



# Technical Assistance Consultant's Report

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## Republic of Palau: Facility for Economic and Infrastructure Management

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For Government of Palau  
and Asian Development Bank

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Privatization and Corporatization Options for Health and  
Education

Working Paper 5



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Asian Development Bank

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## ACRONYMS

BPW	– Bureau of Public Works
CT	– computerized tomography
GOP	– Government of Palau
MOE	– Ministry of Education
MOH	– Ministry of Health
MRI	– magnetic resonance imaging

## Executive Summary

1. This Working Paper is one of a series addressing opportunities for privatization, corporatization or increased private sector participation in activities currently performed by Government institutions. The Paper is based heavily on separate Working Papers produced as a result of the work of the Human Resources and Social Services Specialist Ms. Judy Otto, and the education and health task forces with whom she has been working. The focus of this particular working paper is limited to those opportunities for increased private sector involvement that have been identified and described in greater detail in the two Sector Papers.
2. Education and health services are normally ranked low on the list of priorities for privatization, since they are characterized more by their focus on social objectives, rather than on profits. Although the sectors lend themselves less readily to the widespread introduction of commercial principles, it is still possible to identify a number of areas where sector efficiency can be improved through greater private sector participation.
3. Because depreciation is not charged on some infrastructure such as school buses and medical equipment, and other maintenance is deferred because of insufficient funds, it is likely that true costs in both sectors are understated. Any moves to achieve greater private sector participation could, therefore, involve an apparent increase in short term costs, but a more significant reduction on long-term costs, since equipment and infrastructure life will be increased because of improved preventive maintenance practices.
4. Within the education sector it is noted that the unit cost per pupil of private schools is lower for private sector schools than publicly funded schools, in particular at the elementary level. The level of government payment per pupil is also significantly lower than the costs that would be incurred if government were to provide all the education services currently met by the private sector. However, unlike private schools, the public school education system provides services throughout Palau, with associated implications on their cost structure.
5. The education working group has identified opportunities for improved financial performance in transportation and meal services by (i) changing employment conditions so that drivers are only employed during school semester time, thus reducing costs by between USD40,000 - USD80,000 per annum; (ii) contracting out responsibility for providing school transportation, and (iii) changing employment conditions for staff responsible for preparing school lunches, so that they are not paid throughout the year, regardless of whether pupils are at school or not.
6. There is some scope for reducing the number of agencies involved in both transportation and school lunches, and for simplifying payment systems. There are almost certainly further opportunities for contracted maintenance of education infrastructure.
7. These recommendations are supported. In addition, it is suggested that the implications of private sector contract maintenance for schools be explored in greater detail.

8. Within the health sector, it has been suggested to the consultant that there is significant underfunding in some areas. Additional funds are necessary to meet sector needs for requirements such as equipment replacement or rehabilitation (estimated at some USD2.0 million (m) plus USD 0.5m per annum for maintenance) and medical supplies. To offset some of this additional cost the Health Sector Task Force has identified ten areas where there is scope for private sector contracting, in order to reduce costs. The areas concerned commence with non-health services such as laundry and housekeeping, and move through a spectrum of increasing sector specialization, ending with contracted professional medical services.
9. The Health Task Force also recommended: (i) increasing the scope of fees payable, in order to generate additional income; (ii) assessing approaches that would enable the private sector to provide alternative beds for elderly and terminally ill citizens, thus releasing space in medical wards; (iii) transferring responsibility for procurement of medical supplies back to the sector, rather than it resting with the Ministry of Finance; (iv) introducing charges for private sector operators, such as the mortuary, who use government facilities to provide services; and (v) rationalizing the present administrative controls that exist within the sector. Decisions on fees and eligibility is a policy question for Government of Palau. All other Task Force recommendations are supported.
10. A health insurance scheme has also been recommended.
11. A public utility model for the hospital has also been suggested as a long-term option, but is not being explored in the Medium-Term Development Strategy.
12. Overall savings to the sector have been assessed at USD1.25m from contracting and improved efficiency; USD1.25m for increased user charges and USD 0.8m from diversified funding.
13. In recent periods changes, in particular in the health sector, have been incremental, and reflected natural staff attrition. If future changes are to be implemented in a more timely manner then it will be necessary to consider reintroducing the “reduction in force” policies that apply to government employees.

