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The currency of the Republic of Palau is US dollars.

ABBREVIATIONS

CIF	–	cost, insurance, freight
CIP	–	capital improvement program
CPI	–	consumer price index
CRP	–	cost reduction plan
CTF	–	Compact Trust Fund
DOI	–	Department of Interior
FATF	–	Financial Action Task Force
FOB	–	free on board
FSM	–	Federated States of Micronesia
GDP	–	gross domestic product
GNI	–	gross national income
IBRD	–	International Bank for Reconstruction and Development
IDA	–	International Development Association
IMF	–	International Monetary Fund
MAP	–	management action plan
O&M	–	operations and maintenance
OECD	–	Organisation for Economic Co-operation and Development
OEK	–	Olbil Era Kelulau (bicameral parliament)
PSIP	–	Public Sector Investment Program
RMI	–	Republic of the Marshall Islands
TTPI	–	Trust Territory of the Pacific Islands
VAT	–	value-added tax

NOTES

- (i) The fiscal year (FY) of the Government ends on 30 September. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2000 ends on 30 September 2000.
- (ii) In this report, "\$" refers to US dollars.

This report was prepared by K. Taniguchi.

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EXECUTIVE SUMMARY

The Republic of Palau (Palau) is comprised of 340 islands on the western edge of Micronesia in the west central Pacific Ocean. The population was estimated at 19,200 in 2000, with an additional 6,500 Palauans living abroad (mainly in the US). About 70% of inhabitants are from Palau and the remainder is largely composed of foreign workers from Asia. Seventy percent of the population lives in urban areas surrounding the capital of Koror, and a further 10% lives in close proximity to the capital.

After periods of administration by Spain, Germany, and Japan, Palau formed part of the United Nations Trust Territory of the Pacific Islands (TTPI) administered by the US (1947-1986). Palau achieved independence in 1994 but retains close links with the US through a Compact of Free Association (the Compact). Under the Compact, Palau granted the US control of security and defense for 50 years as well as exclusive access to certain land adjoining the airport and seaport. In return, the US agreed to provide Palau with economic aid, defense, and security; and allow Palauans to enter the US as nonimmigrants and work.

Palau's real gross domestic product (GDP) is estimated to have grown by an average of 2% per year since 1994. Much of this growth took place in the first two years of the Compact and there has been little subsequent growth. Current GDP per capita is estimated at \$5,487 per year, which, in real terms, is slightly below the 1994 level (\$5,620). Palau's per capita gross national income (GNI) is estimated at \$6,870 in 2004. These figures must be used with caution given weaknesses in Palau's statistics.

Despite weak economic growth, employment grew by 4.7% per year (1994–2003). Most of this growth has been in the employment of foreign workers—there are now as many foreign workers in Palau as Palauan workers. Palauans have been slowly moving to higher paid positions in the workforce and enjoy a very low unemployment rate (2.3% in 2000).

The economy is heavily reliant on public expenditure and the tourism industry. Public expenditure as a ratio to GDP has trended down over 1994–2004 but remains high at 60–65%. Despite some adverse external events, the tourism industry has expanded substantially and visitor numbers have almost tripled over 1994–2004 to 95,000 per year.

US financial assistance is key to the large public sector. Total payments provided for under the first 15 years of the Compact (from 1 October 1994) are estimated at about \$600 million—five times annual GDP. Palau now faces a period of substantial fiscal adjustment. The Compact provides for the end of basic grants for operations and maintenance (O&M) in 2009. Allowing for increased drawdowns from a Compact trust fund, an immediate funding shortfall of 6–8% of total revenue and grants equivalent to 5% of GDP is likely in 2003. In addition, Palau will no longer benefit from substantial grant and in-kind support provided for capital projects when financial aid ends.

The Government has planned cuts in current expenditure. While some success has been achieved in expenditure control, the slow rate of progress suggests that such initiatives cannot be solely relied upon to meet the looming shortfall in current revenue. Additional revenue will need to be raised domestically. Minor revenue initiatives have been identified and could be implemented quickly with legislative support. However, more fundamental revenue reform will probably be required to fully meet the shortfall in current revenue for capital expenditure.

The required fiscal adjustment could be lessened through private sector led growth. In particular, substantial land resources have good physical capacity for activities such as tourism, agriculture, and aquaculture. This would boost revenue collection and allow for the transfer of some responsibility for infrastructure to the private sector. It would also provide an alternative

source of employment for Palauans displaced from the public sector. The economy has considerable potential to achieve private sector led growth but any attempt to diversify the economy away from the public sector would face many challenges, given the narrow production base, small population, and remoteness from major markets.

Increased private sector growth would substantially change Palau and its society, entailing important social risks. The mobilization of land for development will impact sensitive traditional and individual rights issues. Palauan labor supply is currently almost fully employed so it is difficult to retain young Palauans and attract overseas Palauans to return. Palauans are more expensive for the private sector to employ than foreign workers. The result is that private sector growth will lead to the employment of additional foreign labor, which will constitute the majority of the workforce. Domestic deposits with the banking system substantially outweigh loans, so there is sufficient liquidity to meet local capital needs. However, local banks are cautious about local lending, partly due to the difficulty of using land to secure loans. This means that foreign investors would probably be required to help fund private sector developments and provide the supporting business network and skills required—notably for larger scale tourism developments. Therefore, private sector growth will increase foreign presence in Palauan business.

Growth prospects are probably weak if Palau chooses to retain the current community structure and cautious approach to increased foreign involvement in business. The economy is highly dependent on imports, there is virtually no manufacturing sector, and the export base is very narrow outside tourism. Since the large public sector is key to high income levels, and external assistance to the public sector is scheduled to decline substantially over the medium term, Palau's current high income levels and high standard of living are probably unsustainable.

Palau is successful at this early stage of development as an independent nation, compared to other developing countries in the region. It is relatively well governed, with very few corruption cases; it has a functioning judiciary system and a relatively transparent financial and economic management process. The Government and the community will be faced with some difficult choices and decisions in the next few years if Palauans are to continue to enjoy the relatively high standards of health, education, and other public utilities which have been provided mostly free or heavily subsidized by the Government. Ongoing foreign assistance from Japan and Taipei, China, the opening up of the island of Babeldaob, and the prospect of offshore oil development in the north island of Kayangel represent a unique opportunity for development and growth. It will be a challenge to balance the competing interests of all stakeholders and the result will determine whether a more open and growth-orientated economy will be pursued or if development is likely to slow or even reverse.

I. INTRODUCTION

A. Geography and Environment

1. The Republic of Palau (Palau) lies on the western edge of Micronesia in the west central Pacific Ocean. Palau is about 1,000 kilometers east of Manila, Philippines and 1,300 kilometers southeast of Guam. Palau is composed of more than 340 individual islands along 700 kilometers (km) from northeast to southwest.

2. The main island group—Palau Islands—contains most of Palau's 458 square kilometers (km²) of land area. The northern portion of the Palau Islands is volcanic in origin and includes the islands of Arakabesang, Babeldaob, Koror, and Malakal. Babeldaob is the largest island in Palau and accounts for 78% of its land area. Economic and government activity is based on Koror, which is connected by bridge to Babeldaob and by causeway to Arakabesang and Malakal. Fertile soil and a tropical climate of high humidity, warm and relatively uniform year-round temperatures produce dense vegetation over these islands, and provide a good basis for agriculture.

3. Koror is the gateway to 300-odd raised coral limestone islands—the Rock Islands—that are scattered throughout a large lagoon and very lightly populated. Their world-renowned natural beauty provides the focus of Palau's marine-based tourism activities. The rest of the Palau Islands—Peleliu and Angaur to the south, and Kayangel to the northeast—are small, low coralline islands characterized by poor soil and limited agricultural potential. Petroleum deposits have been identified offshore of Kayangel.

4. The outer islands—the four southwest islands of Sonsorol, Hatohobei, Merir, and Pulo Anna—are culturally distinct from the Palau Islands. They are formed primarily from coral, vegetation is sparse because of poor soil and high salinity, and the population is small (about 50 people).

5. Palau's natural environment is notable for its diverse marine life, endangered turtles and dugong, 1,357 in-shore fish species, and more than 800 coral species. The terrestrial environment is also diverse, including 1,258 plant species (104 endemic), 141 bird species (8 endemic), and the endemic fruit bat. Threats to the marine ecosystem mainly arise from sand and coral dredging, illegal fishing practices and overfishing, clearing of mangroves, and overuse of key sites by divers and other tourists. Waste disposal from the heavily populated areas of Koror also presents a key threat to the natural environment.

B. Population

6. The population of Palau was 19,200 in 2000, with an additional 6,500 Palauans living abroad (mainly in the US). The latest population estimate (2005) was 20,303.¹ About 70% of inhabitants are from Palau, 2.5% are other Micronesians, and temporary residents constitute the remaining population.² Average annual population growth was 2.4% (1990–1999), which slowed to 1.9% (2000–2003). About 70% of the population lives on Koror, Arakabesang, and Malakal islands (urban areas of Palau) and 10% lives in close proximity to Koror on Babeldaob island (Airai area). Almost all the remaining population lives within one hour of Koror. The median age increased from 25.6 years (1990) to 30.8 years (2000), while the dependency ratio decreased from 57.0 (1990) to 51.0 (1995) to 41.4 (2000). Low fertility, high rates of youth emigration, and the large presence of foreign workers who typically do not bring their families to Palau have contributed to aging demographics.

¹ The Central Intelligence Agency. 2005. *The World Factbook*. Available: www.cia.gov.

² Most temporary residents are from the Philippines (15%) and the People's Republic of China (5%).

C. Historical Background

7. The initial settlers of Palau are believed to have reached the islands from the Philippines or Indonesia between 2000 and 3000 BC. Spain obtained sovereignty of Palau in 1885 and sold it to Germany in 1899. The Germans successfully introduced coconut planting, phosphate mining, and sanitary measures to stop the spread of communicable diseases. The local population was decimated by the diffusion of foreign diseases and is reported to have reached a low of 3,700 in the early twentieth century. Japanese control commenced in 1914 and saw the expansion of medical facilities, public vocational schools, and a large effort to introduce basic infrastructure such as roads, electricity, water, and sewerage facilities. The indigenous population's standard of living increased dramatically, and local capacity and skills were enhanced. At the same time, Palauan traditions and the local political system were discouraged and a power shift was imposed from village chiefs to Japanese administrators.

8. Following World War II, Palau formed part of the United Nations Trust Territory of the Pacific Islands (TTPI) that covered most of Micronesia and was administered by the US (1947-1986).³ The administrators showed low interest in Palau during the early years of the TTPI and development received little funding until the early 1960s. Since then, substantial funding and the large public sector created by the US have provided good basic social services. The Pacific Islands gradually moved toward self-rule and Palau chose not to join the Federated States of Micronesia (FSM) in 1978. An independent government was set up, and a new constitution was adopted in 1981.

9. Palau retains close links with the US through a Compact of Free Association (the Compact), which was approved in 1986 and ratified in 1993. Independence was achieved on 1 October 1994. Under the Compact, Palau granted the US control of security and defense for 50 years, and exclusive access to certain land adjoining the airport and seaport. In return, the US agreed to provide Palau with economic aid, defense, and security; and allow Palauans to enter the US as nonimmigrants and work.

D. Political Organization and Government

10. The Palauan constitution calls for the separation of powers between the executive, the legislative, and the judiciary. The constitution and delimitation of administrative powers is broadly based on the U.S. governance model. One feature that distinguishes Palau from the US is that the President and the vice-president are elected from two different tickets. The legislative branch of the Government is made up of a bicameral parliament (Olbiil Era Kelulau [OEK]), consisting of a senate and a congress elected for 4-year terms. Senators represent the whole population of Palau and are selected at large, whereas each of the 16 states elect one congressman as their representative. There are 9 senators and 16 congressmen. The President can introduce as well as veto legislation but the OEK can overrule a presidential veto. Politicians—including the President and vice president—stand in elections as individuals as there is no political party system. Overseas Palauans have the right to vote in elections, while temporary residents cannot vote.

