



Third Annual Report of the Economic Advisory Group for Palau

May 2025

 palaueag.org

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May 1, 2025

Dr. James Galbraith

Chairman

Nominated by Palau
Selected by the United States

Dr. Denise Konan

Member

Delegated by the United States

Dr. Peter Watson

Member

Delegated by the United States

Hon. Kaleb Udui, Jr.

Member

Delegated by Palau

Dr. Naoyuki Yoshino

Member

Delegated by Palau

The Honorable Marco Rubio

Secretary

U.S. Department of State
2201 C Street NW
Washington, DC 20520

The Honorable Doug Burgum


Secretary


U.S. Department of the Interior
1849 C Street NW
Washington, D.C., 20240

Dear Secretaries Rubio and Burgum:

I am pleased to share with you the 3rd Annual Report of the Economic Advisory Group for Palau. This Report details our activities during the period from May 2024 – April 2025. You may recall the “Advisory Group” was formed in the early summer of 2022 and renewed pursuant to the 2023 Compact Review Agreement (2023 CRA).

The mandate of the Advisory Group has been extended through the March 15, 2024, entry-into-force of the 2023 CRA with minor modifications. Each of us are now privileged to be working for a three-year period through March 15, 2027 (renewable), to work with the government of Palau to help identify and overcome the challenges and to benefit from the opportunities Palau presently faces, and to share our perspectives and recommendations with Palau, the United States, and with Palau’s other partners in economic management and development.

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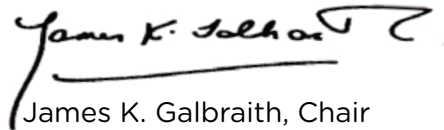
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In our third year, we have worked within our mandate to lay the foundation for a sustained effort to optimize policies and take the most advantage of the favorable terms under the COFA for the 20-year period through FY2043. Palau faces many early and important choices with respect to fiscal and economic policy. We intend to offer our best advice and recommendations and, when necessary, warnings. As our interactions with the government and people of Palau have increased in depth and breadth, the specificity and strength of our recommendations have also increased. Already we see our role has having been positive in opening new windows of opportunity with a focus on private investment and private sector development with U.S. government agencies and with other donors, especially with respect to Japan. As we monitor and engage in efforts to support the sustainable evolution of Palau's economy, we will endeavour to promote the ongoing strengthening of bilateral and multilateral relations. As within the enclosed report, we will share our specific and constructive recommendations in a timely manner with both governments.

It is a privilege and a pleasure to serve as part of the Economic Advisory Group for Palau, and in this I speak for each of my four colleagues.

Signed on Behalf of the Economic Advisory Group for Palau,

A handwritten signature in black ink, appearing to read "James K. Galbraith", with a horizontal line underneath it.

Enclosure: **3rd Annual Report of the Economic Advisory Group for Palau** (May 2025)

cc: **Hon. Scott Cameron**
Senior Advisor to the Secretary of the Interior
Hon. Jonathan Fritz
Acting Assistant Secretary of State for East Asian and Pacific Affairs



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Member

Delegated by Palau

Dr. Naoyuki Yoshino

Member

Delegated by Palau

His Excellency Surangel Whipps, Jr.

President

Republic of Palau


Post Office Box 6051


Palau, PW 96940

Dear President Whipps:

I am pleased to share with you the 3rd Annual Report of the Economic Advisory Group for Palau. This Report details our activities during the period from May 2024 – April 2025. You may recall the “Advisory Group” was formed in the early summer of 2022. Since then we have completed three successful visits to Palau—during which we were treated to the utmost of respect and kindness by you, Mr. President, by the leadership and government officials, and by the people. For that we are, indeed, profoundly thankful.

The task of the Advisory Group was extended through the March 15, 2024, entry-into-force of the 2023 Compact Review Agreement (2023 CRA) with minor modifications. Each of us are now privileged to be working for a three-year period through March 15, 2027 (renewable), to work with the government of Palau to help identify and overcome the challenges and to benefit from the opportunities Palau presently faces, and to share our perspectives and recommendations with Palau, the United States, and with Palau’s other partners in economic management and development.

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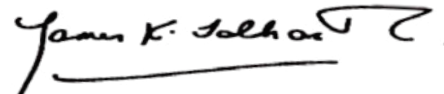
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In our third year, we have worked within our mandate to lay the foundation for a sustained effort following the successful conclusion of negotiations for renewal of the Compact of Free Association between Palau and the United States. Under the terms of the 2023 CRA, Palau faces many early and important choices with respect to fiscal and economic policy. We intend to offer our best advice and recommendations and, when necessary, warnings. As our interactions with the government and people of Palau increase in depth and breadth, the specificity and strength of our recommendations will also increase. Already we see our role has having been positive in opening new windows of opportunity with US government agencies and with other donors, especially with respect to Japan. As we monitor and engage in efforts to support the sustainable evolution of Palau's economy, we will endeavour to promote the ongoing strengthening of bilateral and multilateral relations. As within the enclosed report, we will share our specific and constructive recommendations in a timely manner with both governments.

It is a privilege and a pleasure to serve as part of the Economic Advisory Group for Palau, and in this I speak for each of my four colleagues.

Signed on Behalf of the Economic Advisory Group for Palau,



James K. Galbraith, Chair

Enclosure: **3rd Annual Report of the Economic Advisory Group for Palau** (May 2025)

cc: **Hon. Gibson Kanai**
Speaker of the House of Delegates
Olbiil Era Kelulau

Hon. Hukkons Baules
President of the Senate
Olbiil Era Kelulau

Third Annual Report of the Economic Advisory Group for Palau

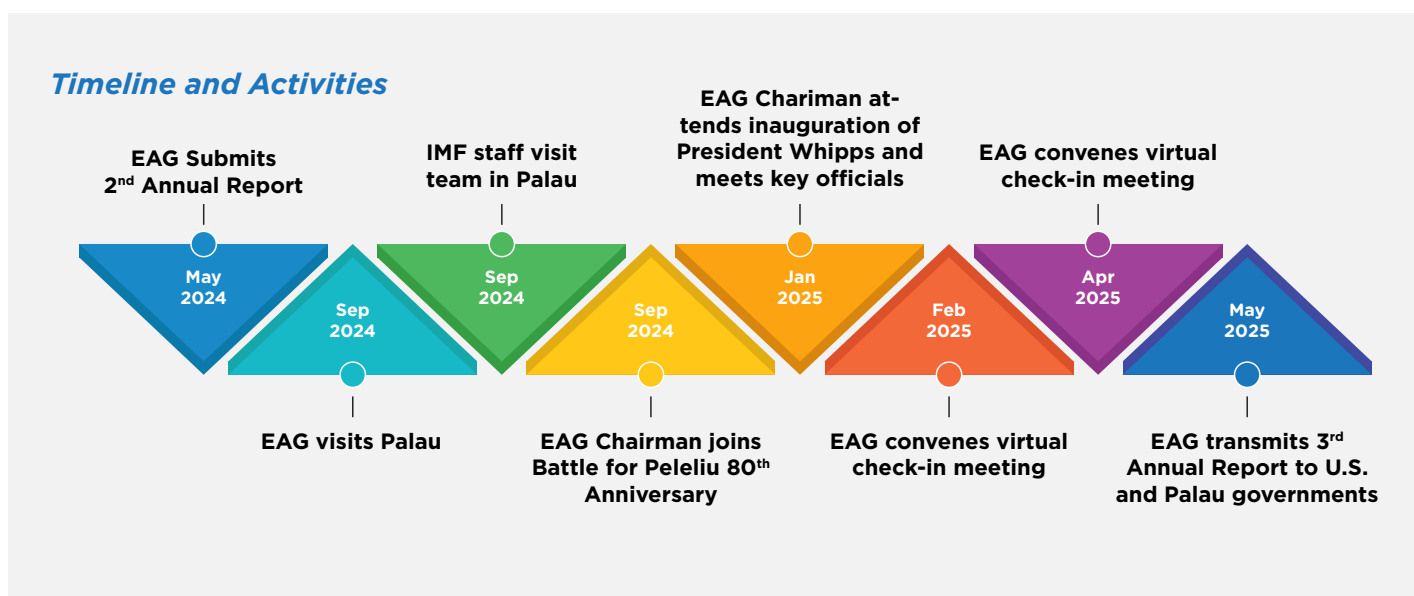
Background

The Economic Advisory Group for Palau (EAG) was formed during the spring and summer of 2022, pursuant to the terms of the 2010 Compact Review Agreement between the Republic of Palau and the United States. With the passage into law and March 15, 2024, entry-into-force of the 2023 Compact Review Agreement (2023 CRA), the EAG has been extended indefinitely and the members who initiated the effort have each been extended for three-year terms through March 15, 2027 (renewable). The EAG consists of five members, two appointed by each government and a fifth nominated by Palau and selected by the United States. All members serve as volunteers. Secretariat assistance is provided by the Graduate School, USA, in Honolulu under funding from the U.S. Department of the Interior with funding committed through March 31, 2026. Financial support for the operations of the EAG comes from the partner governments.

