



Private Sector Road Map

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PALAU: Country Partnership Strategy (2009–2013)

PRIVATE SECTOR ROAD MAP

A. Private Sector Situation and Key Issues

1. Palau's physical and geographical characteristics pose major challenges and fundamentally influence the range of viable and sustainable economic development scenarios. Palau is relatively remote and transport costs are high, compounded by limited cargo volumes. It is also one of the smaller countries in the Pacific with a very small population. While these factors do not prevent private sector development opportunities *per se*, the small domestic market prevents the local capture of scale economies, thus implying that Palau should aim to integrate with world markets to the greatest extent possible.

2. The inability to achieve economies of scale in public administration is a particular challenge, which results in a higher per capita cost of public goods and services, including policy formulation, regulatory activities, law and justice, etc. Private sector development is thus constrained by both expensive and poor government services. Indeed, the public sector is overstaffed in many areas, but suffers from critical gaps in others. The inability to achieve economies of scale is exacerbated—in both the public and private sectors—by Palauans' unrestricted access to the United States. The result is scarcity of both skilled and unskilled labor.

3. Recognizing the particular challenges that Palau faces, the Private Sector Development (PSD) agenda, as set out in Palau's Private Sector Assessment (PSA),¹ is characterized by the need to formulate, adopt, and implement measures to reduce the constraints to doing business in an increasingly globalized and competitive international environment. Such reforms would help to mitigate or compensate for the challenges of Palau's natural endowments.

4. The Government's National Master Development Plan² (NMDP) identified uncertainty over property rights and particularly over title and access to land as a major constraint on economic development. It sets out twin objectives of increasing private land ownership and the availability of land suitable for development, and lists a number of measures to achieve these objectives. More recently, the National Economic Symposium³ highlighted the need for land-use planning and zoning.

5. The immediate challenge is to identify labor market reforms that both promote private sector development while responding to community concerns regarding the potentially adverse effects of an increased reliance on foreign workers. Non-discriminatory measures to achieve these objectives would include the introduction of a uniform minimum wage with no exceptions, and the introduction of a variable uniform fee for foreign workers with the fee used to influence the number of foreign workers in accordance with policy objectives.⁴ The adverse impact on the economy of higher labor costs could be mitigated or even overcome through the use of

¹ ADB. 2006. *Policies for Sustainable Growth: A Private Sector Assessment for Palau*. Unpublished Manuscript. Manila.

² Palau National Master Plan Taskforce. 1996. *The Palau 2020 National Master Development Plan*. Koror.

³ The findings and recommendations of the National Economic Symposium are reported in Compact Review Commission, 2007, *Report on the National Economic Symposium*, Koror.

⁴ An alternative to the variable uniform fee, as suggested by the PSA, would be a process for auctioning work permits.

complementary policies to liberalize the foreign investment regime, improve land lease arrangements, and to enhance vocational skills amongst Palauan workers.

6. Although the gaps in the commercial legal framework and the shortcomings of domestic financial markets have been well documented by donors, they have been subject to relatively little attention from Government. The NMDP proposed the establishment of a Public Trustee to facilitate lending against land, but was silent on the subject of the gaps in commercial law. In 2007, the National Economic Symposium endorsed the PSA recommendations to address the gaps in commercial law. In relation to domestic financial markets, the Financial Institutions Act was strengthened last year in response to the collapse of a domestic bank. While the enhanced legislation can be expected to reduce the likelihood of future bank failures, it does not address the underlying reasons for poor credit extension by the domestic banking sector.

B. Government's Private Sector Policy and Planning Framework

7. The 2001 Management Action Plans (MAP) serves as a strategic roadmap to reform government administration, build economic institutions, develop infrastructure, and strengthen the tourism sector. It explicitly recognizes the importance of private sector development to the future of the country. Reflecting the current crowding out of private sector activity by the large public sector, the Government adopted a Cost Reduction Plan in 2002, which has been successful in reducing the relative size of the public sector. As a result, the public sector's proportion of total employment has fallen from 43% in 1995 to 25% in 2007, and its contribution to GDP from 26% in 1999 to an estimated 20% in 2007.

8. More recently, the National/State Leadership Symposium and the National Economic Symposium brought together prominent members of Palauan society and the economy to discuss the country's development needs and aspirations. Both events reaffirmed the communities' recognition of the role of private sector development as a means to improve living standards. That said, as has been pointed out recently,⁵ the Government's support for private sector development faces two overarching constraints:

- (i) an expectation that someone else should pay for most government services, and that government services to firms and individuals should be heavily subsidized, and
- (ii) conflicts of interest, which make it difficult to gain acceptance for and to put in place effective governance arrangements and to adopt policies that benefit the community as a whole.