11. The President operates without a central policy body. An informal group acts like a policy advisory body—chief of staff, minister of finance (often represented by the minister's financial adviser), and a senior counsel. The other main sources of advice to the President are (i) ministers who act as political advisors, (ii) directors in ministries who provide advice to ensure observance of public service rules and regulations, and (iii) council of chiefs which focuses on

³ The US ended its administration on 3 November 1986, although the United Nations only formally ended the trusteeship on 22 December 1990.

traditional customs, land issues, and the political environment. Policy is often presented in the form of a law, frequently prepared by lawyers in the Office of the President.

12. This structure produces a rather loose policy development process. If a minister has an idea, it is often shared with the chief of staff of the President's office and then the President. If the chief of staff finds merit in the issue, a legal counsel is assigned to develop a law or other legal document, as appropriate. Ministries react to draft laws. Laws originating from the OEK are also sent to every ministry for comments. There is interministerial consultation in this sense, but the cabinet is small and disagreement becomes clear early on in the process. Interministerial disagreements are resolved in a meeting attended by the conflicting ministers and the President. The chief of staff sometimes mediates such disagreements to avoid showdowns in front of the President. Ultimately, the President decides on disagreements and may request a legal opinion before making a final decision. Little interministerial consultation existed until a few years ago but this is now changing.

13. Sixteen state governments evolved from preexisting municipalities and adopted typical local government functions (e.g., trash collection, maintenance of local roads). The 16 state constitutions resemble the Palau constitution for a certain degree but each state constitution was written by a group of title holders (chiefs) and non-title holders, and reflects the local view of the balance between modern principles of government and local traditions. For example, selection of lawmakers differs from state to state. In seven states, all members of the legislature are elected by the people, but other states adopt a mixed legislature with some elected members and some chiefs.

14. Palau traditionally contained chiefdoms—sociocultural systems with ascribed hierarchical social ranking. Matrilineal descent determined social position, inheritance, kinship structure, residence patterns, and land tenure; and women appointed male chiefs. Although Palau society has changed dramatically during 300 years of contact with people from outside Micronesia, traditional society continues to play an important role in daily activities and politics, particularly in rural areas. The political system is a blend of democratic and local traditional institutions, which preserves local culture and customs. The President is advised by a permanent council of chiefs, and women remain an important informal presence in government though very few have been elected to the Government. While government roles and functions are clear in the constitution, the traditional hierarchy of chiefs and local practices often lead to misunderstandings and differences over authority.

15. The current capital is Koror. The constitution provides for the establishment of a capital in the state of Melekeok on Babeldaob island, and a new capital is being built about 20 km northeast of Koror. A constitutional convention (ConCon) was underway in mid 2005, as part of the periodic review stipulated in the constitution. The convention is broad ranging, dealing with issues as diverse as the role of traditional chiefs in the Government, the powers of state governments and the role of women in assigning control of land. Amendments to the constitution require three-quarters majority at a national vote.

II. THE ECONOMY

A. Overview

16. Real gross domestic product (GDP) is estimated to have grown by an average of 2% per year since 1994. Much of this growth took place in the first 2 years of the Compact, given a surge in government funding, and there has been little subsequent growth. Current GDP per

capita is estimated at \$5,487 per year, which, in real terms, is slightly below the 1994 level (\$5,620) (Table A1.1).⁴

17. Despite weak economic growth, employment grew by 4.7% per year (1994–2003). Most of this growth has been in the employment of foreign workers, as Palauans have been slowly moving to higher paid positions in the workforce and enjoy a very low unemployment rate (2.3%).⁵ Foreign workers are paid below average wages to develop infrastructure that provides little immediate economic stimulus, which helps explain why employment has expanded despite weak economic growth.

18. The economy is heavily reliant on public expenditure and the tourism industry. Public expenditure as a ratio to GDP has trended down over 1994–2004 but remains high at 60–65%. Despite some adverse external events, the tourism industry has expanded substantially and visitors have almost tripled over 1994–2004 to 95,000 people per year.

B. GNI Per Capita

19. According to the World Bank, Palau's per capita gross national income (GNI)⁶ in 2004 is estimated at \$6,870 (atlas method, current \$)—income category V.⁷ This means Palau is eligible to borrow from the International Bank for Reconstruction and Development (IBRD) but there is no access to International Development Association (IDA) funds. Palau has not sought to borrow internationally on a commercial basis, so there are no Standard and Poor's or Moody's ratings.

20. Palau's statistical system could be greatly improved to prepare more accurate GNI per capita estimates. Balance of payments reporting and real sector data is incomplete, and monetary surveys are not undertaken. A key impediment is the absence of a statistics law, which means there is no legal basis for enforcing data reporting and collection. Therefore, per capita GNI estimates should be used with great caution.

C. Structure of the Economy

21. The Palauan economy has been dominated by the public sector for many decades. Public administration is currently estimated to account for 26–27% of GDP. Government businesses are active in the supply of electricity and communication services, and water and waste disposal. Public sector demand is critical to the construction, transport, and trade industries. The ratio of public expenditure to GDP is estimated at 63% for FY2003-2004. Tourism is the second major stimulus to the economy. The tourism industry has recovered steadily after a series of adverse external events—the Asian financial crisis (1997/1998), 9/11 terrorist attacks (2001), and SARS⁸ outbreak (2003). Visitor arrivals were below 35,000 prior to the Compact (1994) and rose to 66,000 in 1997 before declining to 54,000 in 2001. The sector has since recovered, registering 95,000 arrivals in 2004, partly due to hosting the ninth Pacific Festival of Arts in July 2004. Visitor arrivals are expected to remain high in 2005, supported by the South Pacific Mini-Games. As a ratio to GDP, visitor receipts are estimated to have increased from a low of about 40% in FY2001-2002 to 80% in FY2003-2004.

⁴ GDP estimation problems in Palau are widely documented and GDP estimates should be seen as indicative only. The estimate of GDP per capita quoted has not been adjusted for purchasing power parity.

⁵ The Central Intelligence Agency. 2005. *The World Factbook*. Available: www.cia.gov.

⁶ GNI differs from GDP primarily by including the capital income that residents earn from investments abroad.

⁷ The World Bank. 2005. *World Development Indicators 2005*. Available: www.worldbank.org;

World Bank GNI estimates of \$7,500 in 2003 appear not to have taken into account a recent fall in incomes, and updated estimates were expected to report an estimate of GNI per capita closer to the current estimate of GDP per capita of \$5,808.

⁸ Severe acute respiratory syndrome.

22. The production base of Palau's economy is very narrow and the services sector is estimated to account for 83% of GDP. Agriculture, forestry, and fishing activity is low—the sector is estimated to represent only 4% of GDP. A further 13% of GDP is contributed by the industry sector—more than half from construction with much of the remainder from electricity, gas, and water. The Compact provides Palauan exports free access to the US market, but local manufacturing activity has been low and was further reduced following the 2003 closure of export-based garment manufacture. There is some local food processing, bottling of drinking water, furniture manufacture for the local market, and handicraft production.

23. Remittance flows are poorly documented but are potentially substantial outflows given the large number of foreign workers. The 2000 census reported temporary residents' total cash income of \$22 million (about 20% of GDP). Much of this income can be expected to flow out of Palau. In addition, Palauans send money to relatives overseas, mainly to children studying at US colleges. Remittances from Palauans living overseas are understood to be small. The precise level of remittances is unclear as the banking sector cannot separately identify remittance flows from other transactions and the small-scale courier system used to transfer foreign workers' cash earnings is informal and undocumented.

D. Labor Force, Employment, and Wages

24. Despite the near absence of economic growth, formal employment has grown by an average of 4.6% per year from 1994 to 2003. However, this upward trend hides a recent weakening in employment growth consistent with deteriorating economic growth (Table A2.1).

25. Owing to a shortage of Palauan workers, most of the employment growth relates to foreign workers—an average 9.3% per year compared to 1.6% per year for Palauans (1994–2003). In 1994, there were almost two Palauans working in the formal economy for every foreign worker. By 2001, there were as many foreign workers as Palauans in the formal economy. The ratio of Palauan to foreign worker has remained close to 50:50 since 2001 (Table A2.1).⁹

26. Labor force participation rates have risen substantially—from 41.6% (1980) to 59.3% (1990) to 67.5% (2000). In 2000, the unemployment rate was estimated at 2.3%.¹⁰ People aged 16–19 years old were most likely to be unemployed, as they were just entering the labor force and could not find work, or because they had trouble keeping their jobs. Key contributors to the low unemployment rate are (i) firm demand for Palauan workers by the public sector, (ii) ability for Palauans to work in the US, (iii) tendency for Palauans living away from Koror to remain in the subsistence sector, and (iv) requirement for foreign workers to return home upon completion of their employment.¹¹

27. Palauans appear to be securing a rising share of the higher skilled positions. About 29% of Palau-born workers were managers and professionals in 1990 but this increased to about 33% by 2000. The second largest category of workers—technical, sales, and administrative support—increased slightly from 28% (1990) to 30% (2000). On the other hand, the share of Palau-born in the service industry decreased from 17% (1990) to 14% (2000). Palauan precision production workers' share fell from 9–6% during the same period. Emigration of Palauans and increased numbers of foreign workers have resulted in an overall reduction in Palauans' representation in most occupations. The share of Palau-born managers has

⁹ This estimate is based on data from Social Security Administration. The 2000 Census reported more foreign workers than Palauan workers in the formal sector.

¹⁰ The Central Intelligence Agency. 2005. *The World Factbook*. Available: www.cia.gov.

¹¹ Some of the 5.1% of the population aged 16 years or more that is engaged in subsistence activities and not in labor force figures—mainly in rural areas away from Koror—may represent hidden unemployment.

decreased from about 4 in 5 (1990) to 2 in 3 (2000). Over the same period, the share of Palauans in technical sales and administrative support decreased from 87–64%; service positions: 57–35%; and operators, fabricators, and laborers: 78–49%.¹²

28. The public sector's relative importance as an employer has declined substantially over 1994–2004 as tourism and construction have grown (Tables A3.1 and A4.1). However, the public sector is still the major player on the labor market—estimated to account for 2,219 jobs in 2001. Rightsizing saw some reduction in employee numbers but increased political appointments recently pushed them back to the 2001 level. In total, around a third of employees are in the public sector (national and state public service, and government enterprises), with many private sector jobs dependent on public sector demand (notably via a large capital works program).

29. The large public works program is key to the significant number of foreign workers, as they undertake most construction work. Foreign workers are also heavily employed in lower-skilled jobs—domestic staff, waiters, retail sales assistants, or vegetable growing—that Palauans are too expensive to employ or reluctant to undertake.¹³ There is a high rate of emigration of Palauan graduates and skilled local workers, especially to Guam, Saipan and the US, partly due to potentially higher salaries.

E. Money, Banking, and Prices

30. Palau uses the US dollar as its national currency. It does not have a central monetary authority and does not operate an independent monetary policy.

31. The financial sector comprises a surprisingly large number of banks and other financial institutions for a country of 20,000 people. In 2004, there were seven commercial banks, the government-owned Palau Development Bank, and several small credit unions and insurance companies. The Bank of Hawaii (by far Palau's largest commercial bank) and two branches of US-based banks—subject to US banking regulation—are estimated to account for about 80% of deposits and more than 60% of net loans (although statistics are limited). Three other commercial banks are foreign-owned and the remaining bank is locally incorporated (operating under a conditional license). There is a large spread between deposit and lending rates—banks cite the difficulty of securing loans and country risk as key contributing factors. For example, in mid-2005 the Bank of Hawaii offered annual deposit rates of 0.3–2.0%, with consumer lending charged at 16–18% and commercial lending around 10%.