The five members are:

- Finance Minister Kaleb Udoi (Palau)
- Professor Naoyuki Yoshino (Palau)
- Dr. Peter Watson (US)
- Professor Denise Konan (US)
- Professor James Galbraith, Chairman (Palau/US)

The 1st and 2nd Annual Reports of the EAG can be found at palaueag.org. This is the 3rd Annual Report which under the new terms of the 2023 CRA is due on May 1, of each year and is meant to inform the government of the United States and the government of Palau in advance of their annual bi-lateral economic consultations to be held no later than August 30, each year.



Year Two Highlights

The successful completion of COFA negotiations and approval by the U.S. Congress of automatic support for twenty years from FY2024-FY2043 opened a new phase in Palau-U.S. relations, based on the principle of commitment to the sustainable development and prosperity of Palau. The role of the EAG – with current members now renewed for three years through March 15, 2027 – thus pivots toward the provision of assistance in framing a viable strategic vision for Palau's development. The EAG will monitor economic and social conditions in Palau, calling attention to problems as they arise, and facilitating communication and coordination between Palau and its partners, notably but not exclusively the United States.

The EAG acknowledges continued support for our efforts by both parties, which includes the Office of the President of Palau, and President Whipples, and the U.S. Department of State, including the Embassy in Palau, and the U.S. Department of the Interior

The EAG conducted its third annual mission to Palau September 9-13, 2024, and Chairman Galbraith remained in Palau through September 16, 2024, to enable his participation in the September 15, 2024, Battle for Peleliu 80th Anniversary commemoration.

The extended itinerary, along with some division of labor, permitted a very extensive program of meetings and consultations. The final program for the visit is provided in appendix 2. During the visit the EAG confirmed that economic and fiscal conditions in Palau have improved dramatically, when compared to the low point of post-pandemic conditions observed on our first visit in 2022. Economic growth has resumed, tourist arrivals have risen to the order of 50 thousand per year, and, thanks to this, plus the successful implementation of the Palau Goods and Services Tax (PGST), the government's budget position has moved from deficit to strong surplus. Overall, the EAG judges the government's use of its improved position to have been prudent so far, though with many challenges and decisions still ahead.

Findings, Discussion and EAG Recommendations

Beginning with the resumption of economic growth mentioned above, makes the following specific observations.

1. The economic gains, so far, have however not translated into improved living standards for many Palauans. On the contrary, outside the corporate sector where wages have kept pace with price increases, average real wages have declined and are lower than they were in 2010, before the tourist boom of that decade. Two reasons primarily account for the decline: first, imported post-pandemic inflation (e.g., cost shocks, notably in energy) on the order of twenty percent over several years, and the fact that local businesses took advantage of the PGST to raise prices by an additional ten percent, while pocketing gains from elimination of the Gross Revenue Tax and import taxes. This behavior no doubt owes to the essentially cartelized nature of a small island economy. It is a reality reflected in substantial gains in profits, which are echoed in receipts from the new gross profits tax. Palau as such does not have an employment problem; a large share of the workforce consists of temporary foreign workers who can leave if there are no jobs. But the increased cost of living is felt by Palauan and foreign workers alike. It is undoubtedly an adverse factor for Palau's demographic future, encouraging emigration to the United States. Efforts to compensate through targeted, means-tested transfers to help the lowest income households, and increases in the minimum wage are in process. However, the lowest earners do not necessarily live in the lowest-income households, and there is a risk that increased employment costs may be passed along, once again, in higher



Palau EAG members in Koror, with Hon. Ngiraibelas Tmetuchl, Minister of Human Resources, Culture, Tourism and Development, and Ms. Lindsey Timarong, chairman of the Palau Trust Fund Committee.

prices. The EAG recommends that efforts to target reforms carefully to ensure well-meaning income support programs will efficiently achieve the desired impact.

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2. On the fiscal front, Palau faces, and quite soon, major decisions on how to maintain and reform its Social Security Administration (ROPSSA) and Civil Service Pension Plan (CSPP). In the case of the CSPP, without government contributions the trust fund would face exhaustion in just three years. Reforms that hold harmless existing pensioners are possible, and there is a \$20m grant approved by the U.S. to be used not just to further defer the inevitable depletion of pension resources, but to support sustainable reform. Early decisions are needed to determine how to share the burden between future retirees, current employees, and the Palauan taxpayer. Decisions taken in the teeth of a cash-flow shortfall are unlikely to be optimal. The EAG recommends that the Government of Palau begin to address ROPSSA and CSPP sustainable reforms at an early date.

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3. Over the long term, Palau faces major demographic challenges in consequence of forces that have developed over the years and that cannot – and often should not – be undone. These include a falling birth rate, characteristic of modern societies everywhere, and special circumstances associated with Palau's American connection. The incentive to emigrate is intrinsic in free access to the United States, in pay differentials, in U.S. educational opportunities, and in the appeal of U.S. military service to young Palauans. The result is that nearly half of Palauans now reside in Guam,



Hawaii, or the continental U.S.. This is their right and their choice, and it represents a tendency that is unlikely to reverse in future years. But in the modern world emigration, while definitive, need not be absolute. It is possible, and in the development of Compact relations it should be made as easy as possible, for expatriate Palauans to maintain a presence in their land of origin and to contribute to its economic and social well-being. Several practical steps can contribute toward this goal:

- a. A VA clinic should be established in Palau to permit Palauan veterans of the U.S. military to obtain most, if not all, of the benefits to which they are entitled by virtue of that service, while they are visiting or living in Palau.
- b. Eventually, the Palauan health service should be qualified for reimbursements under Medicare and Medicaid, so that those qualifying for those benefits can receive them in Palau.
- c. Internships and sabbatical working arrangements should be developed and encouraged so that key professionals – nurses, teachers, engineers, police – can return on a part-year basis to provide services in the islands, perhaps with some salary support from their U.S. institutions. On a longer-term basis, Palau's Ministry of Finance is collaborating with the University of Hawaii at Manoa to track and eventually place undergraduate and graduate Palauan student in key study areas to enhance skills and be available to replace aging, mostly government workers. Notably, UH Manoa has also completed an articulation agreement with Palau Community College to promote the transition of Palauan students in an efficient and effective manner.
- d. A retirement community might be built, in conjunction with the new hospital, to make retirement, assisted living and end-of-life care available to Palauans inclined to return after spending their careers in the U.S.
- e. The U.S. Congress should consider a tax-sharing plan, permitting Palauans and U.S./Palau dual nationals to designate (say) fifty percent of their U.S. income tax payments to the government of Palau. This could provide a major benefit to Palau at very minor cost to the United States.
- f. The U.S. should assist Palau in establishing a low-cost mechanism for cross-border financial transfers and internal payments, consistent with safeguards against money laundering and tax evasion.
- g. Perinatal services should continue to be modernized and brought in line with best practice, discouraging unnecessary caesareans and other practices that give expecting mothers reasons to relocate to Guam or Hawaii to give birth.
- h. The EAG recommends that Palau be made eligible for FEMA's services and assistance in the case of natural disasters, in line with practice for the other two COFA nations.

