



Technical Assistance Consultant's Report

Project Number: 40595
July 2008

Republic of Palau: Facility for Economic Infrastructure Management (Financed by the Japan Special Fund)

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For the Government of Palau
Ministry of Finance

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Asian Development Bank

GOVERNMENT OF PALAU

**MEDIUM-TERM FISCAL STRATEGY FOR SUSTAINABLE
ECONOMIC DEVELOPMENT**

JULY 2008

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ABBREVIATIONS

ADB	–	Asian Development Bank
CSPP	–	Civil Service Pension Plan
CIP	–	Capital Improvement Projects
DOI	–	Department of Interior
FEIM	–	Facility for Economic and Infrastructure Management
GDP	–	gross domestic product
IMF	–	International Monetary Fund
PFTAC	–	Pacific Financial Technical Assistance Centre
PSC	–	Project Steering Committee
MDG	–	Millennium Development Goals
MTDS	–	Medium-term Development Strategy
MTFS	–	Medium-term Fiscal Strategy
SSF	–	Social Security Fund
US	–	United States of America
VAT	–	value added tax

ACKNOWLEDGEMENTS

The medium term fiscal strategy (MTFS) set out in this document was prepared with the assistance of the Facility for Economic and Infrastructure Management (FEIM). The FEIM was established by the Government of Palau and the Asian Development Bank in October 2007 to help the Government prepare a medium term development strategy (MTDS) for Palau. The MTDS covers all the major sectors and policies relevant for economic and social development of Palau while also taking account of environmental objectives.

1. Executive Summary

1.1 Introduction

1. This paper sets out the government's medium term fiscal strategy (MTFS) to support sustainable economic development. The fiscal strategy recognizes the specific features of Palau and in particular its vulnerability because it is still heavily reliant on external aid. Aid finances around 40 percent of current expenditures and virtually all capital expenditures. However, the strategy has been designed to be appropriate irrespective of the amount of aid that Palau can realize.

2. The MTFS has been formulated as part of the medium term development strategy (MTDS) for Palau. The MTDS is a comprehensive strategy covering goals, strategies, policies and actions for all the major sectors relevant to the economic and social development of Palau, while also taking account of environmental objectives.

1.2 Goals, principles and focus

3. The overarching goal for fiscal policy is expressed as:

"A sustainable fiscal policy that will maximize income for the country, that is equitable and that will contribute as much as possible to other development objectives."

4. An effective fiscal strategy has to ensure that:

- (i) the aggregate level of government expenditure is affordable over the medium-term;
- (ii) medium-term development strategic priorities are reflected in government expenditure allocations;
- (iii) government functions and activities are undertaken in a cost effective manner.

5. An effective fiscal strategy also requires that appropriate complementary economic, social and environmental policies are implemented.

6. In a development context, an effective fiscal strategy also needs to define an appropriate role for external aid. In addition, an effective fiscal strategy will help to ensure that external aid makes the maximum contribution to the welfare of the country.

7. These requirements for an effective fiscal strategy have been incorporated into the MTFS for Palau.

8. The prospect of a significant fiscal adjustment and the current fiscal features and policies for Palau help to define the strategy for the medium-term, as one which **focuses as a priority on being more self reliant with respect to financing current expenditure.**

9. The key element of the MTFS is the implementation of a fiscal policy and management framework that aims to finance current expenditure entirely from domestic revenues. The scale of the adjustment that is required over the medium and longer terms means that it is essential that there be:

- (i) comprehensive tax reform;
- (ii) a significant reduction in the level of current expenditure;
- (iii) an improvement in the efficiency of government; and
- (iv) a strategy for financing debt and maintenance expenditure and ongoing capital expenditure and that also for addressing fiscal holes and any significant staff retrenchments considered necessary for efficiency improvements.

10. These latter issues (point (iv)) will be the focus of external aid over the medium and longer terms.

11. The prospect of significantly lower financial support from the United States of America (US) creates considerable uncertainty in formulating a medium term fiscal strategy as part of a medium-term development strategy (MTDS). However, the strategy is considered to be highly credible as it could be sustained (albeit with considerable difficulty and a reduction in available trust funds) over the medium-term in the absence significant US assistance or additional assistance from other countries. This feature should enhance the prospect of being able to attract external assistance in a transition phase and for non-current expenditure purposes.

1.3 The scale and scope of the required fiscal adjustment

12. The scale of the fiscal adjustment that Palau faces in the event of no ongoing financial assistance from the US is estimated to be around 20 percent of gross domestic product (GDP). This is also the adjustment needed to meet the target of 100 percent financing of current government expenditure. Such a large adjustment is really only feasible over the longer term. Thus for the medium-term period of 5 years, the target will be an adjustment of around 10 per cent of GDP. This assumes that either there is some transitional finance from the US or another donor to address any remaining gap or that the gap is financed by drawing down the trust fund.

13. To achieve this target of a 10 percent adjustment over 5 years, the following sub-targets are being adopted:

- (i) domestic revenue to increase by 5 per cent of GDP over a 5 year period;
- (ii) current government expenditure (excluding maintenance) to decrease by 5 percent of GDP over a 5 year period, but with most of the decrease occurring in the first two years and focused on the government's wage bill; and
- (iii) the goals to be re-evaluated in the third year of the MTFSS and adjusted, if appropriate.

14. In relation to debt policy, the policy will be that unless a development project can finance debt itself and without reliance on substantial government guarantees, the project should not be financed by debt and there should be no additional debts incurred by the public sector as a whole over the medium-term.

15. Taking account of uncertainty about future external assistance and the need to have a reasonable reserve to be able to respond adequately to unexpected risks, another important sustainability principle that will be recognized is to maintain the real per capita value of trust fund assets.

1.4 Tax reform

16. Comprehensive tax reform will be needed as a priority in order to achieve the revenue target. The main directions for tax reform based on sound economic principles have already been well documented. However, further work would be useful on the timing of reforms and documenting the likely benefits of reforms as well as implementing an effective communications strategy to explain the need for and benefits of the reforms. Further work on tax reforms along these lines will be undertaken as part of the MTFS.

1.5 Expenditure adjustment and the allocation of expenditure to match priorities

17. Significant expenditure adjustment will also be necessary and this will increase the difficulty of allocating budget resources in line with priorities defined in the MTDS. Work will be undertaken on the desirable functional allocation of expenditure in the context of a tight budget and objectives of the MTDS. The separate studies of various sectors as part of the Facility for Economic and Infrastructure Management (FEIM) project will provide helpful information but the views of the Project Steering Committee members for the FEIM project will be sought in establishing priorities.

18. In addition, the MTDS has proposed that there will be a comprehensive review and reform of the role, functions, activities and modes of operation of government administration and associated human resource management. The review will help identify the extent to which government activities can be modified or eliminated for each major functional expenditure category. The review will also help identify expenditure adjustment priorities at the functional level in the context of the medium term fiscal targets and development priorities.

19. In the mean time the approach will be to commit to a reallocation of expenditure over the medium term to priorities identified in the MTDS and rely on the normal budget allocation process to reduce expenditure in non-priority areas.

1.6 A medium-term expenditure planning and monitoring framework

20. A medium term expenditure planning and monitoring framework is essential for:

- (i) ensuring that budget allocations reflect MTDS priorities within the available resource envelope;
- (ii) monitoring of the performance of the government's revenues and expenditure programs over the budget year; and
- (iii) regularly evaluating the outcomes of the government's fiscal policy settings.

21. The Office of Budget and Planning has been developing the main elements of suitable medium-term expenditure and planning framework. However, the framework needs further work to ensure that policies are better reflected in budgets and that all key stakeholders are aware of and committed to the framework. The status of the main components of the framework and directions for further development are set out in this paper to aid in communication and serve as a guide for the implementation of the proposed medium-term fiscal strategy.

22. As the budget and complementary policies are being implemented there is a need for an ongoing monitoring and evaluation process. Palau already has some relevant monitoring and evaluation elements in place in the form of performance reports and corporate and strategic plans and processes for review. However, there is a need to put more effort into key performance indicators and to assess functions, activity and expenditure in the light of these performance indicators on a regular and transparent basis to ensure that MTDS priorities are being effectively met and that government activity is efficient. There is also a need to integrate performance monitoring into the budget process through an effective medium term expenditure and planning framework.

23. The responsibility for identifying and monitoring relevant performance indicators should initially be at the department or bureau level but subject to review by the Office of Budget and Planning on an annual basis, consistent with the medium-term expenditure and planning framework set out in this paper.

24. Some suggestions for key performance indicators covering fiscal, economic, social and environmental objectives are presented in this report, in the separate FEIM report on “Economic Policies and Institutions for Sustainable National Development” and in the separate FEIM reports that are being prepared for other sectors, as well as in the draft MTDS that the FEIM is helping the government of Palau to prepare.

1.7 External aid focus

25. Palau is more likely to be able to secure external aid if it has in place an effective medium-term fiscal strategy, fiscal management framework and appropriate complementary economic, social and environmental policies consistent with a well formulated MTDS. Appropriate complementary policies are being developed as part of the draft medium term development strategy which is the main output of the FEIM project.

26. The proposed fiscal strategy is sustainable over the medium-term without donor support; provided the medium-term adjustment of around 10 per cent of GDP is achieved and greater use is made of the trust fund (which would be rapidly depleted without ongoing donor support). This should be helpful in persuading donors of the credibility of the fiscal strategy.

27. However, meaningful economic and social development will not occur without donor support over either the medium or longer term. The strategy of making meaningful progress in local financing of current expenditure while seeking donor assistance to deal with major fiscal holes, a maintenance fund and capital expenditure is practical and considered to be consistent with donor objectives. There is really little realistic alternative for Palau given its circumstances and the need to avoid a disaster scenario that would arise if the proposed strategy or something similar is not adopted and pursued effectively. However, it is also important to highlight that the strategy has been designed to be appropriate irrespective of the amount of aid that Palau can realize.