32. Despite the large number of financial institutions, formal lending is small and focused on salary-secured small consumer loans. Local deposits are 60–80% of GDP, around half of which is invested in US and other international financial markets. Informal lenders fund small business development, while the National Development Bank has reduced commercial lending given past difficulties and home lending now accounts for most of its loan portfolio.

33. Palau was on the list of noncooperation countries of the Financial Action Task Force (FATF) but was removed following implementation of an anti-money laundering policy based on (i) Financial Institutions Act (2001), (ii) creation of Financial Institutions Commission (2002), and (iii) establishment of Financial Intelligence Unit (2003). Although the number of commercial banks has been substantially reduced from 38 in the late 1990s, and the financial sector's regulatory framework is much improved, gaps remain and implementation capacity is very limited. The Palau Development Bank, credit unions, and 12 to 16 remittance companies are currently outside the scope of the prudential regulation.

¹² Office of Planning and Statistics. 2004. *Republic of Palau 2000 Census: Population and Housing Profile*.

¹³ For example, Palauan males are traditionally involved in fisheries but not agrarian work.

34. Palau only began preparing a consumer price index in 2000. There was almost no inflation from 2001 to 2003 but it rose to 5% in 2004 following the rise in oil prices and increased taxes on cigarettes and alcohol. Inflation remained relatively high in the first half of 2005 (Table A4.2).

F. Exports, Imports, and the Balance of Payments

35. Merchandise exports are small relative to the size of the economy and mainly comprise fish, reflecting the small agriculture, fishing, and manufacturing industries. There is a very high dependency on imports, with the ratio of imports to GDP ranging from 75–115% in the last few years. The US (including Guam) supplies about half of total imports to Palau; Japan, Republic of Korea, Singapore, and Taipei, China are the other major sources of imports. A very high trade deficit and net outflow of remittances have led to current account deficits in most recent years, despite a large services account surplus due to substantial tourism receipts and official transfers, which have kept the capital account in surplus. Overall balance of payments is reported to have been in surplus in most recent years (Table A5.1).¹⁴

G. Regulatory Environment

36. Palau's regulatory environment performs satisfactorily against the World Bank's cost of doing business indicators in 2004.¹⁵

- (i) The number of procedures for starting a business was 8 (6.5)¹⁶, time taken was 33 days (39), and cost was 9% (29%) of per capita income. These results compare favorably with the average for East Asia and the Pacific—8 procedures, 51 days, and 47%; and the Organisation for Economic Co-operation and Development (OECD)—6 procedures, 25 days, and 8%.
- (ii) Time taken to close a business was 6.5 years (3.6) and the recovery rate was 3.5 cents per dollar (25). These results are substantially poorer than the average for East Asia and the Pacific—3.4 years and 30 cents per dollar and OECD—1.7 years, and 72 cents per dollar.
- (iii) The number of procedures to enforce a contract was 34 (26), time taken was 270 days (304), and cost was 35% (78%) of debt. These results compare favorably with the average for East Asia and the Pacific—27 procedures, 316 days, and 57% and OECD except for the cost indicator—19 procedures, 229 days, and 11%.

37. There is a minimum wage restriction for Palauans working in the Government but not for Palauans outside the public sector or foreign workers. The Government charges an annual fee of \$500 per foreign worker although compliance has weakened recently. A foreign worker can only work for the contracting party while in Palau and if they return home they can only return for a third party after 5 years.

38. The Foreign Investment Act in 1990 reserves the following activities exclusively for citizens: (i) wholesale or retail sale of goods, including restaurants; (ii) all land transportation including bus and taxi services, and car rentals; (iii) bakeries; (iv) tour guides, fishing guides, diving guides, and any other form of water transportation; (v) travel and tour agencies; and (vi) commercial fishing for species that are not highly migratory. Certain other activities can be undertaken by foreign investors but only in partnership with Palauan citizens, including (i) handicraft and gift shops, (ii) bar services not in a hotel or restaurant, (iii) manufacturing, (iv)

¹⁴ Balance of payments data contain a very high level of errors and omissions that may obscure important developments.

¹⁵ The World Bank. 2005. *Doing Business Database*. Available: www.worldbank.org.

¹⁶ Regional averages are shown in brackets throughout this section.

equipment rentals for land and water, and (v) any other businesses as may be determined by the Foreign Investment Board. However, foreign investors often engage Palauan “fronts” to operate businesses in restricted industries and controls are understood to be lightly enforced. Foreign investors may also engage in restricted activities through the creation of legal structures that present a Palauan as the business leader while effective control is retained by the overseas investor. Applications for foreign investment are usually considered within 30 days of submission, with a maximum time limit of 90 days. There are currently 111 approved foreign investment certificates, not all of which are actively engaged in business in Palau.

39. Government monopolies operate communication and electricity services, and supply water and sewerage services to Koror and its surroundings. Stevedoring (loading or unloading ships) is undertaken by a private company operating within the government-controlled port area. Continental Micronesia airline is the main supplier of scheduled international air services, operating charter flights from Asia. A competing airline was established in 2004 with investment from the Palau Development Bank, local businesses, and the State of Yap (FSM), but ceased operations within 6 months. These monopolies operate without independent oversight of prices or service standards. The communications and electricity services are controlled by independent boards that set their own prices, and the stevedoring operation also enjoys price-setting privileges. Water and waste disposal prices are supplied by government ministries which control price levels.

40. Access to land is widely seen as a key constraint to private sector development in Palau. Most land was held on a customary basis prior to 1971, with state-owned land constituting only a small share of the total area. Since 1971, Palau has been engaged in a titling process that has seen individual lots surveyed and ownership determined under the auspices of the Land Court. Land titles are drawn up on a clan or individual basis, depending on custom, agreements reached within clans, and history. About 10,000 out of 17,000 lots in the central land register, established under the Japanese administration, have been surveyed and had their ownership determined. The Government has recently directed that the titling process be completed by February 2008. Since land is a highly sensitive issue in Palau, it is likely that the titling process will extend beyond the 2008 deadline. A supplementary process of splitting lots is expected, even for titled land. The Government expects this to potentially affect more than 10,000 lots. Only Palauans can own land and in effect only Palauan-owned banks can take land as security. However, foreigners can obtain leases and foreign-owned banks can accept leases as security for loans. The Constitution provides for 99-year leases, but courts have ruled that this is effectively ownership and, in practice, leases are for a maximum of 50 years.

III. THE GOVERNMENT AND ITS FINANCES

A. US Financial Assistance

41. Compact funds are provided for three main purposes: (i) funding government services; (ii) building basic infrastructures, such as roads and energy, transport, and communication facilities; and (iii) creating a Compact Trust Fund (CTF) to accumulate cash reserves to replace US budgetary support provided over the first 15 years of the Compact. Use of Compact funds is subject to specific requirements, including adoption of the economic development plan, prepared by the Government as the foundation for the transition to a self-reliant market economy, and measures to provide for financial accountability.

42. Total payments provided for under the Compact from 1 October 1994 to 30 September 2009 are estimated at about \$600 million (Table A6.1), broadly constituted as follows.

- (i) Basic grants to fund current operations and maintenance (O&M). After adjustment for inflation, these were about \$20 million per year for the first four years of the Compact, then reduced to \$12 million per year, and cut by a further \$1 million in FY2004–2005.
- (ii) Around \$41 million to encourage increased self-sufficiency in energy production—not less than \$7 million was to be devoted to the energy needs of parts of Palau not served by the central power-generating facility. These funds were paid up-front (FY1994–1995).
- (iii) \$70 million for establishment of the CTF, comprising \$66 million (FY1994–1995) and \$4 million (FY1996–1997).
- (iv) In-kind provision of federal services—\$149 million for construction of the Compact road, an 85 kilometer two-lane sealed road of highway standard forming almost a complete loop on Babeldaob, and a link between the new national capital and Koror. Weather, postal, and aviation services are also to be provided at an estimated cost of \$36 million.
- (v) Funds for maritime surveillance, health care (including overseas referrals), and scholarships for tertiary education in the US.

43. In addition to Compact grants, Palau is eligible for assistance from other US programs. The total value of such grants over the first 15 years of the Compact is estimated at \$111 million.

44. US cash financial assistance has ranged from \$21 million to \$23 million per year since FY1998–1999, the equivalent of about 20% of GDP. In addition, funds provided as lump-sum payments in the early years of the Compact (mainly for capital projects) have been spent progressively, annual drawdowns from the CTF of \$5 million commenced in FY2001–2002 as a source of general budget funding, and construction of the \$149 million Compact road has been underway since FY1994–1995. The impact of this funding on economic activity is difficult to establish, as a substantial share of US support is retained or flows offshore as payment for overseas-supplied labor, services, or materials. Nonetheless, it is undeniable that US grants have played a major role in the economy and achievement of high living standards.

B. Overall Fiscal Situation

45. Palau has recently recorded some of the highest fiscal deficits among Pacific Island countries. The ratio of overall deficit to GDP ranged from 18–28% (from FY1998–1999 to FY2001–2002). The deficit was reduced to 3% of GDP (FY2002–2003), rose to 7% (FY2003–2004), and is expected to fall to 5% (FY2004–2005). Fiscal deficits were largely financed by the drawdown of non-CTF assets. These assets were accumulated at the beginning of the Compact, when certain grants were front-loaded and issued as a lump sum. This resulted in a budget surplus of 110% of GDP (FY1994–1995). It was inevitable that the expenditure of these front-loaded grants, and the returns from their investment, would result in large budget deficits in most later years of the initial 15-year Compact. Therefore, large budget deficits do not necessarily represent poor fiscal management. However, the pace at which non-CTF assets were used (fully spent by FY2003–2004 though intended to be used until FY2008–2009) and the nature of activities funded are of concern for sound fiscal policy.

46. Recent sources of deficit financing have also included (i) \$20 million concessional loan from Taipei, China, (ii) \$1 million loan from the main commercial bank, and (iii) start of CTF drawdowns. Drawdowns from the CTF began in FY2002–2003 at \$5 million per year and are scheduled to remain at this level until FY2008–2009. In the absence of additional loans over the medium term, deficits until FY2008–2009 will be limited to the size of the annual CTF drawdown, i.e., annual deficits of \$5 million (about 4% of GDP) are likely over the medium term.

47. The initial 15 years of the Compact end in September 2009, when O&M base grants of about \$12 million per year are scheduled to cease. The annual base grant is to be largely replaced by a \$10 million increase in annual drawdowns from the CTF (\$5 million to \$15 million per year). Unless Palau secures additional loans, the annual CTF drawdown will determine the budget deficit beyond 2009.

48. The schedule of drawdowns from the CTF was prepared when CTF began on the assumption that a 12.5% rate of return per year would be earned but actual returns have only averaged 8% per year. At this annual rate of return with drawdowns of \$15 million per year, the CTF would be exhausted by about 2035 and would not support drawdowns until 2044, as originally intended. At a rate of return of 6% per year,¹⁷ the CTF would be exhausted around 2025. If the CTF is to meet the objective of providing a constant annual source of deficit financing over the final 35 years of the Compact to 2044, the size of the annual drawdown will need to be reduced or additional funds will need to be injected into the CTF.