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The PGST has been controversial in Palau, in part for reasons given above – the unfortunate conjunction of its introduction at a time of rapid outside cost shocks and the opportunistic behavior of merchants. However, the tax has three advantages: a) it is enforceable; b) it yields a robust and stable revenue stream to the government; and c) it is paid in substantial part by tourists and other visitors to Palau. Those advantages argue that adjustments, if any, should be made from the now-existing tax structure rather than a retreat to the previous taxes (the GRT and import taxes). However, adjustments are possible, both to enhance income-based rebates and to lower the rate on a temporary basis in difficult times. A Palau discount card could ease the burden on qualified residents. The EAG recommends against exempting particular classes of goods as this complicates tax administration and invites evasion. Ultimately, income reporting can lead toward income taxation, but this should be considered only once Palau becomes a mature economy with a predominantly formal employment sector. Otherwise, such a tax encourages informality to the detriment of jobs and wages for Palauans.

The EAG recommends against exempting particular classes of goods as this complicates tax administration and invites evasion.

As noted, Palau's current fiscal position and outlook have brightened, but this improvement opens the way toward decisions on how to deploy fiscal resources, including the trust fund, the accumulated cash reserve, and the Compact resources. We urge Palau to reduce any disadvantageous debt, saving future interest payments, and to consider whether cost-sharing with donors on major projects, such as the new hospital, can help galvanize the necessary support on favorable terms. The EAG recommends against the use of fixed (and exhaustible) reserves for operating expenses, and (equally) the accumulation of excess reserves. The right time to build the future of Palau is now, subject to material, personnel, planning and logistical constraints.

In this connection, the EAG has worked to bring the U.S. Trade and Development Agency (TDA) and the Development Finance Corporation (DFC) to Palau to assist in important infrastructure projects. We were dismayed by the needless obstacle to this work thrown up when a modest recovery of tourism caused the World Bank to reclassify Palau as a high-income country – a classification that presently precludes DFC involvement in Palau. This use of the World Bank classifications is inappropriate for a fragile and volatile island economy. Anyone visiting Palau understands that it is not a stable, high-income country. We are encouraged that Congress is moving toward resolving this problem for the DFC by granting DFC management flexibility in this matter. We urge the World Bank to take a less mechanistic approach to its classifications.

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Tourism continues (and will continue) to be Palau's major industry and source of external income. The revival of tourism since 2022 – to about one-third the peak levels of 2015 – is an encouraging development. However, Palau needs to develop tourism strategically, so as to ensure the maximum benefit to the Palauan economy. Here there are two dangers. One comes from a focus on low-end package tours that contribute sub-optimally but still substantially to the economy and to state revenues, but have high externalities, including congestion at key tourism attractions and social disruption. The other is excessively grandiose high-end developments that may become, in effect, enclaves with little Palauan involvement. To avoid these twin pitfalls, The EAG recommends the Palau national government integrate policy and planning with the state government of Koror to integrate tourist development within the urban fabric of Koror and in the rural setting, mainly of Babeldaob. The lack of such integrated efforts has long been a source of missed

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opportunities. The EAG further recommends that development on Malakal foster the removal and cleanup of junkyards and old industrial sites, leaving space for business development in potentially attractive areas. Relocation of the current industrial and shipping port (as well as a fishing port) to Babeldaob would help transform this area for tourist development. If the U.S. military wishes to expand and maintain the existing port for dual-use by visiting naval forces and cruise ships, so much the better.

Transport is a critical element in the steady revival of the tourist industry. For a small island state, the problem is not simple: without demand there will be few flights, but without flights the level of demand is



Palau EAG members with H.E. Surgangel Whipps, Jr., President of Palau, following a discussion of recent economic developments.

difficult to determine. Moreover, flights from specific destinations must be available at a certain minimum frequency; once a week may be adequate for cargo and official travel, but tourists will be reluctant to travel into Palau if their return flight might be canceled or delayed, forcing them to spend a second unplanned week in-country. A recent weekly service from Australia fell victim to this problem, although this issue may be resolved by the start of a Qantas service from Brisbane.

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In this connection, the institution of regular flights from Taipei, at four times weekly, has proven of great value, since Taipei is accessible from all over Asia and Europe, permitting visitors to aggregate there for transfer to Koror, using narrow-body aircraft suited to the present runway. Very likely the best solution to Palau's access problem is to foster similar services from other major cities, notably Tokyo and Seoul, in the hope that demand will rise to match the supply. Impending service from Tokyo will also aid the development of a market for Palau's freshest fish – a topic to be dealt with below. We believe that a solution along these lines would obviate the need to extend the Koror runway to accommodate flights by long-distance, wide-body planes. The EAG recommends Palau focus on frequency and strategic connections, not distance and per-plane capacity, as the most immediate means of achieving a sustainable increase in tourism. Moreover, if and as increased high-end rooms become available, airlines with larger business classes may be induced to provide service.

The EAG reviewed and discussed several substantial infrastructure projects. We are aware that in building out infrastructure, Palau faces specific, if not unique, challenges, as at any given time neither materials,

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nor labor, nor project managers are in elastic supply. Yet a comprehensive modern infrastructure base is the foundation of an efficient, diverse and stable economy. Further it is important for financial viability that infrastructure networks – and their rate base – be as complete as possible, despite the fact that some clients may prefer their own solutions to specific technical problems. In particular:

- a. On telecommunications, Palau's PNCC is making impressive progress toward a modern 5G (and eventually, 6G) system, having obtained considerable foreign funding to upgrade from the previous network. A second fiber cable will add to the resilience of Palau's system. The EAG recommends efforts to maintain PNCC's financial viability including cautious incorporation of satellite-based alternatives, which have their greatest utility in the most remote locations.

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- b. On water and wastewater, we are advised that issues with the completion of KASP (Phase 1) have been resolved. However, issues will arise with the provision of water and wastewater to certain proposed major new projects on Malakal. If these are provided privately, they infringe on the financial viability of the PPUC; if they are a public responsibility, the services needed may be slow to arrive. On the whole the EAG recommends a solution favoring the long-term viability of the PPUC water and sewer system. If the infrastructure is privately installed, it should nevertheless become part of the PPUC rate base once operational, just as would any externally-funded project. This is a reasonable condition for doing business in Palau.

The EAG recommends a solution favoring the long-term viability of the PPUC water and sewer system.



EAG Chairman Dr. James Galbraith with H.E. Surangel Whipps, Jr., at the presidential inauguration in Palau (January 2025).

- c. The EAG strongly recommends giving high priority to the siting, design and construction of a new hospital and health complex, taking account of the existing population concentration in Koror and the availability of land for future ancillary uses, such as staff housing and a potential retirement community-. In this respect, dividing medical services between urgent care center(s), easily accessed in Koror, and specialist and long-term care (nearby) may be the sensible solution. The EAG would greatly welcome the assistance of India, as a partner in the Quad, in establishing the next generation of health care in Palau.

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- d. The port and port area are, at this point, dilapidated and unsightly, and an obstacle to successful redevelopment of Koror as an attractive town for Palauans and visitors alike. A solution may be to move the commercial port to the west coast of Babeldaob, in conjunction with the proposed fishing port, while redeveloping the present region for cruise ships, with support from the U.S. military which could also use the facility for naval visits, including R&R for servicemen and women.
- e. Palau's electrical grid continues to struggle with ambitious plans to increase the availability of renewable power sources. While the jury is out on the long-term prospects of significant reliance on renewables, an argument in their favor remains that they help to dampen external shocks to energy costs. Nevertheless, the EAG recommends as a general matter that under the circumstances of a small island economy, it is neither necessary nor desirable for Palau to attempt challenging experiments on the frontiers of new technologies.

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- f. In all of these matters, the EAG recommends Palau carefully note the importance of pacing and coordination, including with private initiatives that can disrupt public investment by drawing off scarce materials, labor, and management. Palau's financial resources, strategically budgeted can help coordinate the pipeline of major projects.