C. Government's Institutional Arrangements and Capacity in the Private Sector

9. Implementation of private sector focused reforms are hampered by an absence of clear institutional responsibility for implementation, inadequate capacity to formulate, implement and enforce reform policies, vested interests that seek to prevent competition and foreign direct investment, and a slow and cumbersome legislative process.

⁵ ADB. 2008. *Economic Policies and Institutions for Sustainable National Development*, TA 4929: Facility for Economic and Infrastructure Management Project. Manila.

10. There is no single agency responsible for the coordination of private sector development policy. The Ministry of Finance is responsible for formulating, implementing and evaluating economic and fiscal policies; developing and implementing national budgets; and revenue collection. It has traditionally been the focal point for ADB operations, but does not take a proactive role in private sector policy, and has limited capacity or resources to lead reforms in this area.

11. The Ministry of Commerce, Industry and Trade is responsible for economic and commercial development; transport and communications infrastructure; and labor policy. In practice, however, the Ministry has tended to focus narrowly upon regulation of labor and foreign investments, rather than the promotion of economic opportunities. While many of the binding constraints to PSD relate to matters that fall within its jurisdiction, the Ministry is not currently well placed to coordinate a wide-ranging private sector reform agenda. It suffers from significant capacity and resource constraints and has not taken a proactive approach to formulating and implementing reform measures to address private sector concerns. Given the wide dispersion of responsibility over the numerous policies, regulations, and laws that influence private sector development,⁶ there is a need to identify and strengthen a central Ministry that can serve as a widely recognized reform champion. In the short-term, it is likely that this would continue to be the Ministry of Finance. In the longer-term, however, there is a need to support the development of appropriate skills and expertise within the Ministry of Commerce, Industry and Trade, which has primary responsibility for economic and commercial development.

D. ADB Private Sector Experience

12. ADB began its first technical assistance in Palau in 2007. To date, there is no experience in private sector development initiatives directly in Palau.

E. Role of Other Development Partners in the Private Sector

13. Palau benefits from considerable external assistance and is one of the world's largest recipients of aid per capita. The US Government provides significant grant funding, although this is scheduled to be withdrawn in 2009, following which Palau would draw more heavily upon the US-established Trust Fund. In addition, Palau has access to most US federal government programs. A number of these have been used to support private sector development. In particular, the US Small Business Administration provides considerable assistance to the Palau Small Business Development Centre, which has been successful in promoting and supporting small-scale business development.

14. Palau benefits from significant external assistance to fund capital expenditures from Japan, the People's Republic of China, Taipei, China and the US. Support has primarily been focused on enhancing transportation infrastructure. During recent years, the airport runway has been resurfaced, a ring road around the main island of Babeldaob has been completed, and major causeways and bridges have been replaced or rehabilitated.

⁶ In addition to the PSD responsibilities of the Ministries of Finance and Commerce, the Ministry of Resources has responsibility for sectoral policy in agriculture and fisheries, while the Ministry of State covers matters relating to international trade and immigration. Any broad-based PSD reform program would need to accommodate each of these agencies, as well as non-government stakeholders such as the Chamber of Commerce.

15. ADB and AusAID are cooperating very closely in supporting PSD reform throughout the Pacific region, especially through the co-financed Regional PSD Initiative.⁷ This initiative provides PSD support in terms of policy dialogue, knowledge products and management, and enables ADB to rapidly respond to reform opportunities. Specifically, the initiative focuses on core themes of SOE reform and private sector participation; legal and regulatory business environment; financial sector reform; and mainstreaming of PSD in other sectors.

F. Links to CPS Outcomes and Other Sectors/Thematic Areas

16. Private sector development is a key strategic focus of ADB's support to Palau. Moreover, the proposed assistance in the above PSD focus areas is closely linked to, and will seek to reinforce, ongoing and planned loan and technical assistance in the other strategic thrusts of the CPS; especially in relation to financial and infrastructure management. A robust and dynamic private sector is necessary in order to strengthen economic and fiscal management and to fund the Government's broader social and development objectives into the future.