C. Expenditure

49. The ratio of government expenditure to GDP has declined from more than 70% at the start of the Compact but remains substantial at 63% (excluding in-kind expenditure). Efforts to control expenditure initially focused on a reduction in subsidies to public enterprises, and subsequently on expenditure on goods and services. Capital expenditure has ranged from 11–17% of GDP over the Compact. The wage and salary bill has remained steady at about 25% of GDP over the Compact period and, relative to the size of the economy, is one of the highest in the Pacific Islands. Efforts were made in 2001 to control the wage and salary bill through a freeze on salary rates and a reduced number of regular public servants, mainly through natural attrition (retirement). While these efforts were initially successful, the wage and salary bill is now rising, following an increase in the number of political appointees and creation of a new category of advisers. The adviser category was created in response to concerns that packages for senior government positions (notably for professionals) were less attractive than in the private sector, Guam, Saipan, or the US; and this contributed to difficulties in retaining senior staff. Advisors are engaged under performance-based contracts and are exempt from public service requirements (such as salary scales); hence, they are higher paid.

50. Around \$150 million of budget funds has been spent on capital expenditure since independence in 1994. One of the major projects has been the construction since 1999 of a new national capital complex on Babeldaob at an estimated cost of \$37.5 million. The OEK, ministers, and selected senior public servants are expected to move to the new complex in early 2006. Other major capital projects include (i) about \$10 million to provide community water system to most rural villages, (ii) construction of an asphalt plant and sealing of the main roads of Koror and surrounds, (iii) upgrade of portions of the water system in Koror and surrounds, (iv) upgrade and rehabilitation of the Koror power plant, and (v) extension of the electricity network to the main villages on Babeldaob. A national gymnasium, education facilities, health dispensaries, additional court buildings, and a national museum have also been built with budget funds.

51. In addition to on-budget capital expenditure, there has been substantial in-kind expenditure not recorded on the budget. This includes about \$150 million from the US Government under the Compact, about \$150 million from the Government of Japan, and numerous projects funded by Taipei, China. Notable in-kind projects include (i) \$149 million Compact road (still under construction), (ii) \$30 million replacement of collapsed bridge between

¹⁷ Recent negotiations of a Marshall Islands-US trust fund assumed a rate of 6% per year.

the islands of Koror and Babeldaob, (iii) \$20 million airport terminal, and (iv) upgrade of causeways to Koror Island.

Table 1: Ratios of Government Expenditure to GDP

Item	(%)				
	FY1999/ 2000	FY2000/ 2001	FY2001/ 2002	FY2002/ 2003	FY2003/ 2004 (provisional)
Total expenditure	72.8	66.7	65.8	63.8	63.1
Current expenditure	62.0	53.8	48.6	51.4	46.9
Wages and salaries	25.2	25.0	25.3	26.0	25.2
Goods and services	26.2	22.5	19.2	21.6	18.1
Other	10.7	6.3	4.0	3.9	3.6
Capital expenditure ^a	10.7	12.8	17.3	12.4	16.2

FY = fiscal year.

^a This excludes substantial in-kind expenditure.

Source: Bureau of Budget and Planning, Ministry of Finance, Republic of Palau.

D. Revenue

52. Grants are the single largest component of government revenue, which fund all capital works and about half the operating costs. The US has been the single largest source of grants, ranging from 17–20% of GDP in recent years. Since FY2002–2003, US grants have been supplemented by capital grants from Taipei, China. In total, grants rose to 29% of GDP (FY2002–2003) and are expected to be at least 25% of GDP (FY2004–2005). Grants have averaged \$2,100 per person per year since the Compact began, or \$2,700 per Palau-born inhabitant. Grants have reduced following the initial surge due to front-loading, but remain substantial. Over the past 5 years, grants have averaged about \$1,400 per person (\$1,900 per Palauan). These are very high levels of grant assistance by international standards.

53. Domestically raised revenue as a ratio to GDP has averaged 26% over the past 5 years, funding about half of current expenditure. Tax revenue has increased in recent years as import duties on “social bads” (alcohol and tobacco) were increased and foreign worker wages were removed as an allowable deduction for turnover tax. Tax revenue was estimated as 21% of GDP (FY2003–2004) and, based on data for the first 9 months of the fiscal year, it is expected to be slightly higher in FY2004–2005. Turnover tax is the main source of tax revenue, followed by import duties, wages and salaries tax, and minor taxes (departure tax, hotel occupancy tax, and fish export tax). Non-tax revenue is typically 4–6 % of GDP and mainly attributable to licenses and fees on foreign labor, port user fees, and revenue from the sale of government services (notably water and postal services).

Table 2: Ratios of Government Revenue and Grants to GDP

Item	(%)				
	FY1999/ 2000	FY2000/ 2001	FY2001/ 2002	FY2002/ 2003	FY2003/ 2004 (provisional)
Total revenue and grants	52.6	44.3	42.1	52.8	52.0
Domestic revenue	25.0	26.5	23.6	24.1	28.5
Tax revenue	19.7	20.1	18.1	18.3	20.9
Non-tax revenue	3.7	4.8	3.7	4.6	6.4
Grants ^a	27.6	17.8	18.4	28.7	23.5

FY = fiscal year.

a This excludes substantial in-kind grants.

Source: Bureau of Budget and Planning, Ministry of Finance, Republic of Palau.

E. Public Debt and Assets

54. External debt stood was \$20 million when the Compact began, and was scheduled for full repayment in FY1999–2000. Furthermore, a new external loan of \$20 million was obtained from Taipei, China to help fund the new capital. The Government had negotiated a concessional loan of \$15 million from Taipei, China for resurfacing the Koror international airport runway and upgrading the new terminal, including the provision of a new instrument landing system to improve air safety. However, the Government recently received a commitment from the US Federal Aviation Administration for a \$25 million grant that makes the \$15 million loan unnecessary, and funds already drawn down will be repaid from the US grant. A \$1 million loan was secured from the Bank of Hawaii to fund the Festival of Pacific Arts in 2004. Public external debt was estimated as \$18.3 million (about 16% of GDP) by the end of FY2003–2004.

55. In addition to these debts, the civil service pension plan is estimated to have an unfunded liability of \$30 million, which will ultimately need to be funded by the budget or via reduced payouts. The social security administration scheme also has an unfunded liability of at least \$10 million, but a positive cash flow and a recent increase in contribution rates is expected to correct this over the long term. The Government is the guarantor of \$3.8 million of outstanding commercial loans issued by the Palau National Development Bank to small and medium enterprises. The Palau National Development Bank is negotiating another concessional loan of \$5 million with Taipei, China to support local business enterprises and homeowners that may also receive a government guarantee.

56. Public assets substantially outweigh debt and the Government is a net lender. From an initial investment of \$70 million, the value of the CTF peaked at \$161 million in FY1999–2000 before falling as the US market weakened. The estimated value of the CTF was \$141 million in April 2005 (121% of GDP). An additional \$14 million was held in deposits with foreign and domestic banks, some of which was set aside for specific projects.

57. Net public financial assets are around 80% of GDP, after allowing for public debt and contingent liabilities.

IV. SECTORAL ISSUES

A. Agriculture and Fisheries

58. Although the agriculture and fisheries sector makes only a small contribution to GDP, it provides the main livelihood for about 20% of Palau's population, which lives far from Koror. Palau has traditionally cultivated taro, cassava, and sweet potatoes, and farming is mainly carried out by women. Cash-based farming is increasingly undertaken by foreign labor on

leased land. Some traditional techniques are being lost through the gradual transition from traditional to modern farming systems. The sector also faces the adverse consequences of a change of diet from local foods to imported goods.

59. Completion of the Compact road is expected to provide substantial opportunities for farmers to grow and sell more products locally through improved access to Koror. The lack of a central market and an inefficient transportation and distribution system make it difficult for farmers and fishers to supply the main demand centers efficiently. There is considerable potential for domestic food needs to be met by an expanded agricultural sector, especially in Babeldaob. However, the likelihood of early growth in the agriculture sector is low, due to (i) constraints from the traditional communal land tenure system; (ii) lack of local labor (younger generation prefers other careers) combined with some inertia in employing foreign labor in the sector; (iii) prevention of economies of scale arising from the small domestic market; (iv) relatively low price of imported products; (iv) poor development of central marketing and distribution systems; and (v) lack of institutional arrangements for agriculture extension and marketing (e.g., agricultural cooperatives). These challenges need to be addressed patiently through a well thought-out development strategy if the sector is to realize its potential.

60. The fisheries sector is divided into offshore and inshore activities (including mariculture and aquaculture). The main offshore resources are tuna and mackerel. The sector's challenge is to achieve greater sustainable returns—higher tax revenue—from foreign fishing vessels' activities in its exclusive economic zone. There is significant potential to raise tax revenues from the fishing industry and secure revenues from foreign vessels' fishing license fees.

61. Inshore fishing is critical to Palau's domestic food supply, especially in outlying villages. The challenges of inshore fisheries include (i) balancing extraction and exploitation rates of resources for subsistence and commercial sales with maintenance of a healthy and diverse ecosystem; (ii) improving economic efficiency to raise the value of the catch and enhance welfare; (iii) protecting endangered species from exploitation; and (iv) developing aquaculture, if substitutable. There is much room for the Government to tighten regulation of marine resource uses, so balance is achieved between income generation and marine resource management.

B. Environment

62. Palau's environment is in relatively good condition, even though it can no longer be called pristine in some areas. Given the major economic role of tourism, sustained economic development is dependent on the integrity of an environment under increasing pressure from development, which is potentially incompatible with fragile island ecosystems. Traditional conservation ethics relied heavily on communal conservation norms, which were enforced by the chiefs. The traditional system began to break down through monetization of the villages and private ownership of land and resources. Large-scale commercial and infrastructure development, over harvesting of marine resources, erosion of traditional conservation ethics, and a rapidly increasing tourist population have already begun to damage the environment. Achieving a balance between conservation and development through environmentally compatible activities is clearly one of Palau's most urgent challenges.

C. Education

63. Under Article VI of the constitution, the Government is required to take positive action to provide free, compulsory public education for citizens. Consequently, Palauans enjoy constitutionally guaranteed access to 12 years of public education. There is also subsidized on-island tertiary education (mainly for outer-island residents) to the associate degree level, and public assistance for off-island tertiary studies. In addition to the public school system, there are

church-based and private primary and high schools. The US Government provides scholarships for study in the US for students who pursue a college education.

64. Palau has achieved literacy and high school participation rates that are relatively high among the Pacific Islands (Table A8.1). However, enrollment in secondary education has declined significantly since the late 1980s due to low population growth and high dropout rates. In recent years, 30% of Palau's youth failed to complete 12 years of basic schooling—the minimum educational requirement for most jobs. Some 30% of students seek university (tertiary) level education. Since Palau has only one community college, these students have to go to the US on scholarship. Although no statistics are available, it is believed that only a small proportion of university-educated graduates return to Palau. The education system, especially at secondary and tertiary levels, is vocationally oriented. As younger Palauans now prefer white-collar public sector jobs and professional vocations (i.e., accountants, lawyers, and doctors), the education system needs to be revised to better address current needs.

65. The student-teacher ratio for public schools is very low. According to the Ministry of Education's 2003 statistical yearbook, the average ratio is 13:1 in high schools and 12.2:1 in primary schools. The student-teacher ratio is particularly low in the outer islands and less populated states in Babeldaob (e.g., it is 4:1 at Angaur primary school). But even at Koror primary school, the student-teacher ratio is reasonably low at 21:1. Maintaining this low student-teacher ratio has significant budgetary implications. Rationalizing school locations and lowering the target standard of education provision may be warranted.

D. Health

66. Article VI of the constitution mandates promotion of health and social welfare through free or subsidized health care. Well-established medical institutions (mostly government-owned) and generous government subsidies have allowed Palauans to enjoy sustained, free primary care, both preventive and curative, leading to improved health—longer lives and freedom from many of the most serious communicable diseases. In 1990, Palau's population had a life expectancy of 69.0 years and infant mortality rate was estimated at 24.0 deaths per 1,000 live births. This improved by 2000, when life expectancy rate rose to 70.5 years and infant mortality rate fell to 18.3 deaths per 1,000 live births. Health conditions in Palau are now among the highest in the region (Table A8.1).