1.8 Communication

28. An additional important task for the MTDS and the medium-term expenditure planning and monitoring framework is the design and implementation of an effective communications strategy. This will aim to explain the government's decisions and their rationale and emphasize the benefits to the community of the policies, plans and framework that are to be implemented.

1.9 Summary of the strategy

29. Table 1 summarizes the goal, strategies and key performance indicators for the Medium Term Fiscal Strategy that is being adopted to help ensure sustainable economic development for Palau.

Table 1: Fiscal Policy Goals, Strategies and Key Performance Indicators for the Medium-Term Fiscal Strategy to Support Sustainable Economic Development

Goals	Strategies	Key Performance Indicators
<p>A sustainable fiscal policy that will maximize income for the country, that is equitable and that will contribute as much as possible to other development objectives</p>	<ul style="list-style-type: none"> • Focus on making good progress in financing 100 percent of current expenditure with local revenues. • Comprehensive tax reform based on well accepted economic principles. • Review of expenditure to determine the “right size” of government and use as a guide along with MTDS priorities to reduce expenditures. • Maintain the real per capita value of the trust fund. • No additional public debt unless it can be directly financed from revenues generated by the project. • Put in place an effective medium-term expenditure planning and monitoring framework. • Attract external assistance to help fund a maintenance fund, address fiscal holes, finance a well structured retrenchment package and capital expenditure. 	<ul style="list-style-type: none"> • Increase domestic revenues by 5 percent of GDP over 5 years. • Reduce current expenditures by 5 percent of GDP over 5 years with emphasis on the wage bill and most of the reduction occurring in the first two years. • Wage bill as a proportion of GDP. • Government expenditure on goods and services as a proportion of GDP. • Comprehensive tax reform adopted. • Real per capita value of the trust fund. • Public debt as a proportion of GDP. • Purpose of financing for any new public debt and extent of direct debt servicing from a project. • Strategic and operational plans for Ministries and Bureaus and public enterprises are consistent with the MTDS and are used to prioritize policies and public expenditure. • The functional allocation of expenditure reflects priorities in the MTDS and allocations are increased for higher priorities and decreased for other categories. • Relevant performance indicators are available and regularly evaluated to help determine priorities and the allocation of expenditure. • External assistance is focused on non-current expenditure items and maintenance.

GDP = gross domestic product, MTDS = medium-term development strategy.

2. Purpose of this Paper

30. This paper sets out the government of Palau's MTFS to support sustainable economic development. It outlines the key fiscal features in Palau and the fiscal pressures associated with different external funding scenarios over the medium-term. It presents the key components of an effective MTFS, suggests options for addressing fiscal issues as part of a MTFS and it also identifies key indicators for fiscal and economic sustainability.

31. A separate FEIM paper on "Economic Policies and Institutions for Sustainable National Development" prepared as part for the FEIM project considers important complementary economic policies and should ideally be read in conjunction with this paper. Note that a paper on taxation reform will be prepared at a later date and the Pacific Financial Technical Assistance Centre (PFTAC) is also providing technical assistance on tax reform. Papers for other sectors will also contain some suggestions for performance indicators.

3. Key Fiscal Features and Pressures

3.1 Key Fiscal Features

32. The key fiscal features in Palau are as follows:

- (i) large financial support from the US;
- (ii) declining assistance from the US but increasing assistance from other countries;
- (iii) the prospect of significantly lower financial support from the US from fiscal year 2009/10;
- (iv) relatively low domestic revenue;
- (v) an underdeveloped and inefficient tax system;
- (vi) relatively low general government debt but significant debt in some public enterprises;
- (vii) relatively low expenditure on maintenance;
- (viii) significant underfunding of liabilities in the Civil Service Pension Plan (CSPP) and the Social Security Fund (SSF); and
- (ix) a budget planning, resource allocation and monitoring framework that is in a formative stage of development.

33. Table 2 summarizes government revenues and expenditures since the mid-1990s. It shows the heavy reliance on US grants, increasing assistance from other countries mainly for capital expenditure and relatively low and declining domestic revenue.

34. Charts 1 to 5 show the profiles of various components of the fiscal accounts.

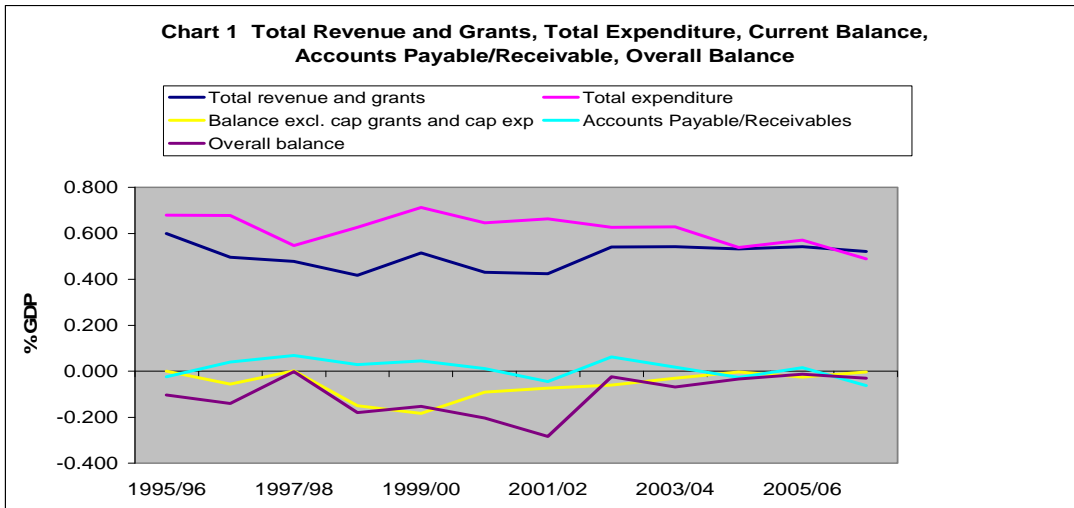
Table 2: Government Revenue, Expenditure, Current and Overall Balances and Financing: 1995/96 to 2006/07

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
	Proportion of GDP											
Total revenue and grants	0.599	0.496	0.477	0.418	0.515	0.431	0.424	0.540	0.541	0.532	0.542	0.521
Domestic revenue	0.242	0.200	0.220	0.226	0.246	0.257	0.238	0.260	0.266	0.280	0.247	0.232
Tax revenue	0.154	0.150	0.164	0.165	0.193	0.195	0.183	0.186	0.200	0.212	0.190	0.183
Nontax revenue	0.073	0.034	0.033	0.040	0.037	0.047	0.037	0.047	0.058	0.044	0.044	0.034
Local Trust Funds	0.015	0.016	0.023	0.021	0.016	0.015	0.018	0.027	0.008	0.009	0.013	0.013
Capital Revenue	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.014	0.000	0.001
Grants	0.357	0.296	0.258	0.192	0.269	0.173	0.186	0.281	0.276	0.252	0.295	0.289
Compact	0.224	0.200	0.182	0.119	0.115	0.112	0.115	0.114	0.108	0.088	0.082	0.065
Other 1/	0.133	0.097	0.075	0.074	0.153	0.062	0.071	0.166	0.168	0.164	0.212	0.224
DOI grants for operation	0.005	0.003	0.005	0.004	0.009	0.008	0.007	0.008	0.009	0.014	0.012	0.008
DOI grants for CIP	0.049	0.025	0.011	0.007	0.004	0.000	0.008	0.009	0.029	0.000	0.000	0.000
Non DOI capital projects	0.012	0.007	0.002	0.005	0.001	0.000	0.000	0.000	0.000	0.011	0.061	0.036
Grants from U.S. grantor agencies	0.064	0.059	0.052	0.052	0.049	0.048	0.047	0.049	0.056	0.051	0.049	0.043
Other countries grants	0.003	0.002	0.005	0.006	0.005	0.005	0.008	0.009	0.006	0.007	0.007	0.028
Other countries CIP grants	0.000	0.000	0.000	0.000	0.086	0.000	0.000	0.092	0.068	0.081	0.083	0.104
Local CIP	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.006
Total expenditure	0.679	0.677	0.547	0.626	0.713	0.645	0.663	0.626	0.627	0.539	0.571	0.490
Current expenditure	0.554	0.520	0.462	0.556	0.607	0.521	0.489	0.500	0.474	0.443	0.424	0.385
Wages and salaries	0.246	0.248	0.235	0.248	0.236	0.231	0.240	0.247	0.239	0.223	0.212	0.195
Other purchases of goods and services	0.187	0.224	0.196	0.237	0.252	0.212	0.180	0.185	0.165	0.151	0.148	0.130
Interest payments	0.000	0.000	0.000	0.000	0.000	0.006	0.006	0.006	0.005	0.005	0.004	0.004
Investment Fees	0.002	0.002	0.002	0.001	0.001	0.001	0.001	0.000	0.000	0.000	0.000	0.000

