	*17.8*	*18.0*	*19.0*	*19.5*	*20.0*	*21.6*
Prices (annual percent change)							
Consumer price index	0.9%	2.5%	0.4%	0.7%	-0.5%	13.2%	10.8%
CPI Domestic items	0.9%	2.0%	-0.5%	1.4%	-4.9%	15.5%	9.3%
CPI Imported items	1.0%	2.7%	1.0%	0.3%	1.9%	12.0%	14.1%
GDP implicit price deflator (average)	-0.7%	-1.0%	-3.1%	-0.1%	1.5%	4.9%	9.9%
Average wage	2.6%	2.4%	1.8%	0.5%	0.9%	3.1%	3.6%
Export price Index	0.3%	1.0%	-0.9%	-2.0%	-3.1%	11.4%	6.8%
Import price Index	4.5%	4.2%	0.0%	-3.1%	2.0%	18.0%	7.0%
Terms of trade	-4.0%	-3.1%	-0.9%	1.2%	-5.0%	-5.5%	-0.2%

Palau summary economic indicators, FY2017-FY2023 cont'd

	FY17	FY18	FY19	FY20	FY21	FY22	FY23
Employment and Wages							
Number of employees	**11,733**	**11,770**	**11,441**	**10,980**	**9,747**	**9,746**	**10,661**
% change	3.4%	0.3%	-2.8%	-4.0%	-11.2%	0.0%	9.4%
Private sector	6,851	6,896	6,598	6,100	5,015	5,063	5,966
% change	3.5%	0.7%	-4.3%	-7.6%	-17.8%	1.0%	17.8%
Public sector	3,877	3,900	3,892	3,954	3,869	3,858	3,869
% change	2.9%	0.6%	-0.2%	1.6%	-2.1%	-0.3%	0.3%
Other	1,005	974	950	926	864	825	826
Palau citizens	5,626	5,765	5,641	5,515	5,206	5,397	5,599
Foreign workers	6,107	6,005	5,800	5,465	4,542	4,349	5,062
Average annual wage	**11,204**	**11,468**	**11,680**	**11,739**	**11,841**	**12,204**	**12,648**
% change	2.6%	2.4%	1.8%	0.5%	0.9%	3.1%	3.6%
Private sector	9,311	9,292	9,325	8,898	8,403	8,903	9,181
% change	1.8%	-0.2%	0.3%	-4.6%	-5.6%	6.0%	3.1%
Public sector	16,145	16,800	17,139	17,441	17,496	17,621	19,115
% change	3.6%	4.1%	2.0%	1.8%	0.3%	0.7%	8.5%
Palau citizens	13,959	14,089	14,293	14,563	14,507	14,579	15,523
Foreign workers	8,665	8,951	9,139	8,888	8,784	9,256	9,468
Average annual real wage (less inflation)	**11,529**	**11,518**	**11,680**	**11,657**	**11,815**	**10,759**	**10,059**
% change	1.7%	-0.1%	1.4%	-0.2%	1.4%	-8.9%	-6.5%
Palau citizens	14,364	14,150	14,293	14,462	14,475	12,854	12,346
% change	3.6	-1.5	1.0	1.2	0.1	-11.2	-3.9
Foreign workers	9,044	9,142	9,304	9,033	9,057	8,444	7,769
% change	0.5	1.1	1.8	-2.9	0.3	-6.8	-8.0