67. The Government categorizes public health services into primary, secondary, and tertiary care. Primary care is mainly preventive health care, including immunization, maternal and child health, school health, dental services, family planning, behavioral health services, control of communicable and non-communicable diseases, health education and sanitation, and environmental health services. Primary care is fully subsidized. Secondary care, including curative care provided by the local hospital, is formally subsidized by 5–20% depending on the patient's income. In practice, subsidies are higher. For example, in 2004, a \$13 million budgetary provision was made for secondary care and patients paid about \$1 million in total. Tertiary care mainly comprises services not provided by the local hospital. An off-island medical referral program is provided for all citizens. Based on the patient's condition, the Tripler Army Medical Center in Hawaii (mainly for cancer) and three Philippine hospitals (St. Luke's, Makati Medical Center, and Medical City General Hospital) are used as referral sites.

68. Although general health has improved over the past few decades, changing lifestyles are creating a potential epidemic of non-communicable diseases (particularly cardiovascular disease, diabetes, and cancer), which undermine many people's quality of life, erode labor productivity, and challenge the financial viability of the publicly subsidized health system. Palau relies heavily on imported food, and the use of these foods focuses on cost and convenience at

the expense of nutritional value. The rising prevalence of non-communicable diseases imposes a major burden on health care resources and this burden is likely to rise. Given budget constraints and declining US grants, the Government has to choose between funding preventive and primary care, which can provide infant and adult health care for the masses or expensive curative care for what may be the wealthy urban minority. A domestic food production policy to provide an adequate supply of locally produced foods and the adoption of a medical insurance (referral) policy may be warranted.

V. DEVELOPMENT ISSUES AND PROSPECTS

A. Introduction

69. There are widespread concerns in Palau over the anticipated adverse consequences of completing the first 15 years of the Compact in September 2009. The Compact specifies a significant reduction in US funding at that time for the Government's recurrent and capital expenditure. Palau has indicated its intention to negotiate continuation of substantial US funding. If Palau is not successful in securing large, ongoing US grants, fiscal adjustment will become necessary. Some progress is being made to prepare the economy for potential fiscal adjustment, but at a slower rate than hoped for by economic managers and external agencies, including the International Monetary Fund (IMF). The slow rate of progress raises the prospect of a sharp adjustment to government activities—hence the economy—if US financial assistance is reduced as scheduled. Management of the adjustment to the new Compact arrangements is central to development prospects over the medium term.

70. Palau's economy relies heavily on the public sector, which, in turn, has been largely funded by external assistance from the US, Japan, and Taipei,China. The economy is also highly dependent on imports, has virtually no manufacturing sector, and the export base is very narrow outside tourism. Considerable difficulties would be faced in any attempt to diversify the economy away from the public sector given the narrow production base, small population, and remoteness from major markets. As the large public sector is key to Palau's high income levels and the level of external assistance provided to the public sector is scheduled to decline substantially, the sustainability of Palau's current high income levels and high standard of living is questionable.

B. Prospective Reduction in US Grants

71. The Compact provides for the cessation of basic O&M grants (\$11 million per year)¹⁸ and special program assistance (\$2 million per year) in FY2008–2009. Palau receives other US assistance (grants) outside the Compact, based on proposals to individual US agencies, which peaked at \$11 million in FY2001–2002 and were budgeted at \$5 million in FY2004–2005. However, they are being reduced by 25% each fiscal year, resulting in a value of only \$1.5 million for FY2008–2009.¹⁹ Against these reductions in funding, drawdowns from the CTF are scheduled to increase by \$10 million per year to \$15 million per year in FY2008–2009. On this basis, assuming current expenditure remains at recent levels, Palau is facing a rising funding shortfall that will reach about \$6.5 million per year in FY2008–2009. This is likely to represent 6–8% of total revenue and grants (5% of GDP). The shortfall will be larger if operating costs rise above current levels.

¹⁸ Estimated value in FY2008–2009.

¹⁹ Palau is eligible for other existing and new programs, which could be accessed to help offset the gradual decline in other US assistance.

72. The US obligation to fund major in-kind capital projects, such as the \$150 million Compact road, will end in FY2008–2009. The Compact does not provide for a repeat of the build-up in non-CTF assets that funded recent deficits and supported infrastructure development and energy, health, and education. These non-CTF grants totaled \$99 million in FY1994–1995. While there is no immediate fiscal impact from the absence of such support, their absence is potentially the main adjustment facing Palau in FY2008–2009 because it will greatly affect Palau's ability to fund continued infrastructure development.

73. The compacts between the US and FSM and the Republic of the Marshall Islands (RMI) contained a provision for automatic renegotiation of grants beyond the initial 15-year period of financial assistance, and both countries successfully negotiated a continuation of substantial US grants. Palau has already indicated to the US Government that it will be seeking to renegotiate grant assistance for the final 35 years of its Compact. However, it is unclear if Palau will enjoy the same success as FSM and RMI. Palau's Compact does not contain provisions for automatic renegotiation of grants, unlike FSM and RMI Compacts. In addition, Palau was given a trust fund at the start of its Compact to replace grants over the final 35 years. FSM and RMI did not have such trust funds, which were only established after the initial 15-year period of their Compacts.

C. The Government Response

74. A management action plan (MAP) was presented by the President in April 2001 to serve as the new administration's strategic roadmap to reform the executive branch of the Government. It stresses the importance of building economic institutions, developing basic economic infrastructure, and strengthening tourism and related industries, while preserving the environment—regarded as one of the country's major assets. MAP also emphasizes the importance of reducing the size of the public sector and developing a vibrant private sector through adoption of reforms aimed at improving the economic environment for business. Privatizing certain public services, decreasing costs, and increasing the efficiency of public enterprises—together with streamlining government operations and rightsizing the civil service—are some of the major MAP reforms.

75. MAP led to a number of actions to rightsize the Government, including enactment of the Budget Reform Act and reorganization of the executive branch. The Budget Reform Act (2001) was the result of a cooperative effort between the executive and legislative branches to raise the productivity of expenditures through annual performance reporting. The act specifies (i) a clearly defined process to prepare a unified annual national budget, which reflects total estimated revenues and their proposed use for the current fiscal year and following 2 years; (ii) a balanced budget; (iii) establishment of a general reserve fund; and (iv) performance reporting by all budget activity heads (to commence in 2002). Reorganization of the executive branch was undertaken in November 2001 to eliminate duplication of services and provide a clear functional direction to reduce operating costs.

76. In September 2002, a cost reduction plan (CRP) was put into place to reduce the cost of the national Government. The CRP established general operations policies and identified initiatives to set the cost reduction targets, focusing on the executive branch, because of its size and the President's direct administrative authority. The CRP was intended to be incorporated into the MAP work program, with initiatives requiring additional funding to be proposed through the national budget process. The CRP aimed to contain personnel, operations, and other fixed costs. Specific initiatives included controls on the use of government-owned vehicles, improved property management and travel policies and procedures, continued implementation of a hiring freeze, travel moratorium, and improved management of contract employees.

77. MAP and CRP built on the 1995–1999 *Economic Development Plan (1994)*²⁰ prepared for the Compact; the *Palau 2020 National Master Development Plan (1996)*²¹, which has been adopted as the nation’s long-term development planning document; and the 2000 Japan International Cooperation Agency (JICA) *Study for Promotion of Economic Development in the Republic of Palau (2000)*.²² The *Economic Development Plan* established policies and strategies to (i) develop a self-reliant, production-based market economy; (ii) reduce and streamline the public sector; (iii) develop natural resources to generate income; (iv) develop human resources; (v) balance regional economic integration and development; and (vi) conserve environmental and cultural assets. The *National Master Development Plan* established strategies to (i) build infrastructure institutions; (ii) provide required infrastructure funding and services in a sustainable, economically efficient, and equitable manner; (iii) raise infrastructure performance to create a more commercial and competitive economic environment; and (iv) implement a comprehensive public sector investment program process incorporating evaluation, prioritization, and monitoring, in addition to investments in key public infrastructure.

78. These planning documents formed the basis of the public sector investment program (PSIP) 2003–2007²³, the third key component of the Government’s current planning framework. PSIP was prepared to set out the priorities for infrastructure development. Three tiers of unfunded priority projects are established (A, B, and C). Tier A (highest priority) identifies 30 projects at an estimated cost of \$204 million, tier B has 20 projects worth an estimated \$105 million, and tier C (lowest priority) has 16 projects at an estimated cost of \$46 million.

79. MAP is presently being revised to take into account achievements to date and build on prioritization of incomplete actions presented in the original MAP, CRP, PSIP, and available sector plans. The revised MAP is intended to form the basis of ministerial budgets, thus form a link between the planning and budget processes. The revised MAP is expected to present an economic development strategy framework that recognizes that the private sector must lead sustainable economic development and that strong private sector led growth rests on the quality of Palau’s fragile natural environment. Accordingly, the intention is to develop and strengthen the private sector while protecting the environment and reducing government involvement in domestic economic activity.

80. Key actions in economic policy are expected to include the following:

- (i) Develop economic institutions—establishing effective regulatory environments in key areas such as banking, foreign investment, tax, and labor—to facilitate private sector growth.
- (ii) Develop infrastructure—within a proper planning framework—to expand capacity in areas including energy, water, sewer, communications, and transportation;
- (iii) Develop economic sectors that have the potential to support sustainable economic growth—where Palau has a comparative advantage and where there is income potential in view of required conservation measures. Opportunities for private sector led investment are expected in the areas of tourism (expanding domestic participation), fisheries (realizing greater returns), aquaculture (domestic and export markets), agriculture (expanding production to meet domestic consumption), and finance and trade (transshipment point).
- (iv) Contain the cost of government.

²⁰ The Government of Palau. 1994. *Economic Development Plan: Fiscal Years 1995-1999*.

²¹ The Government of Palau. 1996. *The Palau 2020 National Master Development Plan*.

²² Japan International Cooperation Agency. 2000. *Study for Promotion of Economic Development in the Republic of Palau*.

²³ The Government of Palau. 2002. *The public sector investment program 2003–2007*.

81. With respect to fiscal policy, the Government recognizes the need to be more efficient while remaining conscious of limited private sector capacity to immediately cover any reduction in the economic contribution of the government sector. Key actions in fiscal policy are expected to include the following:

- (i) Maintain expenditure growth below revenue growth by (a) streamlining government structure (organizational restructuring to eliminate duplication, clear functional direction, etc.); (b) restructuring personnel through staffing plans and position control, retraining and transfer, and severance pay provision; (c) outsourcing services such as utilities, maintenance and construction; and (d) improving expenditure accountability and productivity (performance-based budgets).
- (ii) Realize sustained increases in revenues by strengthening collection efforts (focusing resources on revenue-generating activities).
- (iii) Expand revenue base (tax reform legislation, new tax initiatives, and user fees).
- (iv) Pursue overseas development assistance aggressively (aid coordination and management framework).