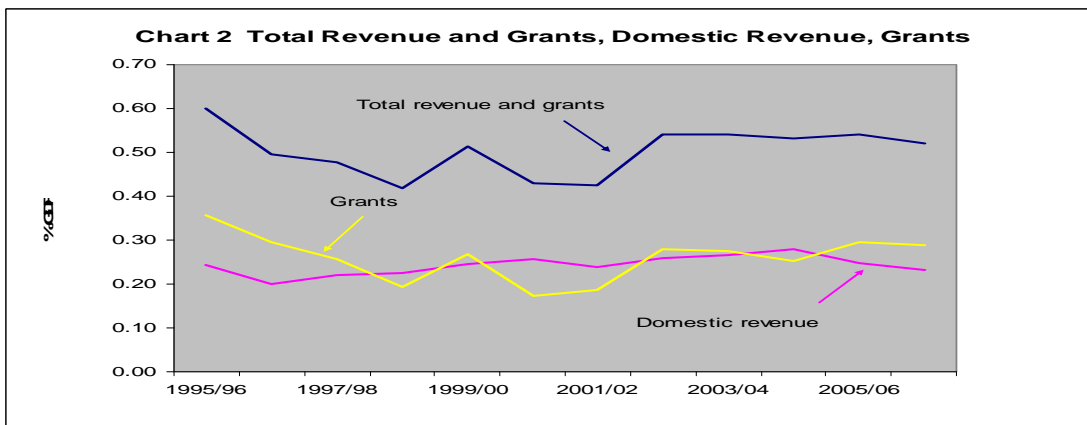
Table 1 continued

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
	Proportion of GDP											
Subsidies, State Gov't and Other												
current transfers	0.118	0.046	0.029	0.070	0.118	0.072	0.061	0.062	0.065	0.063	0.060	0.056
Public enterprises	0.075	0.027	0.008	0.012	0.027	0.023	0.014	0.014	0.012	0.011	0.010	0.009
State block grants	0.000	0.000	0.000	0.000	0.016	0.017	0.027	0.029	0.035	0.032	0.031	0.029
Other	0.043	0.019	0.021	0.059	0.075	0.031	0.020	0.019	0.019	0.021	0.020	0.018
Capital expenditure	0.125	0.157	0.085	0.070	0.106	0.124	0.174	0.126	0.153	0.096	0.147	0.105
Balance excl. cap grants and cap exp	0.000	-0.056	0.002	-0.150	-0.183	-0.091	-0.073	-0.060	-0.030	-0.003	-0.026	-0.004
Errors and Omissions,	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Accounts Payable/Receivables	-0.023	0.040	0.068	0.028	0.045	0.012	-0.045	0.062	0.017	-0.027	0.015	-0.062
Overall balance	-0.103	-0.141	-0.001	-0.180	-0.153	-0.203	-0.283	-0.024	-0.069	-0.034	-0.013	-0.031
Financing	0.103	0.141	0.001	0.180	0.153	0.203	0.283	0.024	0.069	0.034	0.013	0.031
Net long-term borrowing	-0.029	-0.030	-0.031	-0.036	0.157	0.000	0.000	-0.005	-0.009	-0.001	-0.007	-0.007
New borrowing	0.000	0.000	0.000	0.000	0.169	0.000	0.000	0.000	0.000	0.011	0.000	0.000
Principal repayments	0.029	0.030	0.031	0.036	0.012	0.000	0.000	0.005	0.009	0.012	0.007	0.007
Change in NTF assets	0.132	0.171	0.032	0.216	-0.004	0.203	0.242	-0.013	0.040	-0.001	-0.012	0.008
Withdrawals from Trust Fund	0.000	0.000	0.000	0.000	0.000	0.000	0.041	0.041	0.038	0.035	0.032	0.030
	In thousands of USD											
GDP	104,962	111,960	116,293	114,444	118,269	123,458	120,755	121,909	130,852	141,889	154,430	167,029

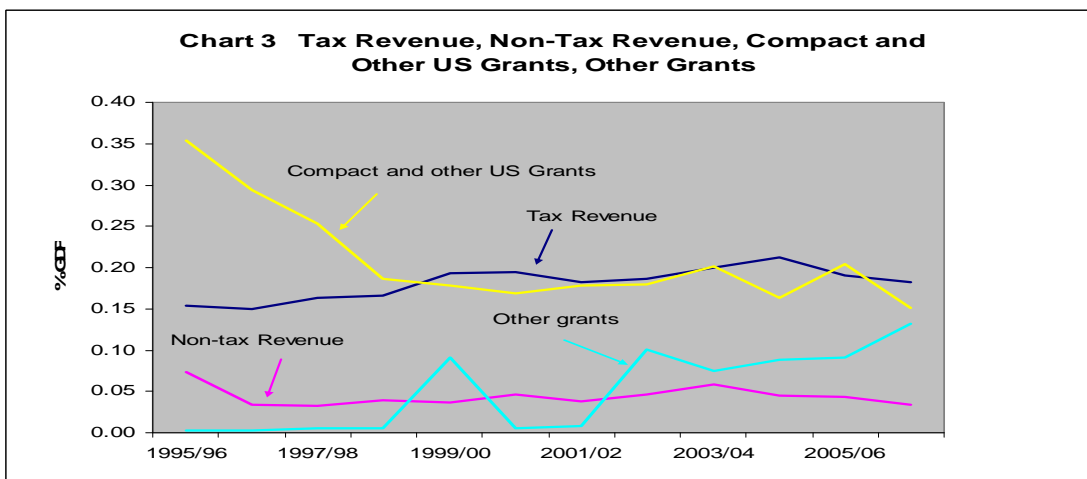
CIP = Capital improvement projects, DOI = Department of Interior, GDP = gross domestic product, NTF = National Trust Fund.
Source: Republic of Palau Office of Budget and Planning



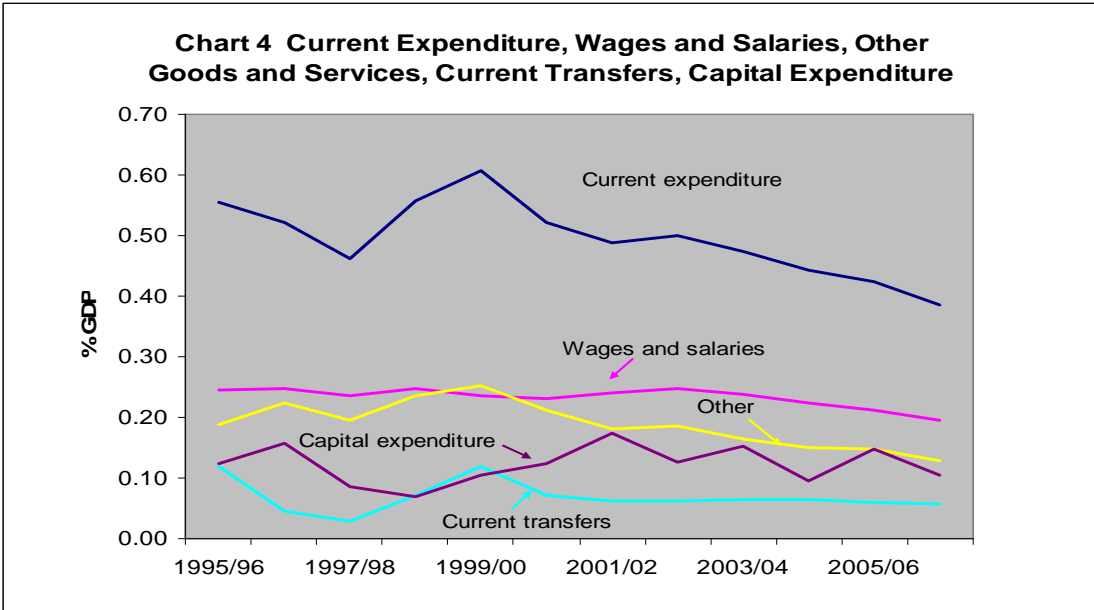
Source: Republic of Palau Office of Budget and Planning.



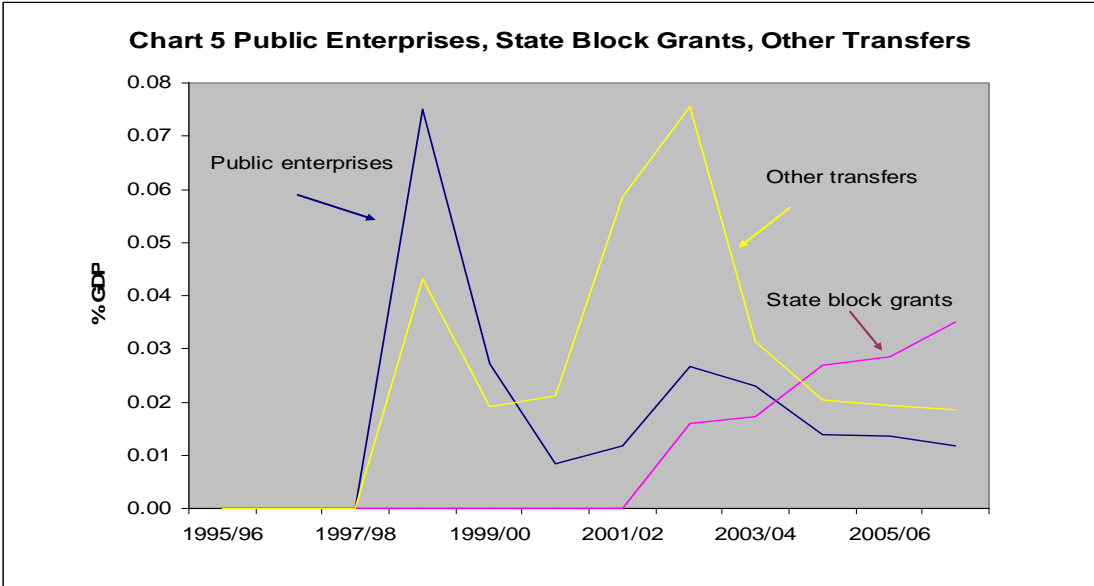
Source: Republic of Palau Office of Budget and Planning.



Source: Republic of Palau Office of Budget and Planning.



Source: Republic of Palau Office of Budget and Planning



Source: Republic of Palau Office of Budget and Planning

3.2 Progress Towards Fiscal Sustainability

35. Despite the heavy reliance on aid, Palau has nevertheless made some progress towards fiscal sustainability. The overall fiscal deficit including grants averaged over 20 percent of GDP from fiscal year 2000 to 2002 but declined to around 1.3 percent of GDP in 2006 before rising to 3 percent of GDP in 2007 (Table 1). In addition, in that year there was a significant improvement in the accounts payable/receivable position to around 6.2 percent of GDP which should have been reflected in a significant reduction in arrears and the time taken to pay accounts.