We were encouraged by plans to sustainably open part of Palau's maritime zone to fishing, along with the development of a fishing port on the west coast of Babeldaob and the requirement that catch be offloaded there. In conjunction with regular flights to Tokyo, Palau could become a significant supplier of high-value ultra-fresh fish to the Japanese market, a significant advantage over the present need to travel back to Okinawa for off-loading. Restoration of Palau's fisheries on a sustainable basis would add a significant extra element of diversification to the economy. We note in passing that Palau's agricultural potential, mainly on Babeldaob, remains largely untapped. The economic, soil, and climate issues affecting agriculture are beyond the scope of our expertise.

The EAG recommends Palau carefully note the importance of pacing and coordination, including with private initiatives that can disrupt public investment by drawing off scarce materials, labor, and management.

The development of a stable, low-cost, transparent, secure electronic payments system for Palau remains a major challenge. A stablecoin has so far not been implemented, and the U.S. Treasury advises that there is no example of a successful stablecoin system at national scale to work with. Presently the best prospect appears to be a World Bank project to deliver a platform that can be commodified and adapted by multiple island states.

The issue of how to deploy Palauan bank deposits for local benefit is a further question of finance. Savings bonds may prove attractive as an alternative to time deposits, with revenues targeted to the national development bank for housing and infrastructure. Such bonds may be of interest particularly to the diaspora, especially if they were made tax-exempt in the U.S.. However, there are risks associated with maturity mismatch and the absence of insurance comparable to that provided by the FDIC.

Palau presently has approximately \$90 million in cash deposits. The EAG recommends Palau develop a strategy for the investment of these reserves to foster earlier achievement of major infrastructure objectives, and restore Palau's compliance with its Fiscal Responsibility Act obligations. Such a strategy could, furthermore, be a step toward obtaining a bond rating and access to international capital markets on favorable terms.

The EAG recommends Palau develop a strategy for the investment of these reserves to foster earlier achievement of major infrastructure objectives, and restore Palau's compliance with its Fiscal Responsibility Act obligations.

Digital residency – now taken up by about twelve thousand individuals, is a concept whose benefit to Palau appears limited to a one-time fee. It is noted that the temptation to use digital residency for money laundering, evasion of capital controls and evasion of financial regulation – for example by U.S. residents to evade restrictions on the use of offshore crypto exchanges – has caught the attention of U.S. Treasury enforcement. The U.S. ambassador also warns that any conversion of digital residency into citizenship would endanger Palau's visa-free access to the U.S.; it is however to be noted that Palau has no such intentions. In these matters, as a general rule, **the EAG recommends that Palau adopt tested and proven financial programs and procedures given that Palau is too small, and its nascent regulatory capacity ill-prepared to deal with unproven, cutting-edge financial innovation.**

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Further Key Points Subsequent to EAG Visit to Palau

Key Points from January 2025:

The completion of the second COFA agreement and the inauguration of President Whipps for a second term make the present a crucial moment to schedule and implement key infrastructure plans to assure a prosperous future and diversified economy for Palau. Key initiatives that should move forward in the near future are: (a) a new hospital, with medical facilities in the near environs of Koror that permit the development of auxiliary facilities complementing the medical services; (b) a new port, on the west coast of Babeldaob, permitting the relocation of commercial/industrial activity from Malakal and the establishment of a fisheries facility; (c) major renovations and extensions of the airport and harbor, provided for from U.S. DoD appropriations; and (d) urban redevelopment, including clean-up of industrial

and abandoned sites in and around Koror, through the effective use of sanitation fees, and supporting the gradual relocation of many Koror residents to the north and suitable provision for public transportation.

There is an urgent need for Palau's donor community to coordinate their projects, sharing plans and funding streams and so permitting orderly and efficient scheduling of major projects. The capacity of the Foreign Investment Board to evaluate private investment projects, in line with regional best practice, should be improved, and FIB governance redesigned to improve accountability while reducing the element of political control.

Key Points from April 2025:

The EAG is gratified that support for Palau under COFA is not foreign aid and has not been affected by changes in U.S. foreign aid policies. The EAG looks forward to favorable resolution of reviews affecting other U.S. federal programs, with Palau engagement, including those affecting health, education and programs administered by the Department of the Interior.

The EAG calls attention to the constructive role being played with respect to major infrastructure projects in telecommunications, health and other areas by the TDA and by the DFC as noted in the main findings above and the EAG looks forward to the continuing engagement of these agencies or designated successors – after appropriate review -- in the important work they have undertaken and had planned to undertake for the benefit of Palau.

The EAG affirms the constructive and important role of the OEK in helping to shape the agenda of the second administration of President Whipps and looks forward to a favorable resolution of personnel and other issues so that the Government of Palau can move forward with its economic planning and policy agenda in an orderly and efficient manner.

Appendix 1:

3rd Annual Palau EAG Performance Monitoring Dashboard

Background

Pursuant to the 2023 Compact Review Agreement (2023 CRA) with entry-into-force on March 15, 2024, the Economic Advisory Group for Palau is described in Article 7, as follows:

- a. *The Advisory Group on Economic Reform established by the 2010 Compact Review Agreement, as amended, shall continue to exist until otherwise agreed by the Signatory Governments but shall be renamed “The Economic Advisory Group for Palau” (the “Advisory Group”). Its purpose shall continue to be to contribute to the economic growth and sustainability of Palau by recommending economic, financial, and fiscal management measures.*
- b. *Upon entry into force of this Agreement, the members of the Advisory Group as of April 1, 2023, shall be redesignated for a three-year term, after which the Signatory Governments shall designate members in accordance with this paragraph and giving favorable consideration to current members. The Advisory Group shall be comprised of five (5) members, two (2) of whom shall be designated by the President of Palau, two (2) of whom shall be designated by the Secretary of the Interior of the United States or their designee, and the fifth of whom shall be chosen by the Secretary of the Interior of the United States or their designee from a list of not fewer than three (3) persons not residents of Palau submitted by the President of Palau. In the event that the Secretary of the Interior of the United States or their designee rejects the persons enumerated in the list submitted by the President of Palau, then the fifth member shall be chosen by the President of Palau from a list of not fewer than three (3) persons submitted by the Secretary of the Interior of the United States or their designee. In making these designations, due consideration shall be given to the mix of expertise that would be most beneficial to the work of the Advisory Group. The Advisory Group shall continue to be chaired by a member chosen by its members from among their number.*
- c. *The Advisory Group shall meet at least twice a year. Each Signatory Government shall provide the necessary support for its designated members on the Advisory Group. Support for the fifth member shall be borne equally by the Signatory Governments.*
- d. *The Advisory Group shall report and make recommendations to the Signatory Governments on these matters and otherwise as it deems advisable by May 1 of each year.*
- e. *Subject to the availability of appropriated funds, the Government of the United States shall provide for technical and administrative assistance for the Advisory Group and support necessary for it to accomplish its purpose.*

Article 4 of the 2023 CRA further specified matters related to “Fiscal Management” in Palau and these provisions will be taken up, in part, by the Advisory Group. Specifically Article 4 includes:

In order to increase the long-term economic stability of Palau and to maximize the benefits of the economic assistance provided by the Government of the United States, the Government of Palau shall continue to undertake economic, legislative, financial, and management improvements, and shall give due consideration to recommendations from the International Monetary Fund (IMF), the Asian Development Bank (ADB), the Pacific Financial Technical Assistance Centre (PFTAC), and the Government of the United States. The Government of Palau shall adhere to sound fiscal principles as outlined in its Fiscal Responsibility and Debt Management Act (FRDMA) of 2021...

In response to the Advisory Group's 2023 CRA, Article 7 mandate that, "its purpose shall continue to be to contribute to the economic growth and sustainability of Palau by recommending economic, financial, and fiscal management measures, annual reports will continue to include an Appendix providing a dashboard approach to performance monitoring.