D. Capacity and Willingness to Reform

82. A wide-ranging development framework is presented in MAP, CRP and PSIP. However, the level of integration of such higher-level policy statements into ministerial actions is uncertain. One of the constraints is a somewhat loose policy development process (para. 12). The relationship between the President and the OEK is potentially of more concern. The legislative process is slow and concerns have been raised with regard to the capacity to proceed in a structured way with the adoption and implementation of the Government's reform process. Key economic reform initiatives rejected by the OEK in recent years include the following:

- (i) New tax law to raise revenue collection and introduce a more efficient and equitable system. A tax reform package was developed with IMF staff and submitted to the OEK in January 2002. The package provided for (a) conversion of four import duty bands ranging from 1-150% to a flat 5%; (b) limitation of duty exemptions; (c) calculation of import duties on cost, insurance, freight (CIF) not free on board (FOB) values; and (d) reintroduction of excise taxes on tobacco, alcohol, fuel, boats, and vehicles. The package was not passed.
- (ii) New foreign investment law to transfer responsibility for issuing foreign investment approvals from a board to a minister, to establish a one-stop shop for foreign investors and a more transparent process for considering applications. The proposed legislation was passed by Congress but not by the Senate.
- (iii) New uniform commercial code designed to establish consistent rules for private sector transaction.
- (iv) More effective banking law to protect depositors and meet international standards. Banking supervision and regulation requires further strengthening to enable effective implementation of banking law principles. The Financial Institutions Commission cannot freely conduct on-site inspections as its regulations still require OEK's approval and it must obtain authority from the Supreme Court to initiate enforcement actions. Different auditing requirements are still applied for domestic and foreign banks, as the former can opt for internal audit, while the latter must be audited by external firms.

83. The next national election will be held in 2008. This timing (just before the end of first 15 years of the Compact) and ongoing differences between the President and the OEK on the

direction of economic and fiscal policy may limit reform potential in the critical lead-up to the scheduled reduction in US financial assistance in September 2009.

84. Many factors contribute to reluctance to pursue economic reform, including the recognition that further growth will require more foreign workers. There are already as many foreign workers as Palauan workers and very little unemployment among Palauans. The difficulty of retaining Palauans or attracting emigrants back to work in Palau raises the prospect of foreign workers accounting for the majority of the workforce if the economy grows. Social change appears to be an unavoidable consequence of Palau's continued economic growth, and perceptions of a weakening of the Palauan identity may be creating reform inertia.

85. At present, official monopolies and a restrictive foreign investment system protect many sectors of the economy from active competition. This protection, combined with Palau's natural beauty and the large public sector, provides good business opportunities for Palauans. Senior members of Palauan society, including some OEK members, have developed extensive business interests in Palau and benefited from this protection. Many of the proposed economic reforms would open the economy and increase competition, an outcome likely to be resisted by established business interests. The broader community may also be concerned at the prospect of increased foreign involvement in the business sector, which can be expected from economic reform.

86. A third key factor is the role of public sector employment as a social support mechanism. Almost 50% of Palauan employees work for the Government, government business, or semi-government organization. On average, the public service offers higher salaries than the private sector, better conditions (e.g., provision of health insurance and additional superannuation), and is widely perceived as a "job for life". Thus, the public sector provides an extensive social safety net and a means of widely distributing the benefits of Palau's substantial grant assistance. These benefits would be eroded if the role of the public sector in the economy was reduced. Furthermore, Palauans released or not absorbed by the public sector in the future may find it difficult to compete with generally cheaper foreign labor, leading to unemployment or increased emigration.

E. Funding Development

87. The Government is pursuing cost savings to address funding shortfalls. The target is to reduce annual recurrent expenditure from \$60 million–\$65 million at present to a fiscally sustainable \$50 million–\$55 million. If achieved, the reduction in operating costs would greatly contribute to correcting the immediate funding shortfall expected in September 2009. However, there is some doubt as to whether such a reduction in recurrent expenditure is achievable, given difficulties faced in controlling the wage and salary bill. Based on data for the first nine months of FY2004–2005, the wage and salary bill alone will rise to \$35 million for the year. Furthermore, the Government is facing a number of cost pressures. The rise in non-communicable diseases, combined with extensive health subsidies, is laying the foundation for rising health care costs. Expansion of public infrastructure over 1994–2004 entails a rising maintenance bill, with the annual maintenance cost of the Compact road alone estimated at \$3 million. The Government is facing additional O&M costs of the large facilities at the new capital, where senior staff and elected representatives will work up to one-hour drive from the main government offices.

88. It will also be difficult to pursue savings in the capital expenditure budget. The infrastructure network remains incomplete and further investment is required to achieve desired growth dividends. The PSIP identifies \$350 million in capital works, some of which are critical and required to make effective use of recent expenditure. For example, road improvements are required to rehabilitate and expand the connection between the Compact road and Koror to deal

with an expected increase in usage. In addition, the area surrounding the new capital and along the Compact road is largely undeveloped rural land that requires supporting facilities (e.g., water supply, waste disposal, feeder roads, and schools) if the new infrastructure is to be well used.

89. A range of minor revenue measures is available to the Government. For example, the removal of import duty exemptions for food, medicine, and personal items could raise an estimated \$3 million–\$5 million per year; tax rates on fuel and social bads (such as soft drinks) are low; and the cost recovery rate on the supply of electricity and water is low, undermining revenue and encouraging overuse. Other countries in the region have demonstrated the potential benefits of more fundamental tax reform based on the introduction of value-added tax (VAT) and a progressive income tax. Palau's ratio of tax revenue to GDP (about 20%) is similar to levels in Fiji and Samoa, Pacific Island nations that have adopted modern tax systems. However, the Cook Islands, which has a similar population, number of visitor arrivals and income levels, has been able to lift its ratio of tax revenue to GDP above 30%. This comparison suggests Palau has could raise tax collections considerably by adopting a modern tax system.

90. Other options for funding development include securing additional grants, reforming government-owned businesses (e.g., privatization), and securing loans. Given that Palau is a net saver, loans effectively represent a future drawdown of the CTF. Unless such loans are self-financing (i.e., generate sufficient additional revenue to meet debt servicing costs), they may further erode the sustainability of the CTF.

VI. CONCLUSIONS

91. Palau's fiscal equation highlights the potential adjustment facing the economy. Annual current expenditure is around \$60 million–\$65 million. The Compact specifies that US grants—the main source of operating grants to date—will largely cease in FY2008–2009. This will leave domestically raised revenue of \$30 million–\$35 million per year, annual drawdowns of \$15 million from the CTF, and a small amount of operating grants. The result is a looming shortfall in funding for current revenue of \$15 million, based on current expenditure levels. At the same time, there are a number of cost pressures on the budget, notably from the health sector and a rising maintenance bill. Unless new operating grants are secured, substantial adjustments will need to be made to expenditure levels or domestic revenue collection just to cover operating costs.

92. Capital expenditure also needs to be funded. Palau has recently secured non-Compact, capital grants of about \$13 million per year, mostly from Taipei,China. Capital expenditure has averaged \$15 million per year over time. If Palau continues to secure substantial support from Taipei,China, the capital budget could be adequately funded. However, these calculations exclude in-kind support for capital projects provided by the governments of the US and Japan. This has totaled about \$300 million since the start of the Compact or \$27 million per year on average. In-kind US support for capital expenditure is scheduled to cease in FY2008–2009, and a continuation of the recent level of support from the Government of Japan is not assured, given demands on the Japanese aid program in Africa. A shortage of capital funds is also looming.

93. The Government has planned cuts in current expenditure. While there has been some success in expenditure control, the slow rate of progress suggests such initiatives cannot be solely relied upon to meet the looming shortfall in current revenue. Additional revenue will need to be raised domestically. Minor revenue initiatives have been identified and could be implemented quickly with legislative support. However, more fundamental revenue reform will probably be required to fully meet the looming shortfall in current expenditure and provide some internal revenue for capital expenditure.

94. The required adjustment could be lessened through private sector led growth. This would boost revenue collection and allow for the transfer of some responsibility for infrastructure to the private sector. It would also provide an alternative source of employment for Palauans displaced from the public sector. The economy has considerable potential to achieve private sector led growth. In particular, substantial land resources have good physical capacity for activities such as tourism, agriculture, and aquaculture.

95. Increased private sector growth would substantially change Palau and its society, entailing important social risks. The mobilization of land for development will impact sensitive traditional and individual rights issues. Palauan labor supply is currently almost fully employed so it is difficult to retain young Palauans and attract overseas Palauans to return. Palauans are more expensive for the private sector to employ than foreign workers. The result is that private sector growth will lead to the employment of additional foreign labor, which will constitute the majority of the workforce. Domestic deposits with the banking system substantially outweigh loans, so there is sufficient liquidity to meet local capital needs. However, local banks are cautious about local lending, partly due to the difficulty of using land to secure loans. This means that foreign investors would probably be required to help fund private sector developments and provide the supporting business network and skills required—notably for larger scale tourism developments. Therefore, private sector growth will increase foreign presence in Palauan business.

96. Growth prospects are probably weak if Palau chooses to retain the current community structure and cautious approach to increased foreign involvement in business. The economy is highly dependent on imports, there is virtually no manufacturing sector, and the export base is very narrow outside tourism. Considerable difficulties would be faced in any attempt to diversify the economy away from the public sector, given the narrow production base, small population, and remoteness from major markets. The large public sector is key to Palau's high income levels but the level of external assistance provided to the public sector is scheduled to decline substantially, and Palau's current high income levels and high standard of living are probably unsustainable.

97. At this early stage of development as an independent nation, Palau is doing well compared to other developing countries in the region. It is relatively well governed, with very few corruption cases; it has a functioning judiciary system and a relatively transparent financial and economic management process. However, the Government and the community will be faced with some difficult choices and decisions in the next few years if Palauans are to continue to enjoy the relatively high standards of health, education, and other public utilities which have been provided mostly free or heavily subsidized by the Government. Ongoing foreign assistance from Japan and Taipei, China, the opening up of the island of Babeldaob, and the prospect of offshore oil development in the north island of Kayangel represent a unique opportunity for development and growth. It will be a challenge to balance the competing interests of all stakeholders and the result will determine whether a more open and growth-orientated economy will be pursued or if development is likely to slow or even reverse.

Table A1.1: Gross Domestic Product

Item	1994	1995	1996	1997	1998	1999	2000	2001p	2002p	2003p	2004p
	Ratio to GDP (%)										
GDP by industrial origin											
Agriculture	8.1	5.8	3.9	3.0	2.9	4.0	4.0	3.9	4.0	4.0	3.9
Mining	0.5	0.3	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Manufacturing	0.8	0.9	0.9	1.2	1.5	1.4	1.4	1.5	1.4	1.4	1.4
Electricity, gas, and water	0.7	0.3	0.0	(0.3)	2.0	3.0	3.0	3.1	3.1	3.1	3.1
Construction	5.8	7.8	7.9	7.8	8.9	7.3	7.4	7.6	7.6	7.6	7.7
Trade	17.4	19.2	19.4	21.1	21.2	20.4	20.4	20.1	19.4	19.6	19.9
Transport and communications	11.7	8.8	6.7	7.7	7.8	8.7	8.8	9.0	8.8	8.8	9.1
Finance	3.7	4.4	4.9	5.8	4.9	3.8	3.8	3.8	3.8	3.8	3.8
Public administration	27.5	24.4	24.8	26.0	24.3	25.9	25.8	25.5	27.3	27.0	26.3
Others	21.8	26.8	30.3	26.1	24.6	23.1	22.9	23.0	21.9	22.3	22.5
Less: Imputed bank service charges	1.7	1.8	1.9	1.9	2.3	2.1	1.1	1.0	1.1	1.1	1.0
Plus: Import duties	3.5	3.3	3.0	3.4	4.2	4.4	3.3	3.2	3.3	3.3	3.2
GDP at current market prices	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	\$ million										
GDP at current market prices	83.5	95.2	108.2	113.2	117.3	113.5	117.2	120.8	115.3	116.8	119.7
Real GDP (at June 2001 prices) ^a	94.3	104.8	116.0	118.4	121.5	115.8	115.9	120.2	115.0	115.4	113.1
Annual percentage change	—	11.1	10.7	2.1	2.6	(4.6)	0.1	3.7	(4.3)	0.3	(2.0)
	\$										
Per capita GDP at current market prices	4,978	5,527	6,148	6,269	6,345	6,011	6,128	6,156	5,771	5,745	5,808
Per capita real GDP (June 2001 prices) ^a	5,620	6,080	6,590	6,557	6,571	6,136	6,060	6,124	5,758	5,678	5,487
Annual percentage change	—	8.2	8.4	(0.5)	0.2	(6.6)	(1.2)	1.1	(6.0)	(1.4)	(3.4)

GDP = gross domestic product, — = not available, p = preliminary estimate.