36. A longer term sign of improvement is that domestic revenues now cover a higher proportion of current government expenditure than in the mid-1990s. This has largely come about as current government expenditure as a proportion of GDP has declined. Local revenue as a proportion of GDP increased somewhat after 1999/00 but has recently declined again, reflecting weaknesses in the tax system.

37. The decline in current government expenditure has mostly arisen as a result of a decline in purchase of goods and services. There has been a smaller reduction in expenditure on wages and salaries as a proportion of GDP, but the reduction is still significant. However, the government wages and salaries bill as a proportion of GDP at 20 percent is still considered to be relatively high; for example around twice the level observed in five major Pacific Islands in the South Pacific (Fiji, Samoa, Solomon Islands, Tonga and Vanuatu as shown in the IMF 2006a, p. 18).

38. Transfers comprise subsidies to public enterprises, block grants to fund State expenditures and other transfers. Transfers as a proportion of GDP have declined noticeably since fiscal year 2000 but State block grants, as a component of total transfers, have risen. It would be preferable to eliminate or substantially reduce subsidies to public enterprises by increasing the prices for their services or improving their efficiency. This issue is being considered in more detail in the separate economic paper and in work undertaken by the infrastructure and privatization advisors in the FEIM project.

39. Importantly, in terms of sustainability it should be recognized that just over half of total (current and capital) government expenditure is financed by aid, while domestic revenues finance only around 60 percent of current government expenditure. This should be a key concern given the uncertainty of aid funding in the medium and longer term. This issue is discussed further in the section on fiscal sustainability principles.

40. Palau has relatively low government debt with gross external public debt being less than 10 percent of GDP. This comprises an outstanding balance of around \$15 million for the relocation of the capital and \$1.5 million for the Palau International Airport upgrade. However, this relatively low public debt is misleading. There are additional debts at the major public enterprises that are not included in these figures. In particular, a debt of \$39 million incurred by the Palau National Communications Corporation in the late 1990s and \$7 million by the Palau Public Utility Corporation in 2006. These two loans constitute around an additional 28 percent of GDP and both these public enterprises are facing financial difficulties. Ultimately the debts of major public enterprises providing essential services are the responsibility of government for government would not allow them to fail to continue to operate. In addition even in the absence of these debts the fact that Palau finances all of its capital expenditure and 40 percent of its current expenditure with external assistance implies that the standard debt sustainability indicators are not relevant for Palau.

41. A longstanding sustainability issue is that there has been inadequate attention to maintenance of infrastructure and other publicly owned assets in Palau. This issue will be a focus of the separate work of the infrastructure advisor who will report on the cost and options in relation to maintenance requirements.

42. Taking a comprehensive view of fiscal sustainability, the commitments and financial position of the CSPP and the SSF are also of concern. An actuarial report in October 2005 showed an unfunded liability of \$41 million. There have been numerous attempts to address the Pension Plan liability, including proposals for increased government contributions, increasing the retirement age and moving from a defined benefit to a defined contribution plan but none of these attempts has been successful. The financial position of the SSF is understood to be not as serious as the Pension Plan. However, the position of the SSF is improved by the fact that foreign workers make contributions but do not receive the full benefit of their contributions. Addressing that problem in an equitable manner would require additional funding.

43. Considerable progress has been made in recent years in building the capacity for more effective budgeting, planning and performance monitoring. However, further work needs to be done in terms of linking funding to priorities and the setting of priorities in the context of financial constraints and in the monitoring of performance. With a tight budget constraint, effective performance monitoring will be especially important to ensure the efficient determination of priorities and the allocation of budget resources. The key elements of a medium term expenditure planning and monitoring framework are set out later in this paper along with indicators of fiscal and economic sustainability. Additional complementary considerations and performance indicators in relation to the MTDS are outlined in the separate FEIM (2008) paper on "Economic Policies and Institutions for Sustainable National Development".

44. Given the expectation of significant fiscal pressures, even in the event of substantial renewal of Compact funding, and in the interests of efficient use of public resources, it would be useful to undertake a study to provide more detailed guidance on the "right size of government" and how best to reduce current government expenditure to meet fiscal constraints. This is considered further in the section setting out the detail of the MTFS. A recommendation has been made in the draft MTDS to undertake a detailed review to address the issue of the "right size of government".

45. The prospect of significantly lower financial support under the Compact after 2010 heightens the need for an effective MTFS. However, irrespective of US assistance it is important for Palau to formulate and implement an effective MTFS that recognizes the need to achieve greater self reliance while also contributing effectively to other development goals. It is also suggested that good progress on a MTFS along these lines would also be likely to enhance the prospect of attracting further external assistance from various sources for certain well specified purposes that are also consistent with the goal of greater self reliance.

3.3 Fiscal Adjustment Pressures

3.3.1 The Scale of the Adjustment

46. Table 3 sets out the fiscal outcome based on a basic scenario for the purpose of understanding fiscal pressures. The key assumptions of the scenario underlying the estimates in Table 3 are as follows:

- (i) GDP as estimated by the Ministry of Finance;
- (ii) US grants to decline in 2007/08 and 2008/09 as indicated in the table and to zero after 2008/09 but grants from other countries to be maintained as a proportion of GDP at the same level as in 2006/07;
- (iii) Domestic revenue as a proportion of GDP to be maintained at the same level in the forecast years as in 2006/07;
- (iv) Current and capital expenditure as a proportion of GDP to be maintained at the same level in the forecast years as in 2006/07;
- (v) Debt repayments as scheduled; and
- (vi) Withdrawals from the trust fund increasing from 2.6 to 7.8 per cent of GDP or from \$5 to \$15 million per year from 2009/10.

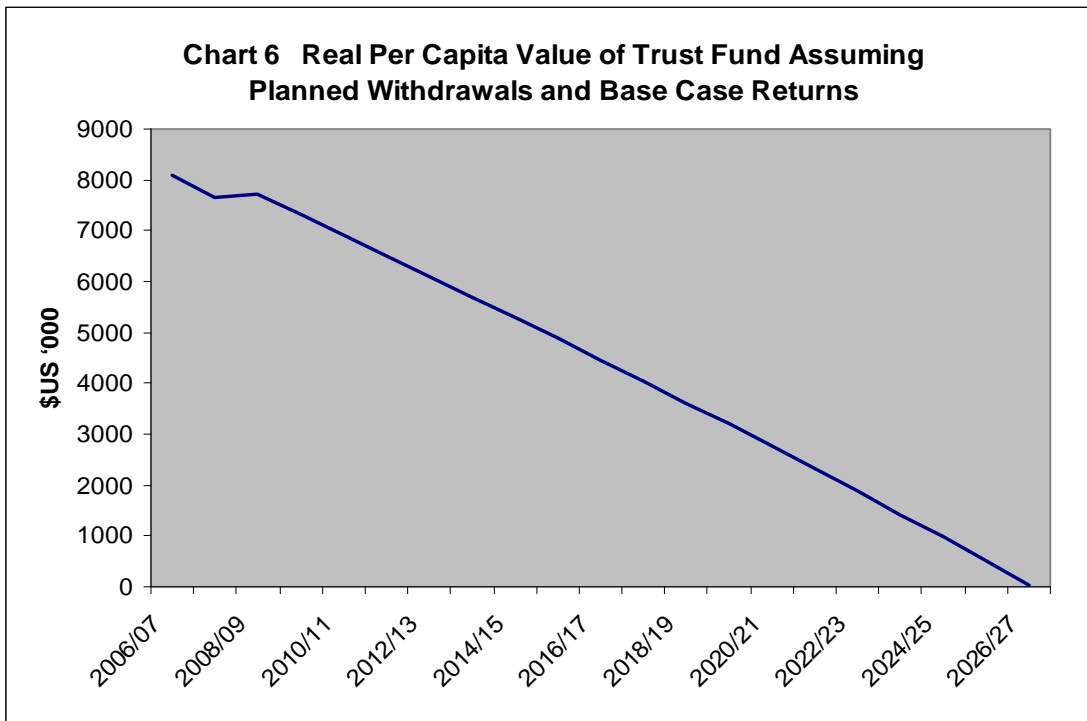
Table 3: Fiscal situation for 2006-2010 given various basic assumptions

	2005/06	2006/07	2007/08	2008/09	2009/10
	Proportion of GDP				
Total revenue and grants	0.542	0.521	0.497	0.467	0.340
Grants	0.295	0.289	0.265	0.235	0.108
Total expenditure	0.571	0.490	0.490	0.490	0.490
Current expenditure	0.424	0.385	0.385	0.385	0.385
Capital expenditure	0.147	0.105	0.105	0.105	0.105
Balance excl. cap grants & cap exp	-0.026	-0.004	-0.027	-0.058	-0.148
Accounts Payable/Receivables	0.015	-0.062	-0.029	0.003	0.077
Overall balance	-0.013	-0.031	-0.021	-0.020	-0.072
Financing	0.013	0.031	0.021	0.020	0.072
Net long-term borrowing	-0.007	-0.007	-0.006	-0.006	-0.006
New borrowing	0.000	0.000	0.000	0.000	0.000
Principal repayments	0.007	0.007	0.006	0.006	0.006
Change in NTF assets	-0.012	0.008	0.000	0.000	0.000
Withdrawals from Trust Fund	0.032	0.030	0.028	0.026	0.078
	In thousands of \$US				
GDP	154,430	167,029	180,003	192,620	191,479

Source: Republic of Palau Office of Budget and Planning and Consultant's estimates.