This dashboard approach is proposed to be maintained as background tracking and to be expanded as economic, financial and fiscal management may allow. ROP leadership and officials have been exceedingly helpful in enabling the gathering of key data over the specified time periods and it is expected that continued cooperation will be necessary to ensure successful monitoring and to inform the recommendation-making process that the EAG will undertake as it achieves increasing levels of understanding of the opportunities and challenges facing Palau.

The Palau EAG Performance Monitoring Dashboard

As an initial effort to report on economic, financial and fiscal management the EAG presented a Dashboard in four sections in its 1st Annual Report (April 2023):

1. Government employment
 - a. National government number of employees
 - b. National government employees as % of total employees
 - c. National government wage bill, nominal and real (\$ millions)
 - d. National government wage bill as % of GDP
2. Fiscal performance
 - a. Tax revenues as % of GDP
 - b. Expenditures as % of GDP
 - c. Fiscal balance as % of GDP
 - d. Unreserved general fund cash balance (\$ millions)
 - e. External debt as % of GDP
3. Financial/Banking performance
 - a. Total depository bank deposits as % of GDP
 - b. Total depository bank loans as % of deposits
4. Economic performance
 - a. Real GDP (2015 prices, \$ millions)
 - b. Real GDP per capita (2015 prices)
 - c. Economic transformation—traded goods as % of GDP

3rd Annual Assessment of Palau's Performance—Based on Audit Figures and estimates for post-Covid Fiscal Years

Each of the fourteen (14) charts includes a brief commentary on the progress (or lack of progress) indicated for Palau over the noted period. 3-year averages over five (5) updated time periods are utilized to smooth some of the volatility suffered by Palau in almost all economic, financial and fiscal matters.

Data for each of the charts was that which was available on April 10, 2024.

It should be noted that US officials persistently highlighted the size and cost of the national government during the period from FY2007-FY2009 (and perhaps before). Importantly, the same US officials

expressed concern as to the ability of Palau to adjust to reduced resource transfers if the mandated Compact section 432 Review (in 2010) led to a result of zero new funding commitments were agreed after FY2009. In such an event the International Monetary Fund (IMF) presented its standard fiscal/financial assessment of Palau in quite dire terms, recommending a strong focus on downward fiscal adjustment (expenditure cuts and/or revenue enhancements).

It should be noted with interest that the dire outcome of a failure to secure additional funding through the 2010 CRA negotiations did not occur; however, an 8-year delay in funding the CRA was virtually tantamount to a zero-funding availability outcome for Palau's access to operational budget support and equated to an 8-year delay in capital funding support. So, the IMF recommendations prove useful in assessing Palau's performance during the period from FY2010-FY2018. The time periods chosen for the dashboard align reasonably well with the 2010 CRA-specified IMF and ADB recommendations. In future it will be the policy of the EAG to include contemporary assessments of Palau's opportunities and challenges in our performance monitoring and in our making of recommendations and timelines associated with our policy recommendations.

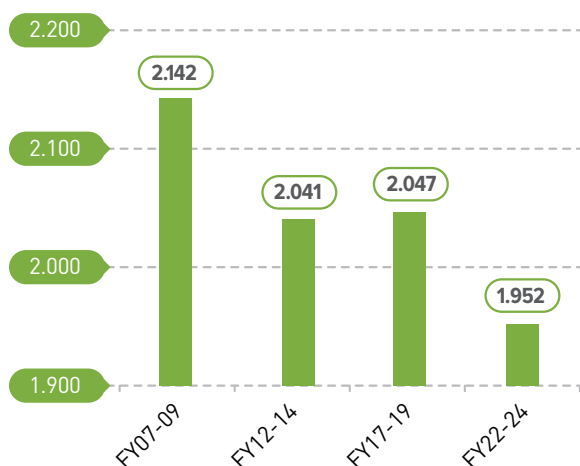
At a high level, we can see that the then prevailing IMF modeling exercise predicted a need to improve the fiscal position by some 0.9 percent annually for the period from FY2009 – FY2021 even with Compact renewal in place. [see the IMF paper referenced in the 2010 CRA, pp 7-10].

In fact, Palau, despite a delayed Compact renewal achieved an improvement in its overall fiscal balance from a deficit of 3.6% at the end of FY2009 to a surplus of 6.2% in FY2018. An adjustment averaging 1.1% annually. FY19 resulted in a small deficit (0.4% of GDP) as a result of active retribution by the government of PRC drastically reducing tourism arrivals. The key takeaway is that Palau did manage its fiscal situation responsibly and outperformed the stark modeling projections for austerity shared by the IMF in 2008. Notably, Palau achieved progress on revenue enhancements—achieving an increase of 6.5% of GDP from FY2009 through FY2018. A key lesson, of course, is that fiscal austerity is easier during periods of economic recovery and growth... a lesson worth applying as the Palau economy is projected to recover from its COVID-19 pandemic-affected depths in the coming years and to be bolstered by the favorable financial results of the 2023 CRA.

The 3rd Annual Palau EAG Performance Dashboard follows.

Government Employment

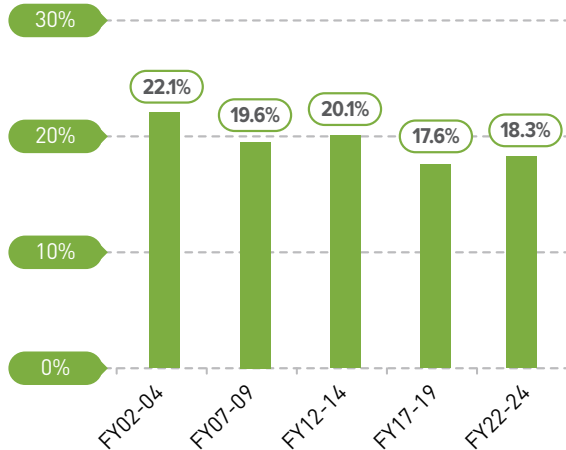
1.a. Nat'l Gov't Employees



A common critique by observers of the Palauan economy during the initial Compact period was that the government workforce was “too big” and absorbed “too many” resources. Whether this was (or perhaps is even true to this date), the size of the government has been reduced to the point where in health, education and financial management vacancies remain unfilled and service levels clearly suffer.

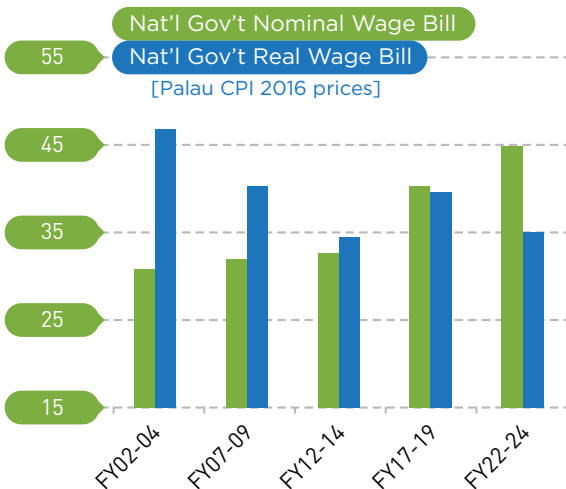
The 19% decline in total national government employees (from 2,412 in FY02-04 to 1,952 in FY22-24) represents the results of persistent and prudent efforts by Palau's leadership to rely more on the private sector in its economic growth strategy. It is expected that the next period (FY23-25) will show a small increase in the size of the national government as the resources available under the 2023 CRA are deployed—presumably to meet priority needs.