^a Real GDP derived using the US consumer price index (CPI) as the deflator to 1999 and the Palau CPI thereafter.

Source: Bureau of Budget and Planning, Ministry of Finance, Republic of Palau.

Table A2.1: Employment Growth

Year	Number of persons			Annual change (%)		
	Palauan	Non-Palauans	Total	Palauan	Non-Palauans	Total
1994	4,596	2,385	6,981			
1995	4,699	2,746	7,445	2.2	15.1	6.6
1996	5,030	3,107	8,137	7.0	13.1	9.3
1997	5,067	3,519	8,586	0.7	13.3	5.5
1998	5,049	3,606	8,655	(0.4)	2.5	0.8
1999	5,066	3,793	8,859	0.3	5.2	2.4
2000	5,265	4,505	9,770	3.9	18.8	10.3
2001	5,231	5,181	10,412	(0.6)	15.0	6.6
2002	5,191	5,166	10,357	(0.8)	(0.3)	(0.5)
2003	5,277	5,212	10,489	1.7	0.9	1.3

Table reports the number of active contributors to the (compulsory) social security scheme.
Source: Republic of Palau Social Security Administration. 2003. *Annual Report Fiscal Year 2003*.

Table A3.1: Employment by Industry by Census Year

Industry	Number of persons				Share of employed persons (%)			
	1980	1990	1995	2000	1980	1990	1995	2000
Agriculture, fishing and mining	81	446	724	668	3.0	8.0	9.3	7.1
Construction	476	861	1,087	1,232	17.3	15.4	14.0	13.1
Manufacturing	79	93	78	65	2.9	1.7	1.0	0.7
Transportation	164	335	281	318	6.0	6.0	3.6	3.4
Communication and other public utilities	64	142	154	181	2.3	2.5	2.0	1.9
Wholesale trade	115	130	699	1,879	4.2	2.3	9.0	20.0
Retail trade	221	670	749	994	8.1	12.0	9.7	10.6
Finance, insurance and real estate	45	119	122	130	1.6	2.1	1.6	1.4
Business and repairs	62	178	296	224	2.3	3.2	3.8	2.4
Personal entertainment and recreation services	77	750	1,090	1,277	2.8	13.4	14.0	13.6
Professional and related services	812	1,045	1,184	1,249	29.6	18.7	15.3	13.3
Health	146	201	301	292	5.3	3.6	3.9	3.1
Education services	575	632	672	669	20.9	11.3	8.7	7.1
Other professional services	91	212	211	288	3.3	3.8	2.7	3.1
Public administration	469	830	1,295	1,166	17.1	14.8	16.7	12.4
Employed 16 years and over	2,745	5,599	7,759	9,383	100.0	100.0	100.0	100.0
average annual growth rate (%)	—	7.4	6.7	3.9	—	—	—	—

— = not available.

Source: Office of Planning and Statistics. 2004. *Republic of Palau 2000 Census, Population and Housing Profile*. Republic of Palau.

Table A4.1: Employment and Incomes by Class of Worker (1999)

Class of Worker	Number			Median income per worker (\$)			Mean income per worker (\$)		
	Total	Male	Female	Total	Male	Female	Total	Male	Female
Total, 16 + years:	9,383	5,827	3,556	5,583	5,710	5,252	8,520	8,829	8,062
Private wage and salary	6,500	4,131	2,369	4,297	4,730	3,745	6,621	12,516	6,049
National government	2,080	1,157	923	10,810	10,726	10,900	13,613	7,348	12,828
State government	511	391	120	5,175	5,152	5,286	6,284	4,911	6,101
US or other government	154	53	101	8,889	10,875	8,143	12,237	5,017	10,078
Self-employed	99	67	32	6,500	8,000	3,750	13,738	4,453	10,163
Unpaid family	39	28	11	6,250	6,500	6,000	6,886	5,088	6,215

Source: Office of Planning and Statistics. 2004. *Republic of Palau 2000 Census, Population and Housing Profile*. Republic of Palau.

Table A4.2: Inflation Rate (Consumer Price Index)

Item	2001	2002	2003	2004	2005 (to Jun)
	% change (period averages)				
All groups	(0.6)	(0.3)	0.9	5.0	1.9

Source: Bureau of Budget and Planning, Ministry of Finance, Republic of Palau.

Table A5.1: Balance of Payments
(\$ '000)

Item	FY1997/ 1998	FY1998/ 1999	FY1999/ 2000	FY2000/ 2001	FY2001/ 2002	FY2002/ 2003	FY2003/ 2004
						Provisional	Provisional
Trade balance	(52,128)	(76,556)	(115,619)	(77,093)	(76,369)	(79,833)	(129,142)
Exports, f.o.b.	11,094	7,296	11,508	18,672	20,343	8,411	8,853
Imports, f.o.b. ^a	(63,222)	(83,852)	(127,127)	(95,765)	(96,712)	(88,244)	(137,995)
Services account	40,292	43,828	38,507	46,951	35,225	49,226	87,326
Receipts	58,003	54,144	53,240	58,531	47,352	57,943	96,940
Travel ^b	58,003	54,144	53,240	58,531	47,352	57,943	96,940
Payments	(17,711)	(10,316)	(14,733)	(11,580)	(12,127)	(8,717)	(9,614)
Freight and insurance ^c	(7,903)	(8,385)	(12,713)	(9,646)	(9,827)	(6,602)	(7,696)
Travel	(1,906)	(1,931)	(2,020)	(1,934)	(2,300)	(2,115)	(1,918)
Income	4,607	4,811	5,455	5,985	5,454	4,458	5,860
Investment income	3,527	3,720	4,149	5,163	4,854	3,911	5,605
Pension Fund Investment Income	456	455	554	605	595	566	309
Social Security Investment Income	624	636	752	917	713	685	658
Income Payment				(700)	(708)	(704)	(712)
Current transfers	19,582	12,373	21,994	19,348	21,152	20,597	24,747
Private	(6,062)	(5,680)	3,273	(1,420)	298	(998)	3,061
Inflows	1,129	1,500	11,135	5,686	7,168	1,789	18,043
Outflows	(7,190)	(7,180)	(7,862)	(7,106)	(6,870)	(2,787)	(14,982)
Official	25,644	18,053	18,721	20,768	20,854	21,595	21,686
Business licenses and fees	1,724	1,915	1,933	2,060	2,259	3,001	3,940
Grants	26,435	18,624	19,298	21,069	21,359	22,133	21,757
Other ^d	(791)	(571)	(577)	(301)	(505)	(538)	(71)
Current account	12,353	(15,544)	(49,663)	(4,809)	(14,538)	(5,552)	(11,209)
(includes official grants)							
Current account	(14,082)	(34,168)	(68,961)	(25,878)	(35,897)	(27,685)	(32,966)
(excludes official grants)							
Capital and financial account	3,546	3,369	35,631	7,142	3,033	14,174	35,162
Public Sector	(54)	(698)	31,330	1,679	2,427	14,217	17,143
Capital grants ^e	3,546	3,369	12,764	1,679	2,427	13,646	16,000
Gross Borrowing ^f			20,000				
Loan repayments ^g	(3,600)	(4,067)	(1,434)			571	1,143
Private Sector			22,867	5,463	606	528	19,162
Foreign direct investment			22,867	5,463	606	528	19,162
Other private inflows							
Errors and omissions	(12,147)	36,848	13,602	22,754	40,692	(10,196)	(18,744)
Overall balance^h	3,752	24,673	(430)	25,087	29,187	(1,574)	5,209
Memorandum items:							
Imports/GDP (in percent)	(54)	(73)	(109)	(79)	(76)	(76)	(115)
Trade account/GDP (in percent)	(45)	(67)	(99)	(64)	(60)	(68)	(108)
Current account/GDP (in percent)							
Including official grants	11	(14)	(42)	(4)	(11)	(5)	(9)
Excluding official grants	(12)	(30)	(59)	(21)	(28)	(24)	(28)
GDP (fiscal year)	116,293	114,444	117,026	121,396	127,964	116,793	119,695

f.o.b. = free on board, FY = fiscal year, GDP = gross domestic product

^a Includes government and tax-exempt imports.

^b Estimate based official visitor numbers data, average length of stay, and average daily spending.

^c Estimated to have amounted to 20% of the free on board (FOB) value of imports.

^d Contribution to international and regional organizations.

^e Grants received for capital improvements.

^f New borrowing of \$20 million from Taipei, China.

^g Principal payment on external debt.

^h Reflects changes in government financial holdings excluding Compact Section 211(f) Trust Fund.

Source: Bureau of Budget and Planning, Ministry of Finance, Republic of Palau.

Table A6.1: Scheduled US Grants
(\$ million)

Item	FY1994/ 1995	FY1995/ 1996	FY1996/ 1997	FY1997/ 1998	FY1998/ 1999	FY1999/ 2000	FY2000/ 2001	FY2001/ 2002	FY2002/ 2003	FY2003/ 2004	FY2004/ 2005	FY2005/ 2006	FY2006/ 2007	FY2007/ 2008	FY2008/ 2009	Total
Basic grants - Section 211(a)	21.2	18.6	18.9	19.2	11.6	11.7	11.8	11.9	11.9	12.1	10.7	10.8	10.8	10.9	11.0	203.2
Operations	14.9	12.8	12.8	12.8	7.8	7.9	7.8	7.8	7.8	7.8	6.8	6.8	6.8	6.8	6.8	134.0
Inflation adjustment ^a	6.3	5.8	6.1	6.4	3.8	3.9	4.0	4.1	4.1	4.3	3.9	4.0	4.1	4.1	4.2	69.2
Energy - Section 211(b)	40.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	40.9
Base grant	28.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	28.0
Inflation adjustment	12.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	12.9
Trust fund - Section 211(f)	66.0	0.0	4.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	70.0
Other direct payments																
Capital improvements	36.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	36.0
Inflation adjustment	16.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	16.6
Military options	5.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	5.5
Special program assistance	6.3	4.9	3.5	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	38.7
Total direct payments	192.5	23.5	26.4	21.2	13.6	13.7	13.8	13.9	13.9	14.1	12.7	12.8	12.8	12.9	13.0	410.8
Federal services	54.3	1.5	97.6	1.8	1.9	2.1	2.2	2.4	2.5	2.7	2.8	3.0	3.1	3.3	3.4	184.9
Road system construction	53.0	0.0	96.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	149.0
Weather, postal, aviation services	1.3	1.5	1.6	1.8	1.9	2.1	2.2	2.4	2.5	2.7	2.8	3.0	3.1	3.3	3.4	35.9
Total Compact aid	246.8	25.0	124.0	23.0	15.5	15.8	16.0	16.3	16.5	16.8	15.6	15.8	16.0	16.2	16.4	595.7
Other US assistance ^b	16.2	13.6	10.6	8.2	7.8	7.4	6.9	11.2	8.4	6.3	4.7	3.5	2.7	2.0	1.5	111.0
Total US grants	263.1	38.6	134.6	31.2	23.3	23.2	23.0	27.5	24.9	23.1	20.3	19.3	18.6	18.2	17.9	706.7

^a Estimates for FY2002–FY2009.

^b Other US assistance is received based on proposals submitted to grant agencies. Based on the Compact, various programs were to phase out from FY1996. Scheduled phase out is 25% reduction of grant authorization for each fiscal year. However, Palau is eligible for existing and new programs.

Source: Bureau of Budget and Planning, Ministry of Finance, Republic of Palau.