Palau summary economic indicators, FY2017-FY2023 cont'd

	FY17	FY18	FY19	FY20	FY21	FY22	FY23
Government Finance Statistics, ($ million)							
Revenue	115.0	126.7	119.4	117.0	134.5	148.8	129.1
Tax revenue	56.9	60.5	51.8	47.3	41.0	43.6	58.2
Grants	37.3	49.4	50.3	55.9	75.5	88.1	58.6
Other revenue	20.7	16.9	17.3	13.9	18.0	17.1	12.3
Expense	-92.8	-102.3	-103.6	-134.3	-132.3	-129.5	-122.4
Compensation of employees	-42.9	-44.6	-45.5	-48.4	-46.4	-45.4	-49.1
Use of goods and services	-25.1	-26.6	-27.1	-26.8	-26.8	-29.3	-33.5
Other expense	-24.8	-31.1	-30.9	-59.0	-59.0	-54.9	-39.8
Net Worth and its Changes	-22.2	-24.4	-15.8	17.2	-2.3	-19.2	-6.7
Nonfinancial assets	-8.4	-6.6	-16.9	-16.5	-19.5	-20.8	-14.5
Financial assets	-18.4	-29.3	-3.3	-28.8	-14.3	-26.2	9.6
Financial liabilities	4.6	11.4	4.4	62.5	31.5	27.8	-1.8
Overall fiscal balance	13.8	17.8	-1.0	-33.7	-17.3	-1.5	-7.8
(In percent of GDP)							
Revenue	39.4%	44.0%	42.3%	44.7%	58.3%	61.4%	48.2%
Taxes	19.5%	21.0%	18.4%	18.1%	17.8%	18.0%	21.7%
Domestic revenues	12.8%	17.1%	17.8%	21.4%	32.7%	36.4%	21.9%
Grants	7.1%	5.9%	6.1%	5.3%	7.8%	7.1%	4.6%
Expense	-31.8%	-35.5%	-36.7%	-51.3%	-57.3%	-53.5%	-45.7%
Compensation of employees	-14.7%	-15.5%	-16.1%	-18.5%	-20.1%	-18.7%	-18.3%
Use of goods and services	-8.6%	-9.2%	-9.6%	-10.3%	-11.6%	-12.1%	-12.5%
Non Financial Assets	-2.9%	-2.3%	-6.0%	-6.3%	-8.5%	-8.6%	-5.4%
Overall fiscal balance	4.7%	6.2%	-0.4%	-12.9%	-7.5%	-0.6%	-2.9%
Depositiory Coporations Survey ($ million)							
Net foreign assets	253.3	254.2	238.5	290.5	286.3	271.1	256.5
Domestic claims	-6.9	-6.4	2.7	-27.9	-26.3	-13.7	-8.7
Net claims on national government	-43.2	-42.9	-31.0	-60.7	-56.5	-45.3	-45.1
Claims on other sectors	36.3	36.5	33.7	32.8	30.2	31.6	36.4
Private non-financial corporations	6.5	8.4	5.4	5.2	4.8	7.0	8.9
Individuals	29.8	28.1	28.2	27.6	25.4	24.6	27.5
Broad money liabilities	237.1	237.9	230.3	254.1	251.0	248.6	234.4
Demand deposits	96.8	91.0	99.4	115.4	120.5	123.3	115.5
Other deposits	140.4	146.9	130.9	138.7	130.4	125.3	119.0
Capital and other accounts	9.6	11.2	10.7	6.3	6.8	7.0	10.9
Loans to deposit ratio, %	15.3%	15.4%	14.6%	12.9%	12.0%	12.7%	15.5%
Memo: item: National Development Bank of Palau lending	19.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Balance of Payments $ million							
Trade balance	-139.5	-138.2	-140.9	-149.8	-127.0	-157.3	-162.4
Goods, Exports	14.1	13.8	10.9	4.3	1.1	2.1	1.7
Goods, Imports	-153.5	-151.9	-151.8	-154.1	-128.1	-159.4	-164.2
Service balance	50.0	46.6	32.3	1.0	-28.9	-23.5	8.6
Services, Exports	118.3	109.6	96.9	55.7	14.3	35.7	64.9
Services, Imports	-68.3	-63.0	-64.6	-54.8	-43.1	-59.2	-56.2
Primary Income balance	-1.7	-1.7	-1.3	-0.4	0.0	0.0	0.0