G. Indicative Areas for Interventions (Including PSOD)

17. ADB will extend support to the Government in developing and implementing critical components of the PSD reform agenda. As guiding principles, ADB's PSD strategy for Palau will focus assistance on reform areas:

- (i) that have been identified as binding constraints to private sector investment, as identified in the PSA and the Country Partnership Strategy;
- (ii) in which the Government has the critical institutional capacity to administer and implement the reforms, and in which it has demonstrated its commitment;
- (iii) that are in line with ADB's core areas of PSD support, as reflected in the January 2008 Midterm Review of the ADB's Pacific Strategy 2005–2009;
- (iv) that have linkages to, and the potential to reinforce, ongoing or planned government reform activities, especially those supported by ADB's TA and loan program; and
- (v) in which ADB has comparative advantages among relevant development partners.

18. In support of the Government's development objectives, and in line with ADB's Private Sector Development Strategy and ADB's Pacific Strategy 2005–2009 (as updated in January 2008), the objective of ADB's private sector development strategy for Palau is to support a conducive environment for the private sector that facilitates an acceleration in the rate of sustainable, private sector-led economic growth. The objective will be achieved through ADB support in the following priority areas: (i) labor market reform, (ii) foreign investment liberalization, and (iii) support for a commercial legal framework. The strategy will be implemented through ADB's relevant TA program for Palau and regional TA resources.⁷

⁷ ADB. 2006. *Technical Assistance for Private Sector Development Initiative*. Manila (TA 6353-REG).

H. Monitoring Mechanism

19. The PSD roadmap is closely aligned with the NMDP and the MAP, and it is anticipated that the forthcoming Medium–Term Development Strategy, which is currently being prepared with ADB support, will strengthen and extend the linkages. The ADB’s Pacific Department (PARD) has developed a results-oriented monitoring and evaluation tool for the purposes of managing PSD operations in the region. The performance of interventions undertaken as part of this PSD road map for Palau will be regularly measured accordingly. The monitoring of delivery progress will be an iterative process that will require close cooperation between executing and implementing agencies and ADB. Specific TA review and broader PSD consultation missions will be an integral part of the ongoing monitoring and evaluation of the PSD road map.

Table 1: Private Sector Results Framework

National Medium-Term Development Strategy		Asian Development Bank Strategic Agenda Inclusive Growth				
MTDS Actions ^a	Key Constraints	Strategy Outcome ^b	Outcome Indicators	ADB Assistance Program	Ongoing Program Performance ^c	Risks & Mitigation
Refine foreign investment and foreign worker policies to generate maximum sustainable benefits for Palau.	<p>Vested interests stall the reform agenda.</p> <p>Complexity and diversity of the decision to be made is stall action.</p> <p>Civil societies understanding of, and agreement to, the implications of greater overseas investment.</p>	<p>CPS Objective 2: Facilitate private sector development</p> <ul style="list-style-type: none"> Facilitate government business enterprise reform. 	<ul style="list-style-type: none"> No budget subsidies to business enterprises operating costs by 2013. 	<p>Ongoing RETA 6353 Private Sector Development Initiative</p> <p>TA 4929-PAL, Facility for Economic and Infrastructure Management</p> <p>Proposed Public Sector Reform Facility Cluster Phase 1 and 2</p>	<p>Focused reform policies, strategies, & measures for an improved enabling business environment</p> <p>Improved economic and infrastructure management</p> <p>Fiscal strategy implemented – government divests business enterprises</p>	<p>Risks</p> <p>1. Domestic businesses and investors are unable to develop commercial alternatives to Government enterprises.</p> <p>2. Civil society rejects measures that may lead to increased foreign ownership.</p> <p>Mitigation</p> <p>1. Support the establishment of business plans and transition arrangements.</p> <p>2. Support to public policy discussion and economic instruments to manage foreign ownership.</p>

^a The MTDS strategic priorities are: **A. Preserving key values** (the environment, cultural values, political stability, public security and civil order, relationships with development partners); **B. Achieving consensus for change** (the benefits of the MTDS, attitudes to the role and functions of Government); and **C. Addressing binding constraints on development** (change people's expectation of subsidies, explore and reduce conflicts of interest). These are addressed in the CPS approach and methodology, while the strategy directly aligns to the key actions over the next 5 years.

^b The program will contribute significantly to the CPS objective. Direct attribution of the CPS is identified in the necessary conditions underneath the CPS objective statement.

^c PI is the Public Financial Management, Performance Measurement Framework, detailing internationally accepted financial management indicators, public expenditure and financial accountability (June 2005).