Table A7.1: Government Revenue, Expenditure, and Budget Financing

Item	FY1994/ 1995	FY1995/ 1996	FY1996/ 1997	FY1997/ 1998	FY1998/ 1999	FY1999/ 2000	FY2000/ 2001	FY2001/ 2002	FY2002/ 2003	FY2003/ 2004	FY2004/ 2005
										Provisional	Provisional
											(end May)
	\$ million										
Total revenue and grants	164.5	48.4	55.5	68.7	47.8	61.1	53.2	51.2	65.4	66.1	54.7
Domestic revenue	21.5	24.9	22.4	38.7	25.8	29.1	31.8	28.8	29.9	36.2	27.3
Tax revenue	13.4	15.6	16.8	19.0	18.9	22.9	24.1	22.0	22.7	26.5	20.4
Salaries and wages	3.8	4.1	4.6	4.7	5.2	5.5	6.0	5.9	6.3	6.5	4.8
Import tax	3.1	3.3	3.9	4.4	5.0	6.4	6.8	5.5	5.7	7.9	5.5
Gross revenue tax	4.8	6.1	6.3	6.3	5.6	6.2	6.9	7.4	7.1	7.9	7.0
Other	1.6	2.2	2.1	3.6	3.2	4.8	4.5	3.3	3.6	4.3	3.2
Non-tax revenue	7.1	7.7	3.8	17.0	4.5	4.3	5.8	4.5	5.7	8.1	5.9
Fishing rights income	0.2	0.2	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1
Interest income	4.6	4.6	0.4	0.2	0.1	0.3	1.4	0.3	0.3	2.1	0.1
from domestic banks	0.1	0.1	0.1	0.1	0.1	0.3	1.3	0.2	0.3	0.0	0.0
from foreign banks	4.5	4.5	0.3	0.1	0.0	0.1	0.2	0.1	0.0	2.1	0.1
Fees and charges	1.2	1.2	1.2	1.4	1.7	2.1	2.4	2.7	2.9	4.3	3.0
Other	1.0	1.7	2.1	15.3	2.6	1.9	1.8	1.5	2.4	1.7	2.6
Local trust funds	1.1	1.6	1.8	2.7	2.4	1.9	1.9	2.2	1.5	1.5	1.1
Grants	143.0	23.5	33.2	30.0	22.0	32.1	21.4	22.4	35.5	29.9	27.4
Compact ^a	126.5	23.5	22.4	21.2	13.6	13.6	13.8	13.9	13.9	14.1	6.2
Other ^b	16.6	0.0	10.8	8.8	8.4	18.4	7.6	8.5	21.6	15.8	21.2
DOI grants for operation	0.2	0.5	0.4	0.6	0.5	1.0	1.0	0.9	1.7	0.9	1.3
DOI grants for CIP	4.7	5.1	2.8	1.3	0.8	0.4	0.0	1.0	1.5	2.0	2.2
Non DOI capital projects	1.1	1.3	0.8	0.2	0.6	0.1	0.0	0.0	0.0	0.0	3.6
Grants from US grantor agencies	10.2	6.7	6.6	6.0	6.0	5.8	6.0	5.7	6.0	6.2	3.8
Other countries grants	0.3	0.3	0.2	0.6	0.6	11.0	0.6	1.0	0.7	0.7	0.5
Other countries CIP grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	11.8	6.1	9.8
Total expenditure	65.7	75.7	77.0	65.0	72.1	84.6	79.9	80.2	79.1	80.1	49.2
Current expenditure	57.2	58.7	58.7	55.2	64.1	72.1	64.6	59.1	63.7	59.6	40.5
Wages and salaries	23.2	25.8	27.8	27.4	28.4	29.3	30.0	30.8	32.2	32.0	23.0
Other purchases of goods and services	23.6	19.9	25.3	23.0	27.3	30.4	27.0	23.4	26.7	23.0	14.1
Interest payments	0.1	0.0	0.0	0.0	0.0	0.0	0.7	0.7	0.7	0.7	0.4
Investment Fees	0.5	0.6	0.5	0.4	0.4	0.3	0.2	0.1	0.0	0.1	0.0
Subsidies and other current transfers	9.8	12.4	5.2	4.4	8.1	12.1	6.7	4.1	4.0	3.9	3.1
Public enterprises	5.5	7.9	3.0	2.0	1.3	3.1	2.8	1.7	1.7	1.4	0.9
Other	4.3	4.5	2.1	2.5	6.7	8.9	3.9	2.5	2.3	2.4	2.1
Capital expenditure ^c	8.5	17.0	18.3	9.9	8.0	12.5	15.4	21.0	15.3	20.5	8.7
Balance excl. CIP grants and cap. exp.	101.6	(16.7)	(6.8)	12.0	(17.6)	(11.5)	(11.4)	(8.9)	(11.6)	(1.6)	(1.4)
Errors and omissions, accounts payable/receivables	1.5	16.5	5.7	(3.8)	3.6	5.3	1.7	(5.3)	10.8	5.0	(3.7)
Overall balance	100.4	(10.8)	(15.7)	(0.2)	(20.6)	(18.1)	(25.1)	(34.2)	(2.9)	(9.1)	1.8
Financing	(100.4)	10.8	15.7	0.2	20.6	18.1	25.1	34.2	2.9	9.1	(1.8)
Net long-term borrowing	(4.5)	(3.0)	(3.4)	(3.6)	(4.1)	(1.4)	0.0	0.0	(0.6)	(1.1)	(0.6)
New borrowing	0.0	0.0	0.0	0.0	0.0	20.0	0.0	0.0	0.0	0.0	0.0
Principal repayments	4.5	3.0	3.4	3.6	4.1	1.4	0.0	0.0	0.6	1.1	0.6
Non-CTF assets	(95.9)	13.8	19.1	3.8	24.7	(0.4)	25.1	29.2	(1.6)	5.2	(4.2)
Withdrawals from CTF	0.0	0.0	0.0	0.0	0.0	0.0	0.0	5.0	5.0	5.0	3.0
	Ratio to GDP (%)										
Total revenue and grants	178.3	46.1	49.6	59.1	41.8	52.6	44.3	42.1	52.8	52.0	—
Domestic revenue	23.3	23.7	20.0	33.3	22.6	25.0	26.5	23.6	24.1	28.5	—
Tax revenue	14.5	14.9	15.0	16.4	16.5	19.7	20.1	18.1	18.3	20.9	—
Nontax revenue	7.7	7.3	3.4	14.6	4.0	3.7	4.8	3.7	4.6	6.4	—
Grants	154.9	22.4	29.6	25.8	19.2	27.6	17.8	18.4	28.7	23.5	—
Total expenditure	71.2	72.1	68.8	55.9	63.0	72.8	66.7	65.8	63.8	63.1	—
Current expenditure	61.9	55.9	52.5	47.4	56.0	62.0	53.8	48.6	51.4	46.9	—
Capital expenditure	9.2	16.2	16.3	8.5	7.0	10.7	12.8	17.3	12.4	16.2	—
Overall balance	108.7	(10.3)	(14.1)	(0.1)	(18.0)	(15.6)	(20.9)	(28.1)	(2.3)	(7.1)	—

— = not available, CIP = capital improvement program, CTF = Compact Trust Fund, DOI = Department of Interior,
^a Includes grants mainly from US Department of Interior and other US agencies. These grants are used to support both current and capital expenditures.

^b Includes subsidies and transfers for current operations.

^c Excludes in-kind capital expenditure.

Source: Bureau of Budget and Planning, Ministry of Finance, Republic of Palau.

Table A8.1: Social Indicators for Palau and the Region

Item	Year	Palau	Cook Island	Fiji	Federated States of Micronesia	Kiribati	Marshall Island	Nauru	Papua New Guinea	Samoa	Solomon Island	Tonga	Tuvalu	Vanuatu
Net enrollment ratio in primary education	1990	81.8		92 (1986)	93.7 (1994)	76.2	89.7 (1988)	75.1 (1992)	66.3	82 (1991)	39 (1986)	91.6 (1986)	98.2 (1991)	74.5 (1989)
	2000	76.2	92.3 (2001)	94.7	92.3	93.5	84.1 (1999)	60.3 (2002)	77.4	87 (2001)	56 (1999)	89.4 (1996)	99.6 (2002)	78.2 (1999)
Literacy rate of 15-24 year olds	1990				71 (1994)	92	74 (1989)		60.6	96 (1991)	62 (1991)		95 (1991)	34 (1989)
	2000	91 (1995)	99 (1996)	93 (1996)					61.7	99 (2001)		99 (1996)		
Ratios of girls to boys in primary, secondary and tertiary education	Primary 1990	0.89	0.98	0.94 (1992)	0.92 (1994)	0.98	0.85 (1988)	1.03 (1992)		0.98 (1991)	0.8 (1986)		0.87 (1991)	0.88 (1991)
	Primary 2000	0.97	0.89 (2003)	0.98	0.93	0.93	0.83 (2002/03)	1.15	0.86	0.93 (2001)	0.86 (1999)	0.9 (2001)	0.93 (2002)	0.91 (1999)
	Secondary 1990	1.08	1.12	1.05 (1992)	0.98 (1994)	1.16	0.91 (1988)	0.75 (1992)		1.02 (1991)	0.57 (1986)		1.05 (1991)	0.84 (1994)
	Secondary 2000	0.88	0.94 (2003)	1.07	1.04	1.14	1.04 (2002/03)	0.84	0.67	1.04 (2001)	0.7 (1999)	0.99 (2001)	0.86 (2002)	0.93 (1999)
	Tertiary 1990	0.7	0.86	0.8 (1995)	0.79 (1994)	1.2 (1995)	0.5 (1995)	0.6 (1995)		1.7 (1995)	0.3 (1995)	0.9 (1995)	0.37 (1991)	0.4 (1995)
	Tertiary 2000	1.3	1 (2001)	1	1.07	1	0.9 (2000/01)	2.5	0.55	1.4	0.3	1	0.92 (2002)	0.5 (1999)
Under five mortality rate (per 1,000 live births)	1990	34	31	22	16 (1994)	88	93 (1988)		133	42 (1991)		27	59 (1991)	79 (1989)
	2000	29 (2002)	24 (2001)	22 (2002)	12	69	48 (1999)		88 (2001)	25 (2001)	73 (1999)	17 (1999)	32.4 (2003)	33 (1999)
Infant mortality rate (per 1,000 live births)	1990	25	25	17	46 (1994)	65	63 (1988)	13 (1992)	82	33 (1991)	96 (1989)	9	41 (1991)	45 (1989)
	2000	17	13 (2001)	16	40	43	29 (2002)	42 (1997 - 2002)	64 (2000)	18 (2001)	66 (1999)	13	21.6 (2003)	27 (1999)
Proportion on 1 year old children immunized against measles (%)	1990		70 (1988)	86 (1991)		67			42 (1995)	89 (1991)	92	81	90	66
	2000	99 (2002)	98 (2001)	73.6	84 (2001)	76 (2001)	80 (2001)		53	98 (2001)	77	96 (2002)	99 (2002)	94 (2001)
Proportion of land area covered by forest	2000	76.1	60.8	44.6	50	12.5	6 (1999)	17	84.9	35.2	88.2	5.4	43	36.3
Ratio of area protected to maintain biological diversity to surface area	2003	0	15.1	2.13	7.33	32.96	0	0	11.29	4.1 (2002)	1.31	9.01	0	0.27
Proportion of households with sustainable access to an improved water source, urban and rural	1999	88.7		71 (1986)	79.1 (1994)	35.1	92.5	71.7		90.9		91.5	90.3	75.8

Source: The Secretariat of the Pacific Community. 2004. *Pacific Islands Regional Millennium Development Goals Report 2004*. Noumea.