1.b. Nat'l Gov't Employees [as % of Total Employees]



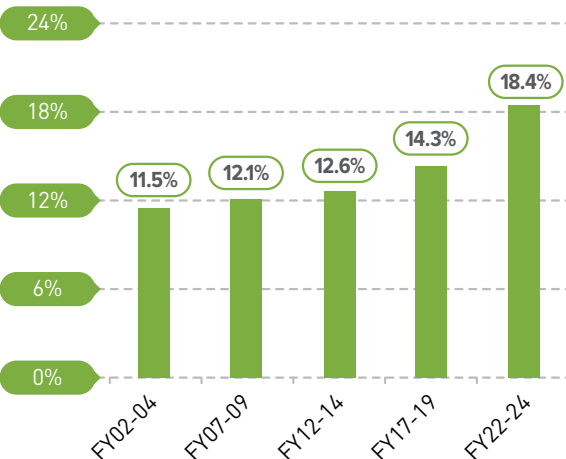
The 17% decline in the share of national government employees as a share of total employees (from 22.1% in FY02-04 to 18.3% in FY22-24) is consistent with a strengthening private sector and is expected to continue as a trend—with even greater declines as the private sector recovers from the deep impact of the COVID-19 pandemic.

1.c. Nominal & Real National Government Wage Bill (\$millions)



The 25% decline in the total real wage bill of the national government (from \$46.8 million in FY02-04 to \$34.9 million in FY22-24 in 2016 prices) also demonstrates a persistent and prudent approach to fiscal management and to reduce the prior imbalance between government wages and private sector wages (in part). The government of Palau has instituted two pay increases for public sector workers and one broader economy-wide minimum wage increase. The EAG members will closely monitor this metric as minimum wage policy has been applied to government workers (about a 12.5% nominal increase in FY23 and a further 11.1% increase in FY24—both in the face of high inflation). This policy represents an attempt to make wages more attractive, especially as senior Palauan workers age and the stated policy of consecutive administrations is to bring more Palauan workers and their families back home. The EAG is aware that increases contemplated to-date are at a level justified based on an approach measuring Palau's basic needs poverty line over time.

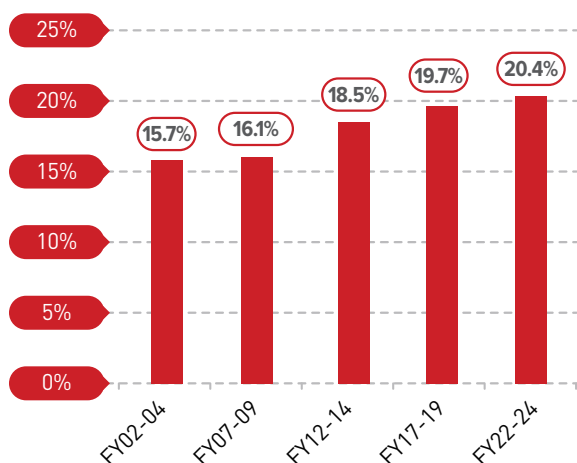
1.d. Nat'l Gov't Wage Bill as % GDP



The 6.9 percentage point increase in the national government wage bill as a share of GDP (from 11.5% in FY02-04 to 18.4% in FY22-24) is the result of two increases in wages in the past three years while the economy (GDP) is still at a post-pandemic suppressed level. Of note is the fact that the IMF analysis referred to in the original 2010 CRA mandate for the EAG assumed this metric would remain stable and the fiscal deficit then present and threatening to deteriorate would, indeed, have created a dire need for the sharp downward adjustments prescribed by the IMF. Palau, instead, chose an incremental path to fiscal adjustment over the long-term and exceeded the total adjustment through FY17-19. A return to a lower ratio is expected over the medium-term; albeit there is some risk that the 2023 CRA resource increase may be insufficiently allocated to meet infrastructure bottlenecks that threaten a return to more robust economic growth.

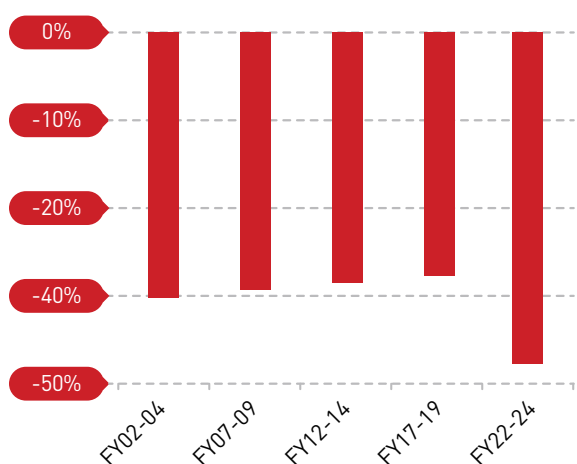
Fiscal Performance

2.a. Tax Revenues as % GDP



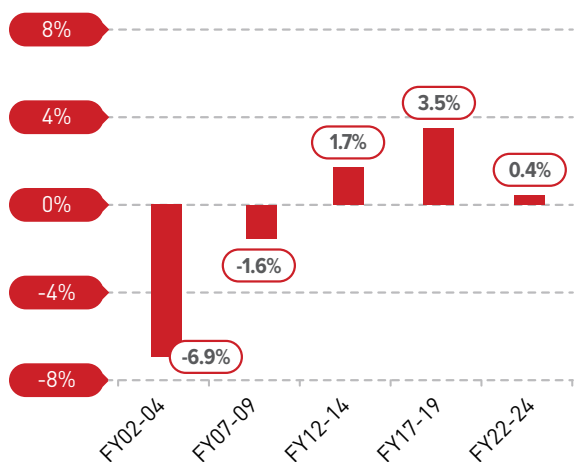
The 30% increase in taxes as a share of GDP (from 15.7% in FY02-04 to 20.4% in FY22-24) is the result of incremental tax policy changes to the long-standing Trust Territory-vintage tax system in Palau. Ultimately, Palau has adopted a tax policy consistent with the advice of the IMF and other observers as far back as 2002. This was an important achievement of Palau's fiscal policy, to replace a tax regime that came with increased tax distortions and with diminishing returns in terms of tax collections in proportion to GDP growth. The EAG will be closely monitoring the macro- and micro-impacts of the comprehensive tax reform passed in FY2022 and implemented as of January 1, 2023. It is already evident that tax collections, especially from the Palau Goods and Services tax (PGST—a value-added consumption tax) are exceeding initial projections and total tax effort will rise again when the impacts of the COVID-19 pandemic are long gone.

2.b. Expenditures as % GDP



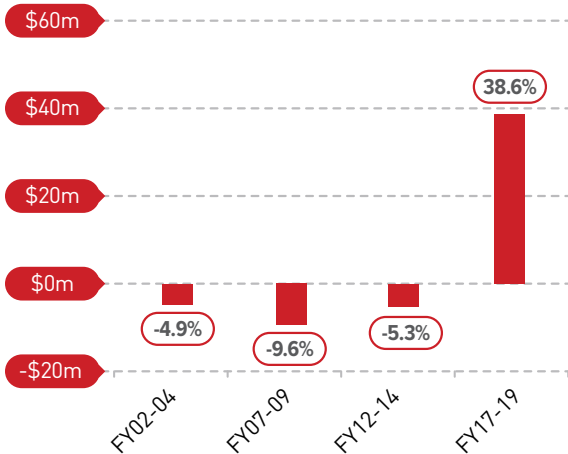
The 25% increase in expenditures as a share of GDP (from 37.7% in FY02-04 to 47.1% in FY22-24) is an anomaly due to the impact of the COVID-19 pandemic. The previous trend of declines in this ratio has been temporarily reversed. The IMF macro-modeling used for the report and recommendations called out in the original 2010 CRA mandate for the EAG implied expenditures remaining steady as a share of GDP, resulting in extensive implied borrowing in the absence of substantial fiscal compression. This outcome was avoided until the pandemic. The EAG expects to monitor this metric closely in the post-COVID period and, in particular, expects a needed increase in capital investments as a share of GDP and as a share of total spending.