## I. Introduction

14. This Working Paper focuses on possible privatization and corporatization opportunities within the education and health sectors. Other Working Papers in the privatization series address similar opportunities across a range of other government services.
15. The Terms of Reference for the Privatization Specialist require consideration of all aspects of service delivery and alternative public service delivery modalities through public private partnerships, state owned enterprise reform or possible privatization.
16. Successful corporatization or privatization is predicated on the philosophy that the private sector is more efficient than the public, because the profit motive encourages (i) cost reduction; (ii) full cost recovery for all products or services, or a quantified level of cross subsidy; (iii) resource optimization (the right equipment and inventory, adequately maintained); and (iv) the elimination of non value added activities. There are many examples that demonstrate the validity of this philosophy.
17. However, the business model and profit motive underlying corporatization and privatization fits less easily with health and education, which are more commonly seen as public rights to which all citizens have a natural entitlement that is not based on full “user pays” cost recovery. The challenge, therefore, is to incorporate incentives to ensure maximum efficiency and value for money from public sector activities.
18. In Palau public education is available free of cost. Private schooling is also available, and receives government subsidies. The level of subsidy is substantially lower than the cost per pupil in public schools. The Palau Constitution requires free or subsidized health services to be provided. The Ministry of Health (MOH) has a sliding scale of fees, last updated in 2006.
19. This Working Paper has been based substantially on (i) the very comprehensive analysis completed by the Social Services Project Specialist, Ms. Otto; and (ii) workshops with representatives from the Ministries of Health and Education, to discuss Medium-Term Development Plans for these sectors. More comprehensive details are provided in the two Working Papers “Medium-Term Sustainable Financing – Health” and “Medium-Term Sustainable Financing Strategy – Education”.
20. The opportunities for increased revenue and cost reduction identified by the sector stakeholders and the Social Services Specialist are discussed in greater detail in the detailed Working Papers provided by Ms. Otto for these sectors. This Paper is limited to the opportunities for greater private sector involvement in the sectors, and possible implications from such involvement.

## II. Education Sector

### A. Overall Sector Objectives

21. Education expenditure in Palau amounts to 11 percent of gross domestic product, which is more than twice the global average. In addition, the Ministry of Education (MOE) have identified an immediate and urgent need for USD1.0m in additional recurrent financing for public schools and USD2.0m in project funding over the period 2009 – 2016. These calls for additional expenditure are at variance with the broad intention of the Project Steering Committee (PSC) is to achieve sustainable financing by reducing direct Government expenditure by 12.5 percent per annum. Part of the pressure for this reduction is the indication given from the U.S. Department of Education that grants from the USA will “sunset” from 2009, unless they are specifically included in the renegotiated Contract.

### B. Sector Structure and Costs

22. Under the oversight of the MOE, and with a total estimated expenditure in 2007 of USD19.1m, the education sector is broadly divided into four segments:
- i) pre-primary segment, with 8 percent of total education expenditure. Nine percent of pre-primary sector expenditure is incurred by the private sector;
  - ii) elementary and secondary education, with 54 percent of total education expenditure. Seventeen percent of segment expenditure is incurred by the private sector;
  - iii) post secondary education, accounting for 35 percent of total public expenditure. Seventy-two percent of post secondary expenditure is incurred by Palau Community College, and 22 percent allocated to scholarships. There is no data for estimating private expenditure at post secondary levels. For students studying abroad, private expenditure is significant, since scholarship money is sufficient for only part of total costs; and
  - iv) cross cutting and other private expenditures, representing 3.7 percent of total education expenditure.
23. Table 1 shows that private schools operate at lower costs per student than public schools, in particular at elementary school level, where the average cost per pupil is 129 percent higher for public schools. This is partly attributed to lower teacher wage rates paid by the private sector.