47. Under the scenario reflected in Table 3, the current fiscal balance (i.e. excluding capital grants and capital expenditure) increases from near zero in 2006/07 to 14.8 percent of GDP in 2009/10. The focus here is on the current balance rather than the overall balance. It is assumed that the capital expenditure of 10.8 percent of GDP is financed by grants from other countries. Thus the current balance is (approximately) financed by withdrawals from the trust fund of 7.8 percent of GDP and a build up in accounts payable to around 7.7 percent of GDP. This scenario suggests that unless further US grants or other external aid are available from 2009/10 the fiscal adjustment is approximately 15 percent of GDP.

48. However, there are additional fiscal pressures to consider. First, withdrawals of \$15 million per year will mean that the real per capita value of the trust fund will rapidly diminish under a broad range of reasonable assumptions. The trust fund balance increased significantly in 2007 reflecting stronger returns in international markets but recent financial market returns in the US are likely to impact adversely on the overall trust fund balance. Assuming the trust fund withdrawals increase from \$5 million to \$15 million per annum as planned, an investment fee of 0.7 percent of trust fund assets, a zero return on assets in fiscal year 2008, an average annual real return of 6 percent from 2008, and population growth of 1.8 percent per annum, the real per capita value of the trust fund would decline significantly over the next 10 years and be exhausted by about 2027 (Chart 6). Returns would have to average an unrealistic real rate of 10 percent per annum to maintain the long term real per capita value of the trust fund under the other assumptions. Thus it is likely to be the case that there will be a significant deterioration in the real per capita value of trust fund assets over the medium and longer term, unless there is some combination of substantial external assistance and expenditure and domestic revenue adjustment.



Source: Republic of Palau Office of Budget and Planning and Consultant's estimates.

49. If the trust fund is to be preserved in real per capita terms over the longer term, then based on the foregoing assumptions drawdowns would need to be limited to \$7 million per annum suggesting a fiscal adjustment of around 20 percent of GDP.

50. It is important to recognize that this estimate of the required adjustment does not take account of the need to increase expenditure on maintenance and to address concerns about fiscal holes for the CSPP, the SSF and the potential need to fund retrenchment packages if public sector employment is scaled back significantly. The Pension Plan and SSF issues are longer term issues but they do need to be addressed effectively over the medium-term. However, it is recognized that the maintenance requirement is an urgent medium-term issue as is the need to make meaningful progress in 'rightsizing' government. Given the scale of the adjustment apart from these issues, it is planned that they be addressed separately as part of a coherent strategy and relying on the assistance of donors where possible.

51. An alternative way to determine the size of the desirable fiscal adjustment over the medium-term, even assuming there is a substantial increase in aid is to determine what would be required to ensure that domestic revenues could fully finance domestic expenditure and assuming a reasonable revenue target. Such an approach is considered to be a more reasonable base case for the purposes of developing a MTFS. But as shown below it turns out that the adjustment is also around 20 percent of GDP assuming that maintenance, fiscal holes and retrenchment packages can be dealt with by separate funding mechanisms and the real per capita value of the trust fund is to be preserved. If this is not the case, then the priority in the medium-term would be to raise additional revenue to finance much needed maintenance expenditure.

4. A Medium-Term Fiscal Strategy

4.1 Introduction

52. An effective fiscal strategy has to ensure that:

- (i) the aggregate level of government expenditure is affordable over the medium-term;
- (ii) medium-term development strategic priorities are reflected in government expenditure allocations;
- (iii) government functions and activities are undertaken in a cost effective manner.

53. An effective fiscal strategy also requires that appropriate complementary economic, social and environmental policies are implemented.

54. In determining affordability it is necessary to establish relevant sustainability principles and, more specifically for the government budget, to determine the aggregate resource envelope that is likely to be available. Over the medium-term, it is important that policy priorities drive the budget rather than resource availability and expenditure or institutional inertia. Appropriate complementary policies are important for the success of individual aspects of the fiscal strategy as well as for enhancing resource availability in the future. Finally, it is important to ensure that government programs and activities contribute effectively and efficiently to development objectives and there is an effective means of monitoring and evaluating performance. A proposed medium-term expenditure planning and monitoring framework is outlined to help with this purpose. Indicators for fiscal and economic sustainability are also presented in a separate subsection below and in the separate FEIM (2008) report on "Policies and Institutions for Sustainable National Development", the separate FEIM reports in other sectors and in the draft MTDS itself (see reference list).

55. In a development context, an effective fiscal strategy also has to define an appropriate role for external aid. In addition, an effective fiscal strategy will help to ensure that external aid makes the maximum contribution to the welfare of the country.

4.2 Fiscal Sustainability Principles and Focus

56. Taking a broad perspective long term fiscal sustainability would normally be defined by a situation where the total sustainable revenues from all sources were sufficient to finance total expenditures without entailing a reduction in the per capita net economic and environmental wealth of the country. This broad perspective would treat the relationship with the US as an economic asset and would also allow debt to be incurred if it was capable of earning an economic return to finance the debt.

57. From this perspective the value that the US places on Palau from a strategic perspective is an asset to Palau that in turn can generate revenue. Similarly ongoing aid from other countries may also be a sustainable income source, particularly in the medium-term. However, a key problem with this perspective is the uncertainty of the value of the asset from the US relationship and associated revenue and also uncertainty in relation to assistance from other countries. This uncertainty exists in both the long-term and the medium-term and is especially important in developing a MTFSS, given that the existing funding arrangements expire in fiscal year 2010. Given this uncertainty and that vulnerability is most likely to arise in relation to the financing of current expenditures, it is proposed that the main focus in the medium-term in terms of sustainability of financing is on increasing the extent to which domestic revenues are able to finance current expenditures.

58. Turning to capital expenditures, it is considered reasonable to assume that external aid will continue to be available on a significant basis to finance capital projects. However, if this is not the case, adjustment to lower capital expenditure would be far less painful for most Palauans in the medium term, than a significant reduction in funding for current expenditure. In addition capital projects should strictly only be undertaken if they earn a meaningful economic return (defined on a comprehensive basis to include anything of value to society) and this usually means a return at least as high as is necessary to finance debt funding either directly or indirectly through additional tax or other domestic revenues. Thus, even if there was no external financing for capital projects, Palau would be able to invest in infrastructure and other capital projects where there was a convincing prospect of earning an appropriate economic rate of return. The availability of this option reinforces the need to focus on sustainability with respect to funding current expenditure.

59. More specifically the foregoing principles suggest that debt could be incurred where it generates an appropriate economic return. However, in the case of Palau the normal debt sustainability indicators at a macroeconomic level are not very relevant because Palau is only able to finance 60 percent of its current expenditures from domestic revenue with the rest of current expenditure and virtually all capital expenditure being financed by aid. In addition although government debt is relatively low, total debt owed by government and public enterprises is relatively high. These considerations suggest that unless a project can finance debt itself and without reliance on substantial government guarantees there should be no additional debts incurred by the public sector as a whole over the medium-term.

60. Taking account of uncertainty about future external assistance and the need to have a reasonable reserve to be able to respond adequately to unexpected risks, another important sustainability principle that is recognized is to maintain the real per capita value of trust fund assets.

4.3 The Scale and Scope of the Adjustment to Ensure Affordability

61. It is difficult to determine a fiscal strategy in the absence of clear commitments for future aid. As shown above the scale of the fiscal adjustment that is required assuming US aid does not continue is around 20 percent of GDP. However, even if substantial aid from the US were to continue it would be important to pursue an objective of 100 percent domestic funding of current expenditure. If US or other aid was available to fund all capital expenditures, establish a maintenance fund and address other fiscal holes, and the real per capita value of the trust fund was to be maintained without additional external assistance, there would still be a need for a fiscal adjustment of around 20 percent of GDP. Alternatively if there was no US financial aid and these other objectives were not pursued at all, there would also be a need for the same fiscal adjustment of 20 percent of GDP in order to fully finance current expenditure. However, in this case these other fiscal issues would not be addressed and the real per capita value of the trust fund could not be maintained.

62. Given the scale of the adjustment that is required based on reasonable base case assumptions, it is clear that there would be a need for both tax policy changes and expenditure adjustment. The underperformance and inefficiency of the existing tax system suggests that tax policy reform is essential and should be a high priority component of the MTFs.

63. Expenditure adjustment will also be necessary but to date the expenditure side of the fiscal accounts has borne more of the fiscal adjustment than tax policy reform (based on implementing the Republic of Palau 2002 Cost Reduction Plan) and it will likely be difficult to cut expenditure on goods and services further while still ensuring effective service delivery. This means that the bulk of the expenditure adjustment would need to be on the wages bill. This could be better facilitated by a well structured program to identify where reductions should be focused and a retrenchment package to ensure political acceptability. In order to ensure the effective ongoing delivery of desirable government functions, it is proposed that there be a detailed review of how to 'right size' government functions and employment to ensure that important government services continued to be effectively delivered as well as to specify the key elements of a retrenchment package. A recommendation along these lines has been made in the Draft MTDS that is being prepared with the assistance of the FEIM project.

64. Domestic revenues are currently around 23 percent of GDP and the International Monetary Fund (IMF) (2006 p.10) has suggested a target of 32 percent of GDP implying an increase in domestic revenue of 9 percent of GDP. Given the underperformance and inefficiency of the tax system this goal is considered to be achievable over the medium- to long-term.

65. If such a target were adopted on the revenue side, then the on the expenditure side the scale of the adjustment would be about 11 percent of GDP. This is considered to be a very large adjustment on the expenditure side and likely to be very difficult to achieve for both political and practical reasons. Further work would need to be undertaken to determine the extent to which expenditure adjustment could occur while still undertaking the important functions of government.

66. As it is reasonable to assume some continuing US funding for current expenditure over the medium-term (or in its absence depletion of the trust fund) and while still recognizing the urgency of the pressures, it is planned that the overall fiscal adjustment targets are adopted as a longer term goal. The MTFS specifies that the medium-term goal over 5 years is achievement of about half of the long-term goal, with the long-term revenue and expenditure goals to be reevaluated in the third year of the MTFS. It is recognized that if funding is not available for a transitional period and a fiscal adjustment of 10 per cent of GDP were adopted in the medium term and 20 per cent of GDP over a 10 year period, with the balance of the fiscal deficit financed by the trust fund, then the real per capita value of the trust fund would be approximately halved over that time frame but then stabilize.