2.c. Fiscal Balance as % GDP



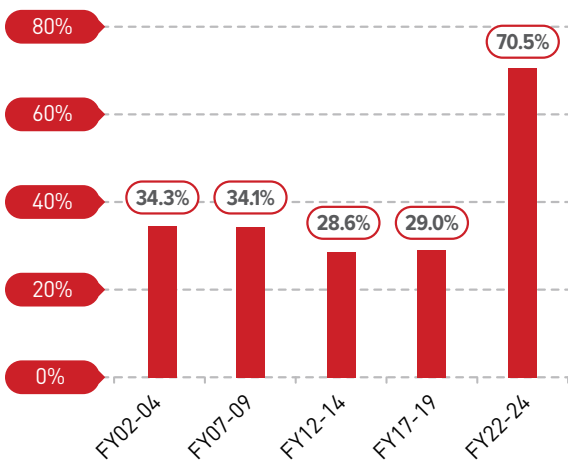
The fiscal adjustment equivalent to 10.4 percentage points of GDP (from -6.9% in FY02-04 to +3.5% in FY17-19) is, perhaps, the most impressive metric within the whole dashboard; that was a greater magnitude of adjustment than the IMF had called for and it is proof of an improved and prudent fiscal stance over an extended period. Alas, the impact of the COVID-19 pandemic was a setback, but fiscal prudence is still evident with the near balance over the pandemic affected period FY22-24 (0.4% of GDP). Palau is still facing the need to “reset” its economic strategy—a clear recommendation of the EAG that will, over time, include more specific focus on elements of that strategy by the EAG. Of note is the EAG-explicitly articulated need—to execute a more sustainable approach to tourism recovery/ growth coupled with restoration of Palau's infrastructure stock and, perhaps with the greatest difficulty and uncertainty... a needed diversification of Palau's economic base.

2.d. Unreserved general fund cash balance (\$millions)



The \$43.5 million increase in Palau's available fund balance (from -\$4.8 million in FY02-04 to +\$38.6 million in FY17-19) is indicative of a major turnaround in its core management of government finances and an achievement, albeit temporary and in the end not fully sufficient, of its long-stated goal to have an adequate "rainy day" fund in the face of climate resilience threats and vulnerability to regional and global economic shocks. The EAG will closely monitor this metric as any return to persistent government deficits would be debilitating with respect to private sector growth and a threat to maintaining long-term stability through each economic cycle. It is, however, anticipated that Palau's reserves as reported in audits will have continued to increase through FY2024.

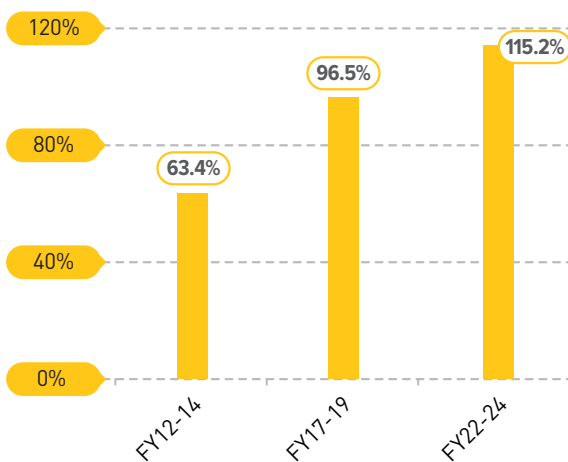
2.e. External Debt as % GDP



The near doubling of Palau's external debt as a share of GDP (from 34.3% in FY02-04 to 70.5% in FY22-24) is a near immediate impact of the COVID-19 pandemic. Unfortunately, the impacts of the pandemic led to an increase in borrowing on the reasonable assumption that the crisis was a cyclical shock. With 20:20 vision it appears that the fiscal shock, due to the level of borrowing and the time delay in economic recovery will leave a small structural deficit for Palau to manage. The EAG will closely monitor Palau's external debt stance which has now been crucially assisted with a six-year, 60 million allocation of debt relief funding under the now in-force terms of the 2023 CRA. It would be best if the fiscal space provided by that provision be largely dedicated to increased infrastructure investment instead of purely operational and recurrent spending.

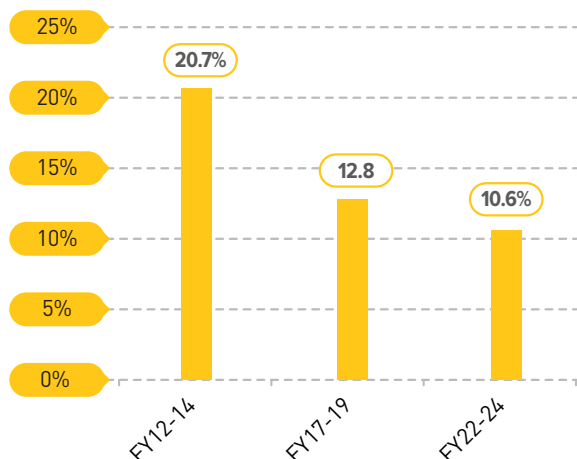
Financial/Banking Performance

3.a. Total depository bank deposits [as % GDP]



The 82% increase in Palau's domestic banking deposits (from 63.44% in FY12-14 to 115.2% in FY22-24) highlights the relatively high and growing penetration of formal banking in the Palauan economy. The banking sector received minimal attention from the IMF and other observers at the time of the 2010 CRA-referenced report. The EAG has a stated objective of trying to find ways for Palau's economy to increase the mobilization of domestic resources. This would preferably be through means that maintained the relatively high and growing level of deposits as a share of GDP while also increasing total lending, especially for commercial lending. Alternatively, the government or a public sector entity may be called upon to intermediate. EAG member, Professor Yoshino, is assisting in the imminent introduction of Palau savings bonds to further mobilize resources with the idea of funding needed infrastructure. The EAG will closely monitor banking and domestic finance as the economy faces the need for substantial investment.

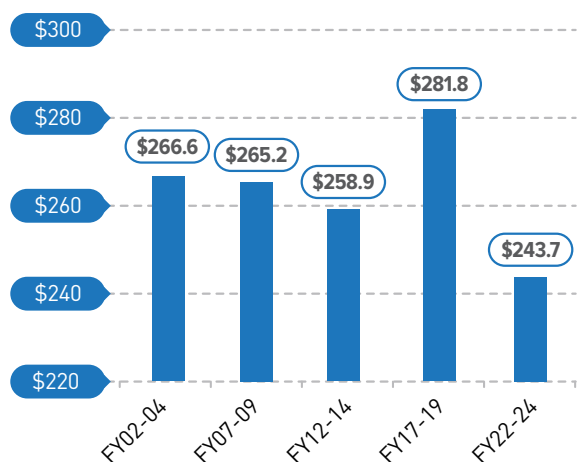
3.b. Total depository bank loans [as % Deposits]



The 49% decline in bank loans as a share of total deposits (from 20.7% in FY0FY12-14 to 10.6% in FY22-24) resulted from a further decline in loans at the time of growing deposits. As noted above, the EAG will closely monitor this metric. If creative means to mobilize bank lending are unsuccessful, then other means to mobilize ample domestic resources to meet the economy's need for infrastructure, improved tourism plant, and diversified production will be considered for recommendation by the EAG.

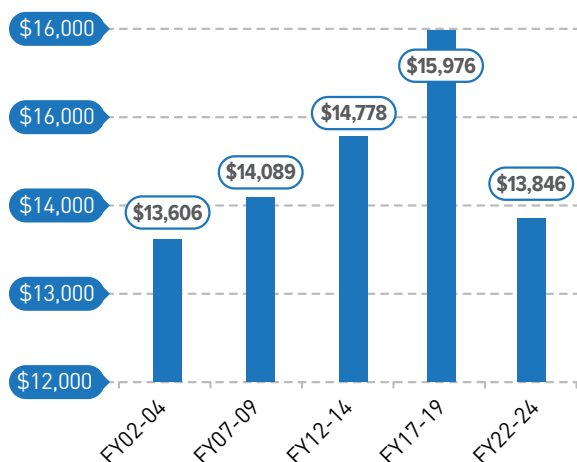
Economic Performance

4.a. Real GDP (2015 prices)