**Table 1 Unit Costs for Education**

	<b>Public Schools</b>	<b>Private Schools</b>
<b>Elementary Schools</b>	(USD)	(USD)
Average Expenditure per student	2,961	1,291
Highest Expenditure per student	6,863	1,329
Lowest Expenditure per student	2,287	1,254
Percentage of total students	82%	18%
Percentage of total expenditure	97%	3%

	<b>Public Schools</b>	<b>Private Schools</b>
<b>High Schools</b>	(USD)	(USD)
Average Expenditure per student	2,841	2,072
Highest Expenditure per student	2,841	1,867
Lowest Expenditure per student	2,841	2,727
Percentage of total students	61%	38%
Percentage of total expenditure	68%	31%

Source: Working Paper on Education

### C. Opportunities for Private Sector Involvement

24. Typically, mainstream education is not based on privatized or corporatized delivery models that use the profit motive as a performance incentive. In Palau the motivation for private sector involvement in delivery of education services is based more on social or religious values than the profit motive. The private sector is already well represented, and provides a significant proportion of total student capacity, particularly at high school level, at costs per student that compare very favorably with public schools. The 2007 - 2008 student subsidies to the private sector amount to USD360 per student in grades 1 – 8, and USD800 per student in grades 9 – 12. As Table 1 shows, this is significantly lower than the cost per student of public sector education. In addition, without these subsidies to private schools, it is unlikely that public schools would have the capacity to meet demand, and total expenditure by Government would increase significantly.
25. Putting aside the option of reduced government subsidies for private sector schools, the Education Working Group has identified only one opportunity that could involve the private sector in education – contracting transportation services. The consultant suggests that in addition to contracting transportation, contracting school lunch services to private sector providers should be considered, rather than these services being provided by public sector employees. There is also the opportunity to consider contracting school maintenance services, although if some maintenance activities are currently undertaken by school bus drivers in what is otherwise idle time during the day, then the latter opportunity may offer less potential for savings. It is noted that MOE consider an additional USD130,000 per annum is required for facilities and maintenance activities, and a further USD46,000 per annum for utilities and maintenance required for a new high school at Babeldaob. Anything that can be done to reduce costs in these areas without neglecting maintenance itself is worthwhile.
26. **School Transportation.** MOE is legally required to provide transportation to schools wherever possible. These services currently cost USD250,000 per annum, but this is probably an understatement, since vehicle maintenance and replacement may be inadequately funded. Financing projections call for an additional USD25,000 per annum to be provided for transportation costs. The Ministry of Justice provides a separate transportation service for High School students in Babeldaob attending schools in Koror, with a cost recovery element of USD1 per student trip. There has already been some discussion on the benefits of unifying transport services under a single government agency, even though this could lead to anomalies in charging policies.
27. There are 19 staff (18 drivers and 1 supervisor) employed on transportation services.

Drivers are employed full time throughout the year, regardless of school holidays. There is some question as to whether vehicle maintenance and replacement costs are currently factored into MOE operating costs. If not, the existing system is effectively understating full costs.

28. The MOE team has considered: (i) the introduction of a fee for transportation; (ii) reducing the employment period of drivers to semester times only; (iii) contracting the work to the private sector; and (iv) repealing the law requiring transportation to be provided. Reducing the contracted employment to equate with school semesters would generate savings of USD40,000 - USD80,000 per annum. A transportation fee system has been rejected as “administratively burdensome”.
29. The MOE review team has recommended the introduction of contracted transport services. It should be noted that to ensure safety and sustainability any private sector provider should be required to indicate that they have included adequate vehicle maintenance and depreciation costs within their price structure.
30. Many countries providing school transportation services do so with non dedicated vehicles that are clearly marked as school buses at the times that they are transporting school pupils, but which can be used for charter or public transport at other times, thus spreading operating costs over a wider market, and enabling more competitive rates to be charged. This can be considered as an option if school transport is tendered for competitive bidding, since it enables the private sector to spread vehicle utilization – and therefore costs – over a wider consumer market.
31. **School Lunches.** This program was introduced in the 1970s. It currently costs USD530,000 or 9 percent of the MOE budget. The cost per meal is estimated at USD1.25, compared to a payment of USD 0.25.
32. Originally the 30 cooks were employed during term time only, but this was later extended to provide full time employment, regardless of school term times. The MOE team have recommended a progressive increase in the lunch fee until it operates on a full cost recovery basis, and a change in employment conditions to eliminate the need for salary payments during school holiday times. Private schools, with the exception of boarding schools, do not provide lunches.
33. Although the working group favors eliminating the lunch program, they do not believe such a recommendation will receive community and political support. The focus, therefore, is efficiency and cost recovery.
34. As is the case with transportation, there is some duplication of services between government agencies, since the Head Start program also provides a similar school lunch program to that provided by the MOE, even though Head Start programs are generally located within or adjacent to elementary schools.
35. Minor productivity improvements are possible by streamlining present payment practices, enabling parents to pay schools directly, rather than requiring them to obtain evidence of entitlement from individual schools; make payments to the Ministry of Finance in Koror, and then produce receipts at the school. The administrative costs of the present system in all probability exceed the revenue of USD11.10 per pupil per semester.