Palau summary economic indicators, FY2017-FY2023 cont'd

	FY17	FY18	FY19	FY20	FY21	FY22	FY23
Primary Income, receipts	22.9	22.5	23.9	20.6	21.7	24.0	24.4
Primary Income, payments	-28.8	-30.0	-25.9	-14.6	-12.0	-20.8	-40.2
Secondary Income balance	-68.3	-63.0	-64.6	-54.8	-43.1	-59.2	-56.2
Secondary Income, receipts	52.1	69.1	48.0	50.6	68.0	78.8	44.1
Secondary Income, payments	-22.1	-22.7	-22.2	-20.4	-16.2	-16.7	-19.5
Current Account, balance	-65.4	-52.6	-84.8	-112.6	-94.3	-115.5	-145.0
Capital Account, balance	20.6	82.6	34.9	26.8	16.9	24.0	19.4
Financial account balance	48.3	-9.8	75.8	49.1	69.0	106.5	143.3
International Investment Position (IIP), $ million							
Total stocks, net	-108.3	-62.7	-135.5	-172.7	-175.6	-384.0	-487.7
Direct investment, net	-633.5	-666.1	-711.6	-755.7	-787.7	-861.7	-935.9
Portfolio investment, net	354.4	438.8	428.3	431.9	494.3	378.8	403.1
Other investment, net	170.8	164.5	147.9	151.1	117.9	99.0	45.1
memo: COFA Trust Fund	219.5	297.5	286.4	280.0	323.4	246.6	275.1
External Debt, $ million							
Gross External Debt, total	78.0	85.1	86.0	134.9	165.9	171.5	212.0
National Government	50.3	59.9	63.3	114.1	146.3	152.7	194.6
Public Enterprises	27.7	25.2	22.7	20.8	19.6	18.8	17.3
Gross External debt as % of GDP	26.7%	29.6%	30.5%	51.5%	71.9%	70.8%	79.2%
Debt Service	7.9	7.2	8.0	8.8	7.2	9.8	15.3
Debt service as % of national government revenues	6.9%	5.7%	6.7%	7.5%	5.4%	6.6%	11.9%
Tourism							
Total Tourism receipts, $ million	**111.1**	**106.1**	**87.8**	**49.0**	**5.9**	**26.0**	**56.8**
Tourist nights	**589,533**	**564,757**	**460,614**	**231,021**	**22,427**	**82,027**	**212,700**
Receipts per visitor, $	913	918	982	1,178	1,747	2,808	1,621
Receipts per visitor night, $	188	188	191	212	265	317	267
Direct value added per visitor night, $ million	99.6	93.1	97.7	93.8	39.4	104.1	109.5
Average length of stay, nights	**4.8**	**4.9**	**5.2**	**5.5**	**6.6**	**8.9**	**6.1**
Tourism arrivals	**121,670**	**115,564**	**89,379**	**41,628**	**3,400**	**9,247**	**35,052**
Japan	25,777	24,384	19,585	10,623	80	762	3,143
South Korea	13,419	12,833	11,541	6,211	12	136	866
Taiwan	9,422	11,296	14,024	6,258	1,912	892	9,373
China	55,358	50,063	28,368	9,721	33	57	7,707
USA	8,490	8,378	7,804	4,009	1,191	5,687	7,960
Europe	4,962	4,447	3,753	2,535	19	563	2,271
Other	4,242	4,163	4,304	2,271	153	1,150	3,732
Hotel occupancy rate	46.6%	43.5%	36.0%	16.9%	1.7%	6.9%	20.3%
Number of Hotel rooms, yearly average	**1,767**	**1,791**	**1,770**	**1,829**	**1,719**	**1,717**	**1,694**
Tourism Direct Value Added, $ million	**58.7**	**52.6**	**45.0**	**21.7**	**0.9**	**8.5**	**23.3**
% change							
Tourism receipts	-12.8%	-4.5%	-17.3%	-44.1%	-87.9%	337.2%	118.8%
Tourism arrivals	-16.8%	-5.0%	-22.7%	-53.4%	-91.8%	172.0%	279.1%
Tourism nights	-13.9%	-4.2%	-18.4%	-49.8%	-90.3%	265.7%	159.3%
Tourism receipts per visitor	4.8%	0.5%	7.0%	20.0%	48.3%	60.7%	-42.3%
Tourism receipts per visitor night	1.3%	-0.4%	1.4%	11.4%	24.8%	19.5%	-15.6%

PALAU
ECONOMIC REVIEW 2024

Republic of Palau

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The Palau Economic Review is produced annually to provide an independent assessment of the Republic of Palau's economic performance and policy environment, along with independently verified economic statistics. It has been developed, in part, to assist the governments of the Republic of Palau and the United States fulfill their respective reporting requirements under Palau's Compact of Free Association with the United States.

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