67. In addressing significant fiscal pressures, experience has shown that it is important to front-load expenditure reductions as otherwise they tend to be continually postponed. In addition if a coherent strategy for government reform can be formulated and accepted it is more likely that it will be possible to secure some funding for retrenchment packages. However, the scope to realize significant revenues from tax reform should not be underestimated. Given these considerations, the medium-term goals are: an increase in domestic revenue of around 5 percent of GDP and a reduction in government current expenditure, also of around 5 percent of GDP but with the expenditure reductions achieved in the first two years year period and focused on the wage bill.

68. Thus the medium-term 5 year targets specified at this stage are:

- (i) an increase in domestic revenue of 5 percent of GDP over a 5 year period;
- (ii) a decrease in current government expenditure (excluding maintenance) of 5 percent of GDP over a 5 year period, but with most of the decrease occurring in the first two years and focused on the wage bill; and
- (iii) the goals to be re-evaluated in the third year of the MTFS.

69. As noted above, if a comprehensive fiscal reform package can be developed including a well structured retrenchment package, there is likely to be a much better prospect of obtaining concessional external assistance to finance the retrenchment package and also possibly to assist in establishing a maintenance funding mechanism and address the fiscal holes associated with the CSPP and the SSF.

70. The following subsections set out some basic considerations in relation to tax policy, expenditure adjustment and resource allocation, a medium-term expenditure planning and monitoring framework and external aid to support a MTFS.

4.4 Tax policy

4.4.1 Current status and broad approach

71. There will be a separate paper prepared considering tax policy in detail. However, as this paper covers the MTFS it is relevant to set out the current status of tax policy reform and principles and strategies for design and implementation of an effective tax reform policy.

72. In addition to the assistance provided by FEIM, PFTAC has been providing advice to the Republic of Palau on tax policy reform and will continue to do so during the course of the FEIM project. The PSC for FEIM confirmed at its first meeting that the FEIM team is to work cooperatively with PFTAC in advising on how to design and implement an effective tax reform for Palau. It is expected that PFTAC will take the lead in this work with the FEIM team providing support where appropriate.

73. PFTAC has prepared a confidential (November 2007) paper for the Ministry of Finance setting out broad directions, which is consistent with previous advice. It should be recognized that the IMF and PFTAC have done considerable work in the past on tax reform for Palau but minimal reforms have occurred.

74. A Tax Review Task Force (2007) report made a number of recommendations to increase revenue generation in the short-term and for tax reform over the long-term. It based its recommendations on a 1998 Tax Review Advisory Committee Report. A two stage process was recommended. The initial stage would involve a number of specific tax increases for existing taxes and some new specific taxes. The second stage would involve more comprehensive reform to be phased in over a number of years. The recommendations were proposed in public consultation process in October 2007, but only two recommendations (increase in export fish tax and hotel room tax) were passed by the legislature.

75. Proposals for a simple value added (consumption) tax and an income tax, based on IMF technical assistance and as documented in the 1998 Tax Review Advisory Committee Report, were reflected in Bill No. 5-266 of July 1998. However the Bill was not passed. The proposals in that Bill are still highly relevant for Palau. Although there may be some scope for simplification of the proposals and adjustments to the timing or order of reform, the main problem with tax reform is one of communicating the need for reform to the wider public so that there is political support for the reforms. If comprehensive tax reform can be approved by the legislature, considerable technical assistance should be available to assist with implementation and improve tax administration.

76. Set out below are some options for tax reform with comments based on applying key criteria for evaluation tax and other public policies at a high level. A more detailed tax policy paper will consider tax reform options in more detail using these criteria and document the likely benefits in a suitable form as material to help communicate the desirability of tax reform.

4.4.2 A preliminary evaluation of key tax reform proposals

77. The key criteria for evaluating tax reform and other public policies are: economic efficiency; equity and administrative efficiency. Economic efficiency refers to the extent to which a policy action is of maximum benefit in terms of the economic income to a country where the normal concept of income can be redefined to include environmental values or other values not normally captured in monetary values provided they relate to improving overall economic welfare as a whole. Equity refers to the extent to which a policy has impacts on different groups in society and its interpretation depends on government expressing a view as to the desirable distributional impact of a policy, recognizing there are often both winners and losers from a policy. Administrative efficiency is a separate criterion here (although it could be incorporated in economic efficiency) that is especially relevant for tax reform, particularly when there is limited administrative capacity.

78. Because economic efficiency is such a broad concept it covers many aspects such as the impact on exports and imports, employment, profits, the environment (when efficiency is properly defined) and all factors affecting average real incomes. In the case of taxation, most taxes in isolation have an adverse impact on some dimension of economic efficiency. However, taxes are necessary to raise revenue which in turn is used to support government functions that contribute to economic efficiency. In evaluating tax policy from an economic efficiency perspective, the focus is on determining the tax policy mix that has the least adverse impact on economic efficiency (as a result of taxes alone) in order to raise a target level of revenue.

79. These three criteria are the essential criteria for evaluating the overall impact of any public policy including tax policy. It is suggested that what is needed with respect to progressing tax reform at this stage is documentation and presentations explaining the broad nature of proposed tax reforms, but setting out and emphasizing the benefits for the economy as a whole, individual sectors, consumers and vulnerable groups. It is understood that PFTAC has considerable relevant material, however ideally a paper will need to be prepared documenting the likely effects in Palau.

80. Tax reform options broadly include:

- (i) continuing to use the current mix of taxes but with adjustments of rates and bases and introduction of new taxes focused on areas where there is leakage – the status quo option;
- (ii) improving tax administration and collection capacity and enforcement;
- (iii) introducing some form of a value added (consumption tax) to replace most of the existing taxes; and
- (iv) replacing the wages and salaries tax with an income tax that would cover income from all sources including dividends, capital gains and fringe benefits.

81. There have been numerous studies concluding that the status quo is inferior to other approaches in terms of economic efficiency and administrative efficiency. The existing taxation structure has not been effective in increasing tax revenues relative to GDP and it entails numerous economic distortions that mean that the economy is not as efficient as it could be under a different tax system. This implies that not only is tax revenue too low given the system but the income and wealth of the economy are lower than could be realized under a different system. However, reform will still entail a mix of effects where certain costs are highly visible while the benefits are not readily apparent given they are spread widely across the economy and realized over a longer time frame. This underlines the importance of developing and implementing an effective communications strategy to ensure sufficient community and political support for the tax reform, as is the case with most public policy reforms.

82. Although the status quo option is not the best option over the medium and longer term, it is likely to be the case that there is scope to adjust taxes and tax bases and introduce some additional taxes in a way that is effective from an economic efficiency perspective while also securing additional revenue. For example, the removal of exemptions for import duties and changing the tax base from free-on-board to a cost-insurance-freight basis for levying import duties are generally agreed to be desirable from an economic efficiency perspective as is an entry tax for tourists. As Palau is not a signatory to any trade agreements that would preclude raising tariffs, and has very limited domestic production (apart from tourism services and fishing) a uniform increase in tariffs would also be effective in raising revenue without

impacting adversely on economic efficiency. However, as with most consumption-focused taxes, these options would lead to higher prices for a wide range of goods, making them difficult to obtain community and political support. It needs to be demonstrated that although prices would rise for consumption goods, the tax reform would lead to a stronger economy and in time higher average real disposable incomes. However, the option of pursuing a higher tax on tourists in terms of an entry tax will be considered as a priority for the medium term.

83. PFTAC has also advised that there is considerable scope to improve tax administration and collection capacity and this should be pursued irrespective of the tax reform options that are adopted. It is understood that improvements in administrative capacity and collection effort could reasonably raise additional revenue equivalent to 1 percent of GDP. In addition, it is clear that inadequate enforcement in relation to the offshore fishing industry has meant that Palau is receiving too little in terms of tax and economic returns from this resource.

84. A value added or consumption-based tax is considered by economic professionals generally to be the most economically efficient tax available to secure the bulk of needed tax revenue. If it is designed well and adjusted to recognize the institutional capacity of both the public and the private sectors, it also scores well in terms of administrative efficiency. This is likely to be particularly true in Palau. An important factor to recognize is that a value added tax (VAT) would be sure of raising considerable revenue in Palau because initially it would apply to all imports and would be collected by the customs department where administrative capacity is considered to be stronger than for other domestic revenue.

85. A VAT being a consumption based tax requires that businesses only pay tax on their value added and not on other business inputs. Thus to maximize the economic efficiency benefits of the tax there needs to be a system for businesses to be able to claim credits for the value added tax they pay when they purchase inputs. This entails administration costs for both businesses and the tax authorities and would require strengthening of tax administration capacity. However, until this strengthening occurs considerable revenue would be realized in the first place given the tax would apply to all imports. In addition, since there is limited domestic production in Palau, distortions associated with limited capacity for an efficient tax credits system would initially not be likely to have a strong adverse impact on overall economic activity or economic efficiency. The main impact would be on consumption rather than production which is one of the key aims of an efficient tax system. The main drawback of a VAT is that it may have adverse impacts from an equity perspective since it focuses its impact on consumption and hence will have more impact on vulnerable people than higher income groups. However, these effects can be limited and need to be balanced against the general benefits provided by ensuring a more secure revenue source as well as the overall impact on economic efficiency and hence the overall income of the country. This higher overall income for the country can in turn be used to finance programs for particularly vulnerable groups.