36. There are no apparent reasons why the school lunch service could not be provided on contract by the private sector or local communities. This would have the advantage that other catering activities could be undertaken concurrently, providing employment opportunities throughout the year.
37. In theory private sector providers who are able to spread overhead costs over additional activities, and generate revenue from other customers, should be able to offer a lower cost service. In practice, if MOE costs only reflect wages and raw materials, and do not take into consideration indirect production costs, such as premises and utility costs, equipment depreciation, or administrative support, then it will be more difficult for the private sector to compete.

**D. Maintenance**

38. School maintenance is considered by the Ministry to be underfunded, but one of the few areas where costs can be reduced painlessly in the short-term. Inadequate maintenance does, however, carry long term implications.
39. The current pricing principles whereby the Bureau of Public Works (BPW) only charges for materials, but not for time, introduces a cost distortion that the private sector cannot compete with, and which prevents full transparency of support costs.
40. Maintenance is an ideal activity for private sector participation. For any such scheme to be entered into it will be necessary to define what services are to be carried out; what materials must be provided and what payment terms apply. It is suggested that this be investigated further. A move to increase private sector participation in maintenance has employment and workload implications for the BPW.

**E. Other Opportunities**

41. Other options evaluated by the MOE do not involve the private sector. They are addressed in greater detail in the Working Paper considering sustainable financing opportunities within the Education Sector, and are not discussed in this Paper. The fact that there have been earlier reviews of efficiency within MOE does not preclude further public sector reform and value added analysis of Ministry activities.

**F. Staffing Constraints**

42. In recent years cost reductions relating to personnel have been introduced only slowly, and linked to natural attrition in the workforce. If more radical cost savings are to be achieved then it will be necessary to consider more intensive application of the "reduction in force" program.

### III. Health Sector

#### A. Sector Structure and Costs

43. At USD15.6 million, the 2007 estimated expenditure on health equates to USD722 per resident, and is in line with global averages of 8.7 percent of gross domestic product. Aid funding supports 33 percent of expenditure. Of this, 52 percent of total Ministry expenditures is from restricted accounts (Federal Programs and Health Trust Funds). Because this aid funding is tied to specific programs, the level of discretionary expenditure available to the MOH is limited.
44. The Bureau of Clinical and Hospital services are funded primarily from allocations approved by Olbill Era Kelulau. The Bureau of Public Health funding, totaling USD6.6m, including USD5.6m USA Federal funding, is perceived to be at risk if Compact negotiations result in reduced support.
45. Private sector expenditure fees paid for government services and for private providers amounts to USD3.5m, or 22 percent of sector wide expenditure. 89 percent of health sector employees are on the payroll of Government of Palau (GOP).
46. Hospital and Clinical Services account for 21 percent of total health expenditure, and the Health Administration Services Bureau for 37 percent of the total expenditure.
47. Health Task Force representatives believe that inadequate provision has been made for equipment maintenance and obsolescence. They estimate that USD2m is required to fund replacement of medical equipment at or beyond its economic life, and a further USD 0.5m per annum is required for equipment maintenance. Full sector costs are therefore understated.
48. There has been limited privatization within the sector, primarily relating to mortuary services and some janitorial services – but the latter has been limited in scope, occurring progressively as staff retire.
49. Task Force representatives are considering opportunities to: (i) raise USD1.25m from additional revenue; (ii) diversify funding by USD 0.8m, (iii) achieve efficiency gains of USD1.25m, in part from privatization; (iv) introduce a medical insurance scheme that would enable citizens to fund future medical expenses; (v) increase revenue from taxation on tobacco and alcohol; (vi) obtain alternative facilities for elderly and terminally ill patients currently occupying 15 percent – 20 percent of medical beds for long-term stays; and (vii) reduce administrative costs, in particular through centralization of administration of US Federal grants.