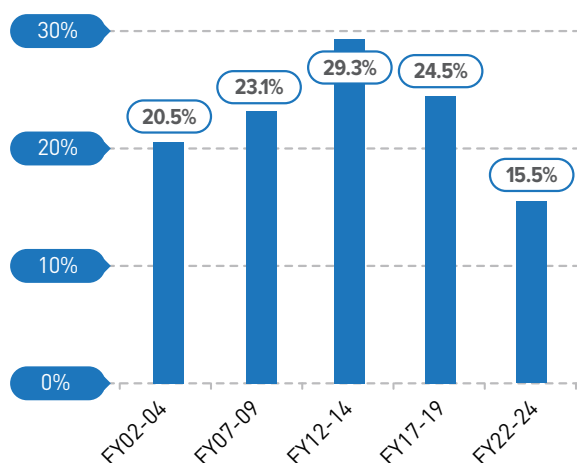


The 9% decline in real GDP (from \$266.6 million in FY02-04 to \$243.7 million in FY22-24) is a disappointing result over a two-decade period. Nearly one-third of the years over the period resulted in negative real economic growth. The fact is the economy suffers from external shocks that are well beyond Palau's control. The COVID-19 pandemic effect on the economy post-FY19 was a decline of 25% increasing the need for a sustainable recovery that does not simply retrace the path to boom-bust economic outcomes. The EAG will closely monitor Palau's economic and fiscal management with an eye toward finding ways to reduce Palau's reliance on a narrow and volatile economic base. This is, indeed, the crux of the problem and the challenge the EAG will partner with Palau to try to overcome.

4.b. Real GDP/capita (2015 prices)



The 2% percent in real GDP per capita (from \$13,606 in FY02-04 to \$13,846 in FY22-24) represents a disappointingly modest growth in the economy (the numerator) and a minor increase in the population (the denominator). The lack of a modestly growing Palauan population—as opposed to foreign workers—indicates the challenge to Palau's leadership that has led them to focus on bringing Palauans home. This metric, too, has shown a large impact post-COVID-19 pandemic. The EAG notes the challenge represented by the fact that, prior to the anticipated onset of renewed and increased terms under the 2023 CRA, Palau will have suffered a two-decade long period of near-zero net gains in income per capita.

4.c. Economic Transformation [Traded Goods as % GDP]

The 24% decline in the share of traded goods in the Palau economy (from 20.5% in FY02-04 to 15.5% in FY22-24) masks the fact that the Palauan economy experienced a large measure of “economic transformation” in which its capacity to produce tradeable goods had expended driven almost exclusively by the tourism sector through the FY12-14 period especially and even through the FY17-19 period despite the collapse of Chinese tourism during that latter period. The FY22-24 was deeply affected by the pandemic as it is expected this ratio will return to its prior earlier levels in the absence of another shock in not too uncommon given Palau’s well-known boom-and-bust cyclicity. The EAG will monitor this lagging and relatively slow-moving metric as a measure of how effectively Palau’s private sector and outward-oriented economic strategy is implemented.

Appendix 2: Final Mission Schedule

EAG Delegation:

- **Dr. James Galbraith**, Chairman (accompanied by spouse)
- **Dr. Denise Konan**, Member
- **Dr. Naoyuki Yoshino**, Member
- **Hon. Kaleb Udui, Jr.**, Member

Mission Team:

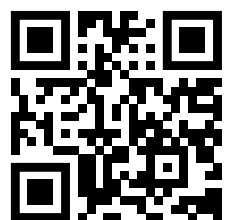
- **Mr. Kevin O’Keefe**, Economist, Graduate School USA
- **Mr. Tabesul Ngiraillemsang**, Program Coordinator, Ministry of Finance
- **Ms. Roleen Ronny**, Microeconomist, Ministry of Finance
- **Ms. Andrea Dukkorr Ngirarois**, Aide Coordination Specialist, Ministry of Finance
- **Ms. Klumch Tanglebad**, Planning Specialist, Ministry of Finance
- **Ms. Leony Christman**, Human Resource Specialist, Ministry of Finance
- **Ms. Vivica Nakamura**, Coordination Expert, Ministry of Finance-Asian Development Bank

Final Mission Schedule:

Time	Activity	Notes
Saturday, Sep-7		
5:30pm	Dr. Galbraith and Spouse Arrival ROR	<i>Mr. Kevin O’Keefe will pick-up</i>
Monday, Sep-9		
12:00am	Dr. Yoshino and Dr. Konan Arrival ROR	<i>PPR will arrange hotel transfer</i>
Monday, Sep-9		
10:30am	Meeting with Callund. Diagnosis and Next Steps for ROP Social Security Administration & Civil Service Pension Plan Reform	<i>ADB Conference Room</i>
12:00pm	Private Lunch	
1:00pm	EAG Internal Meeting <ul style="list-style-type: none"> • Economic/Fiscal Briefing • Internal Planning Discussion <i>(Moved to Thursday)</i>	<i>ADB Conference Room</i>
2:00pm	Meeting w/ President Surangel Whipps, Jr.	<i>Meyuns Office of the President</i>
3:30pm	Palau National Communications Corporation Mr. Simon Fraser, CEO	<i>ADB Conference Room</i>
Tuesday, Sep-10		
	Morning Sessions	<i>ADB Conference Room</i>
8:30am - 9:30am	Ministry of Human Resource, Culture, Tourism, and Development Hon. Ngirai Tmetuchl, Minister	<i>ADB Conference Room</i>

9:50am - 10:50am	Office of the Minister of Finance Ms. Roleen Ronny, Ms. Andrea Dukkoro Ngirarois, Ms. Klumch Tangelbad, Ms. Leony Christman, Ms. Vivica Nakamura, and Mr. Tabesul Ngirialemesang Digital Residence Office Mr. Jay Anson, Director	<i>ADB Conference Room</i>
11:00am - 12:00pm	Office of Technical Assistance, U.S. Department of Treasury	<i>ADB Conference Room</i>
12:00pm - 1:15pm	Private Lunch	
	Afternoon Sessions	<i>ADB Conference Room</i>
1:20pm - 2:20pm	Bureau of Revenue and Taxation Mr. Elway Ikeda, Director Savings Bond Mr. Rison Nakamura, Finance Specialist	<i>ADB Conference Room</i>
2:40pm - 3:40pm	Ministry of Agriculture, Fisheries, and Environment Hon. Steven Victor, Minister; Mr. Jordan Yuri, Executive Coordinator; and Ms. Lukes Isechal, Marine Spatial Planning Coordinator	<i>ADB Conference Room</i>
4:00pm - 5:00pm	Bureau of Customs and Border Protection Mr. John Tarkong, Director	<i>ADB Conference Room</i>
Wednesday, Sep-11		
9:00am - 11:00am	Meeting w/ Diplomatic Corps and Donor Partners Ambassador Joel Ehrendreich, US Embassy Ambassador Hiroyuki Orikasa, Japan Embassy Ambassador Jessica Lee, Taiwan Embassy Ambassador Richelle Turner, Australia Embassy Ms. Vivien Ngirarsaol-Protine, Palau Chamber of Commerce	<i>ADB Conference Room</i>
12:00pm	Private Lunch	
1:30pm	Palau Public Utilities Corporation Mr. Torual Gibbons, Corporate Services Manager and Acting CEO; Mr. Manny Adelbai, and Mr. Clarence Kitalong	<i>ADB Conference Room</i>
3:00pm	Bureau of Public Health Ms. Sherilynn Madraisau, Director	<i>ADB Conference Room</i>
6:30pm	Dinner Hosted by US Embassy	<i>US Embassy Residence</i>
Thursday, Sep-12		
OPEN DAY		
Friday, Sep-13		
9:00am	Ministry of Education Hon. Dale Jenkins, Minister	<i>Ministry of Education</i>
10:30am	Palau Community College Dr. Patrick Tellei, President	<i>Palau Community College</i>
12:00pm	Private Lunch	

1:00pm - 2:30pm	Leadership Debriefing with OEK <ul style="list-style-type: none">• Chair and members share observations• Dialogue with gathered leaders• Chair shares potential recommendations and next steps• Closing remarks	<i>Old OEK Satellite Building</i>
6:30pm	Private Dinner	
Sunday, Sep-15		
All-day	Battle for Peleliu 80th Anniversary commemoration	<i>EAG Chair to join US Embassy</i>



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