86. The limitations of the existing wages and salaries tax have also been well documented. In particular the tax is not levied on other forms of personal income such as interest and dividends. In addition, it is understood that although in theory fringe benefits may be included in the tax base in some circumstances, in practice no revenue is raised by taxing fringe benefits because it is simply not pursued by the authorities. These are considered to be major loopholes in the system from both an economic efficiency and an equity perspective and clearly need to be addressed. The main problem with introducing an income tax levied on a wide base in Palau, is that it

would entail considerable costs from an administrative perspective. This suggests that in establishing priorities a VAT should be preferred.

87. The government of Palau has noted the broad options set out here and will provide guidance on priorities and desirable additional work that FEIM and PFTAC should undertake in helping to prepare the MTDS.

4.5 Expenditure adjustment and resource allocation

88. It is clear that significant expenditure adjustment will be necessary given the fiscal pressures that Palau will face but also in order to ensure efficient delivery of government services. The allocation of resources will be especially difficult in a tight budgetary situation if MTDS priorities are to be met. This is because some programs and activities will need to receive additional resources while others will need to receive less in order to make total resource availability constraints.

4.5.1 Economic rate of return

89. There are several ways to formulate priorities for a reduction in expenditure. In terms of economic efficiency, the most desirable method assuming information is available is to calculate the economic rate of return for each program or activity and to prioritize projects and activities in terms of the returns they are expected to realize.

90. The economic rate of return is not just a financial return but rather a measure that indicates the gross benefits to society (broadly measured) relative to the costs. Where programs, projects or activities do not realize reasonable economic returns then their expenditure should be reduced.

91. The problem with this approach, when applied in detail, is that it is extremely information intensive and not likely to be feasible in Palau. However, it does highlight that at the department or broad functional level, professional and managerial staff should be best placed to determine the allocation of expenditures across programs and activities based on their experience and available information. To improve the quality of these estimates, the departments must be held accountable for performance and must develop meaningful key performance indicators for the program/project/activity expenditures. This approach is being pursued in the health and education sectors and it is recommended for all sectors over the medium-term.

4.5.2 Across-the-board versus targeted expenditure reductions

92. In the medium term there is a need to significantly reduce overall government expenditures relatively quickly. Where the economic rate of return approach is not feasible in prioritizing expenditure reductions, three approaches are available and will be considered. These are:

- (1) across-the-board reductions to existing expenditures to meet the overall expenditure constraint (for example, all departments and all programs will receive 5 per cent less funding next year than this year);
- (2) specific reductions to specific sectors, departments or programs (for example, departments X, Y and Z will receive 10 per cent less funding next year but

departments A and B will receive the same amount of funding); and

- (3) a combination of approaches 1 and 2 (for example, all departments will receive 5 per cent less funding for staffing expenses, but departments A, B and C will receive 3 per cent more funding for their programs).

93. It is reasonably clear that there is a need to increase maintenance expenditure and to focus a more than proportionate reduction on the wage bill rather than on other goods and services in order to meet aggregate fiscal expenditure targets. However, some consideration needs to be given as to whether it is possible to establish priorities at the broad functional level that in turn imply greater expenditure adjustment for some functions compared to others.

94. Ultimately, decisions on the allocation of expenditures across sectors and programs are made by elected officials. However, in setting priorities for a proposed MTDS, the Ministry of Finance will undertake, in the first instance, its own assessment of priorities in the functional allocation of expenditure. This assessment will be informed by:

- (i) reviewing the current allocation at a broad level and considering how best to allocate a reduced budget across broad functional levels, with input from the various sectoral studies undertaken as part of the FEIM project; and
- (ii) using the expert functional expenditure review, proposed in the MDTS, to identify the extent to which activities can be modified or eliminated for each major functional expenditure category and to establish the broad priorities at the functional level in the context of the anticipated necessary expenditure adjustment.

95. As a starting point the functional allocation of expenditure is shown in Table 4.

96. From an economic efficiency perspective an important candidate for an expenditure reduction is subsidies to public enterprises. This would constitute only about 1 percent of the adjustment, however as a proportion of GDP, and most of it would probably need to be achieved at least in the short term with price increases for public enterprises. Elimination of other subsidies would contribute about another 1.8 percent of GDP (refer to Table 2). A decision on reducing current expenditure in other categories would be best informed by the proposed detailed public expenditure review as well as the separate FEIM reports on agriculture, fisheries, the social sectors, the environment, infrastructure and privatization.

Table 4: Government Expenditure by Function, 1999/00 to 2006/07

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
	Percent of total							
Office of the President and Vice President	2.8	2.6	3.2	2.2	2.1	2.3	2.5	6.2
Health	12.1	13.0	12.6	13.9	15.3	15.9	15.0	17.0
Education	10.7	11.8	10.9	11.2	11.1	10.4	9.8	13.5
Resources and Development	10.9	9.6	8.5	8.5	8.0	9.4	8.0	8.0
Finance	3.2	3.1	3.6	5.0	4.1	5.5	3.7	3.4
Justice	5.2	4.4	4.5	4.6	4.4	5.0	4.5	4.0
State	2.9	3.0	2.7	3.1	2.7	2.8	2.7	2.5
Commerce and Trade	1.7	1.9	1.6	2.0	2.0	2.2	1.9	1.4
Community and Cultural Affairs	0.9	1.0	1.0	1.5	1.6	1.9	1.1	2.5
Legislative Branch	4.3	4.2	4.2	4.4	4.1	4.5	4.0	3.3
Judiciary	2.7	2.8	2.9	2.8	2.7	2.8	2.5	1.9
Agencies and Other	6.8	7.6	5.9	8.2	4.8	6.0	6.5	7.3
Boards and Public Enterprises	4.4	4.2	2.6	2.7	2.6	2.8	2.4	0.6
State Block Grants	5.8	5.6	5.6	5.9	5.6	5.9	5.3	4.0
Other Transfers	10.6	4.9	3.1	3.1	3.7	3.9	3.4	3.7
Interest Payments	0.2	0.9	0.9	0.9	0.8	0.9	0.7	0.8
Capital Expenditure	14.8	19.3	26.3	20.1	24.4	17.8	25.8	19.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Republic of Palau Office of Budget and Planning.

97. Given the information constraints, institutional inertia and political constraints in changing sectoral allocations, one approach will be to try to commit to a reallocation of expenditure over the medium-term consistent with medium term policy priorities. The commitment would involve increasing the proportion of the total budget allocated to a specified list of priorities based on the detailed sectoral work. For example a commitment could be made to increasing the proportion of the budget spent on: certain activities focused on improving the environment, HIV/AIDS prevention, primary health, a high priority area in education, maintenance of infrastructure, improving land leasing arrangements and promotion of priority income earning opportunities. With these commitments the functional allocations would need to change to ensure the priorities were met and this would mean more than proportional reductions for non-priority and marginal activities and programs. These reductions could then be agreed to as part of the normal budget processes.

4.6 A Medium-Term Expenditure Planning and Monitoring Framework

98. A medium-term expenditure planning and monitoring framework is essential for ensuring that budget allocations reflect MTDS priorities within the available resource envelope and also for monitoring the performance of government expenditure and evaluating government functions on a regular basis. This section sets out the main elements of an effective medium term expenditure planning and monitoring framework, some of which Palau has made good progress in putting in place.

4.6.1 Objectives of a Medium-Term Expenditure and Planning Framework

99. It is now well recognized that best practice in policy development, planning, budgeting and execution of policies requires an integrated medium-term expenditure planning and monitoring framework that typically covers a three year time horizon (World Bank 1998 and PFTAC 2006). It is important to recognize that a medium-term expenditure planning and monitoring framework does not have the primary purpose of multi-year budgeting but rather is ideally established to meet the following three main objectives:

- (i) Macro-fiscal discipline and stability to avoid public financial crises and provide a secure platform for confidence and economic growth and development.
- (ii) Effective resource allocation to ensure government policies are effectively reflected in the structure of government spending.
- (iii) Technical efficiency to ensure value for money.

100. Effective budgeting needs to address all three objectives. However, it is often the case, particularly where there are limited fiscal resources, that the first objective dominates. The macro-fiscal discipline objective is important because if there is a fiscal crisis, the ordinary operational activities of government can become extremely difficult, private sector confidence can be adversely affected and attention of public sector managers can become focused on dealing with the crisis at the expense of effective operations and delivery of all government policies and programs. Thus assuming that there is reasonable macro-fiscal stability, it is important that the framework ensures that policies are effectively reflected in budgets and implementation plans rather than the inertia typically inherent in budgets driving activities and outcomes. The aspect of technical efficiency is related to ensuring effective accountability for performance.

101. A medium-term framework is highly beneficial because current decisions have a multi-year impact in terms of both costs and outcomes and it takes time for programs to be implemented and improvements realized. Thus a rolling medium-term approach where performance is continually monitored and adjustments are made to the medium-term framework depending on performance, economic developments and new policies is likely to be most effective.

4.6.2 Palau's Proposed Medium-Term Expenditure and Planning Framework

102. The Office of Budget and Planning has been developing the main elements of suitable medium-term expenditure and planning framework but as noted the framework needs further work to ensure that policies are better reflected in budgets and that all key stakeholders are aware of and committed to the framework. The status with respect to the main components of the framework and directions for further development are set out below to aid in communication and serve as a guide on the implementation of the MTFs.

Component 1: Macroeconomic framework and overall revenue envelope

103. The starting point for the expenditure and planning framework is a sound forecast of the overall economy which in turn is needed to estimate government revenue. With the help of PFTAC, the Office of Budget and Planning has recently developed a plan and capacity to prepare economic and revenue forecasts (Taplin 2007). This framework builds on the national accounts and other data estimates that have been the focus of efforts of the Office of Planning and Statistics in recent years.