#### B. Current Private Sector Involvement

50. In addition to the involvement of community-based organizations, there are three private businesses that operate completely independently of the MOH – the Belau Medical Clinic; Roberts Medical Clinic and Pacific Family and Optical. In addition, three insurers provide coverage for about 20 percent of the population. In addition:
  - i) Morgue services are contracted to the private sector, using hospital premises. No

payments are received for rental costs, but electricity costs are reimbursed by the private sector. The operator receives payments from relatives for body storage. The Hospital Administrator believes that services provided to the government free of charge by the operator offset the loss of rental revenue for space used. These services include retrieval of bodies and autopsies when required.

- ii) Housekeeping services are partially provided by the private sector, but MOH continue to service “sensitive areas” such as sterile areas. The contract is valued at about USD100,000.

- 51. Proposals to charge rental costs to private sector institutions using health sector facilities, in particular the morgue and West Convenience Store, are supported by the consultant, even if this results in reduction of “free” support offered by these institutions.

### **C. Other Privatization (Contracting) Opportunities**

- 52. Already partly privatized, janitorial services will be extended as employee attrition makes this possible without incurring additional severance costs. Contracting can be expedited more speedily if the “reduction in force” policies are applied.

- 53. Health systems in many parts of the world have used a combination of “user pays” and contracting to hold costs to reasonable levels. Activities that support health services, but do not involve technical expertise are frequently contracted. The Public Health Tasks Force thinking reflects this trend. The first five of the following list are contracting opportunities that are widely supported; and the remaining opportunities are being debated.

- i) Contracting maintenance for biomedical equipment (already agreed);
- ii) Laundry services;
- iii) Security Services;
- iv) Housekeeping;
- v) Catering;
- vi) Dental treatment and restoration (where a 2 hour cleaning treatment to remove stains resulting from betel nut chewing is charged at only USD5.00);
- vii) Hyperbaric chamber services;
- viii) CT and MRI scans;
- ix) Pharmacy services, but with subsidy payments for supplies;
- x) Medical Services from doctors, based on performance contracts.

- 54. Some concern has been expressed that involving the private sector in additional activities such as housekeeping will result in a loss of jobs for Palauans, since lower cost guest workers are more likely to be employed.

#### **D. Administrative Services**

55. The Task Force believes that there is significant inefficiency in the administration of Federally funded programs, with perhaps as much as 25 percent administration costs, equivalent to USD1.4m.
56. Recommendations have been made that procurement of medical supplies and drugs be transferred from the Ministry of Finance to the MOH, and that the current rules relating to local procurement be strictly adhered to.
57. It is noted that although MOH is described as having an excellent budgeting and financial accounting system, the costs of individual services are not known. The consultant supports the need for improved cost allocation as a prerequisite for assessing the financial impacts of increased contracting to the private sector. Without a sound understanding of existing cost structures it is difficult to assess the financial benefits that may follow from contracting out services such as laundries and cleaning, and the associated adjustments that can be made in GOP financial allocations.
58. There is a very high level of debtors, many of which have been outstanding for some considerable period of time. Sound management principles dictate that those debts that stand no chance of being collected are written off, but more active collection processes be introduced to ensure that future payments are received in a timely manner.
59. Finally, in terms of administrative responsibility, it has been suggested that enhanced efficiency and performance could result if Community Health Centers were transferred to community management. The cost implications of this measure have not been assessed.

#### **E. User Pays Contribution**

60. The present fee scale is based on a payment scheme developed for Saipan, and introduced in Palau on 1997 – 1998. It incorporates a sliding scale of fees based on household size and income, so to some extent is “pro poor”. However, it does not consider all costs associated with treatment – for instance, making no provision for equipment depreciation, or professional services (physicians, dentists etc.). The Working Group has recommended a review of the fees, and of eligibility for support.

#### **F. Other Issues**

61. Officials have suggested that current expenditure is insufficient in a number of areas. In particular, there is a backlog of capital expenditure, with items valued at approximately USD2.0 m awaiting funding availability. Maintenance has been neglected, in order to reduce costs by some USD0.5m per annum, but this will result in equipment being unserviceable unless the situation is remedied. Procurement of supplies is also estimated by officials to require an additional USD3m, although this is probably overestimated if recommendations on procurement are implemented.
62. The main hospital also requires major rehabilitation or replacement, to remedy deficiencies in original construction.

### **References:**

Facility for Economic and Infrastructure Management June 2008 Medium-Term Sustainable Financing – Health  
Facility for Economic and Infrastructure Management June 2008 Medium-Term Sustainable Financing Strategy - Education