104. The forecasting plan involves the forecasting of the main drivers and industry components of GDP, imports and inflation. The revenue forecasts involve forecasting the changes in each type of revenue based on the economic forecasts, changes in policies and tax and other relevant parameters, recent developments in revenue collection and other specific information where relevant. The forecasts are to be documented providing explanations of assumptions and rationale for the forecasts, key features and risks and uncertainties supported by summary tables and charts for effective communication.

105. A Forecasting Committee has been established to take responsibility for preparing the forecasts and for monitoring them during the year. It comprises representatives from Budget and Planning, Revenue and Taxation, Customs and Treasury. Forecasts will be finalized by early April 2008 to support the revenue numbers to be presented in the Budget Papers and Compact Report this year. However, preliminary forecasts are needed early in the process to set the overall expenditure envelopes for the start of the Budget Cycle.

106. It is important to ensure that revenue estimates are as reliable as possible and provided a complete picture of government revenue including external aid. It is also useful for the purposes of analysis, to prepare separate estimates for revenues without policy or administrative changes and estimates with policy and administrative changes.

107. Once reliable estimates of total revenue are obtained broad expenditure forecasts can be prepared based on current policies continuing, which are referred to as 'baseline estimates'.

108. Given the revenue and expenditure estimates, the overall fiscal deficit is calculated and where a deficit exists, sources of financing need to be identified or measures suggested to reduce or eliminate the deficit. In a medium-term framework the future path of the fiscal deficit assuming current policies continue is important for policy determination.

109. Once the baseline forecasts have been prepared they are to be documented in a fiscal policy paper that would also explore trends in fiscal policy and options for policy change. The fiscal policy paper should ideally be presented to the Cabinet for discussion mainly in order to focus on policies to attain government objectives.

Component 2: Sectoral Strategic Plans

110. This stage can proceed in parallel with component 1 and involves the determination of ministry or sector objectives and activities consistent with the MTDS and the costing of activities.

111. The strategic plans at the Ministerial or sector level need to have a medium-term framework which requires forecasts of programs, activities and associated costs. Some parameters for the forecasts such as inflation and an indicative resource envelope based on existing forecasts need to be provided by the forecasting committee to the ministries and sectors. Priorities and performance indicators need to be established for all key programs and activities.

112. In Palau annual performance reports and the strategic plans that are underway would be important inputs for this stage as would the MTDS.

Component 3: Sectoral Expenditure Framework and Resource Allocation Determination

113. Once components 1 and 2 are complete, a framework and principles need to be established to allocate resources across Ministries and sectors. The outcome establishes expenditure ceilings for the upcoming budget and the forecast years.

114. The principles that are developed for allocating resources at the sectoral level, need to reflect priorities established in the MTDS as well as other relevant policies and priorities established by the leadership and relevant economic, environmental and social criteria.

115. The framework and principles need to be used to help the Cabinet make strategic resource allocations based on reliable information, particularly in relation to the implications of trade-offs.

Component 4: Preparation of Sectoral Budgets

116. Given the ceilings agreed on in component 3 the details of sectoral budgets can be prepared at the Ministry or sector level. The amount of flexibility that Ministries have depend on individual circumstances and the flexibility of aid and other funding sources.

Component 5: Final Political Approval

117. This stage of the process entails final political approval of the annual budget. However, there is scope for obtaining separate approval of the MTDS and multi-year goals and there may be scope in the future to move to a 2 year budget cycle which would be valuable in contributing to fiscal stability and reducing costs but also in ensuring there is more focus on a medium-term horizon which is so important for effective policy implementation. The PSC may want to consider recommending a 2 year budget cycle be developed along with the other components of the medium-term expenditure and planning framework set out here.

Component 6: Monitoring and Evaluation

118. As the budget and complementary policies are being implemented there is a need for an ongoing monitoring and evaluation process. Palau already has some relevant monitoring and evaluation elements in place in the form of performance reports and corporate and strategic plans and processes for review. However, there is a need to put more effort into key performance indicators and to assess functions, activity and expenditure in the light of these performance indicators to ensure that MTDS priorities are being effectively met and that government activity is efficient.

119. The responsibility for identifying and monitoring relevant performance indicators should initially be at the department or bureau level but subject to review by the Office of Budget and Planning on an annual basis, consistent with the medium-term expenditure and planning framework set out here. However, some suggestions for key performance indicators covering fiscal, economic, social and environmental objectives are presented in the section below on Indicators of Fiscal and Economic Sustainability and in the separate report on “Economic Policies and Institutions for Sustainable National Development” and in the separate reports that are being prepared for other sectors.

Component 7: Effective Communication

120. An additional important task is the design and implementation of an effective communications strategy to explain decisions and their rationale and emphasize the advantages to the community of the policies, plans and framework that have been adopted.

4.7 External aid focus

121. At the heart of the MTFS is the objective of making meaningful progress in terms of being able to fully finance current expenditure from domestic revenues. The scale of the adjustment that is required over the medium and longer term means that it is essential that there be comprehensive tax reform, as well as a reduction in current expenditure and an improvement in the efficiency of government. In addition there needs to be a strategy for financing and undertaking maintenance expenditure, for dealing effectively with fiscal holes, for financing any significant retrenchment that is considered to be needed and for financing ongoing capital expenditure. It is suggested that it is these latter issues that should be the focus of external aid over both the medium and longer term.

122. However, if the real per capita value of the trust fund is to be preserved, while still making a small ongoing contribution to budget revenues and recognizing the scale of the objective of self reliance with respect to financing current expenditure, some ongoing external assistance will still be needed to help finance current expenditure. If this is not forthcoming the trust fund will be rapidly depleted. For example if the drawdown from the trust fund was increased from \$5 to \$25 million it would be completely depleted within about 10 years, based on reasonable assumptions about rates of return.

123. As noted above, Palau is more likely to be able to secure external aid if it has in place an effective MTFS and appropriate complementary economic, social and environmental policies. Appropriate complementary policies are being developed as part of the draft MTDS which is the main output of the FEIM project. The fiscal strategy is sustainable over the medium-term without donor support, provided the medium-term adjustment of around 10 percent of GDP is achieved and greater use is made of the trust fund (which would be rapidly depleted without ongoing donor support). However, without donor support, there would be no means to finance significant maintenance expenditure, capital expenditure, a significant retrenchment program if needed and capital expenditure. Nevertheless, the feasibility of the fiscal strategy without their support should be helpful in persuading donors of the credibility of the fiscal strategy.

124. As noted, meaningful economic and social development will not occur without donor support over either the medium or longer term. The strategy of making meaningful progress in local financing of current expenditure while seeking donor assistance to deal with major fiscal holes, a maintenance fund and capital expenditure is practical and considered to be consistent with donor objectives. There is really little realistic alternative for Palau given its circumstances and the need to avoid a disaster scenario that would arise if the proposed strategy or something similar is not adopted and pursued effectively. However, it is also important to highlight that the strategy has been designed to be appropriate irrespective of the amount of aid that Palau can realize.

5. Indicators of Fiscal Sustainability

125. As noted above, each Department or Bureau should be responsible for developing their own key performance indicators. A number of indicators are likely to be needed for each department, program or activity but it is important that they be able to be assembled without unreasonable cost, in terms of time and effort, as well as being focused on consistency with meeting MTDS objectives and the efficiency of activities. Indicators that are quantifiable are preferred but often not available or appropriate and qualitative indicators are also relevant, particularly in measuring progress with certain policy and institutional reforms.

126. The separate FEIM reports for “Economic Policies and Institutions for Sustainable National Development” and other sectors, as well as the draft MTDS itself, make reference to a number of relevant performance indicators that are in place or proposed.

127. It should also be recognized that Palau is a signatory to the Millennium Declaration of the United Nations General Assembly which entails a commitment to achieve the Millennium Development Goals (MDG). The MDGs set objectives for development over the period 2000 to 2015 relevant to achieving improvements in a range of areas relevant for achieving economic and environmental sustainability and social development. The Office of Budget and Planning is working on indicators in relation to the MDGs and how to integrate them into the planning and budgeting process.

128. Thus this section focuses on the key performance indicators relevant to fiscal sustainability. Table 4 summarizes the goal, strategies and key performance indicators for the Medium Term Fiscal Strategy for Sustainable Economic Development.

Table 4: Fiscal Policy Goals, Strategies and Key Performance Indicators for the Medium-Term Fiscal Strategy to Support Sustainable Economic Development

Goals	Strategies	Key Performance Indicators
<p>A sustainable fiscal policy that will maximize income for the country, that is equitable and that will contribute as much as possible to other development objectives</p>	<ul style="list-style-type: none"> • Focus on making good progress in financing 100 percent of current expenditure with local revenues. • Comprehensive tax reform based on well accepted economic principles. • Review of expenditure to determine the “right size” of government and use as a guide along with MTDS priorities to reduce expenditures. • Maintain the real per capita value of the trust fund. • No additional public debt unless it can be directly financed from revenues generated by the project. • Put in place an effective medium-term expenditure planning and monitoring framework. • Attract external assistance to help fund a maintenance fund, address fiscal holes, finance a well structured retrenchment package and capital expenditure. 	<ul style="list-style-type: none"> • Increase domestic revenues by 5 percent of GDP over 5 years. • Reduce current expenditures by 5 percent of GDP over 5 years with emphasis on the wage bill and most of the reduction occurring in the first two years. • Wage bill as a proportion of GDP. • Government expenditure on goods and services as a proportion of GDP. • Comprehensive tax reform adopted. • Real per capita value of the trust fund. • Public debt as a proportion of GDP. • Purpose of financing for any new public debt and extent of direct debt servicing from a project. • Strategic and operational plans for Ministries and Bureaus and public enterprises are consistent with the MTDS and are used to prioritize policies and public expenditure. • The functional allocation of expenditure reflects priorities in the MTDS and allocations are increased for higher priorities and decreased for other categories. • Relevant performance indicators are available and regularly evaluated to help determine priorities and the allocation of expenditure. • External assistance is focused on non-current expenditure items and maintenance.

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