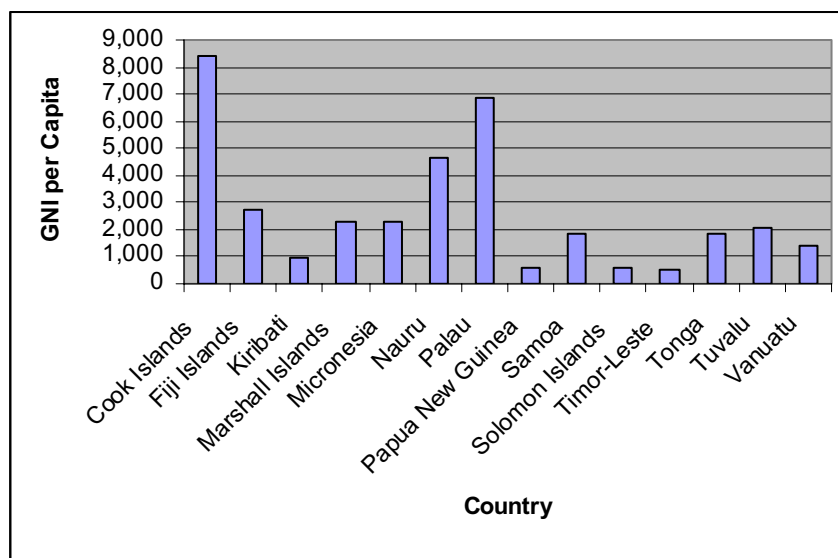


## I. INTRODUCTION

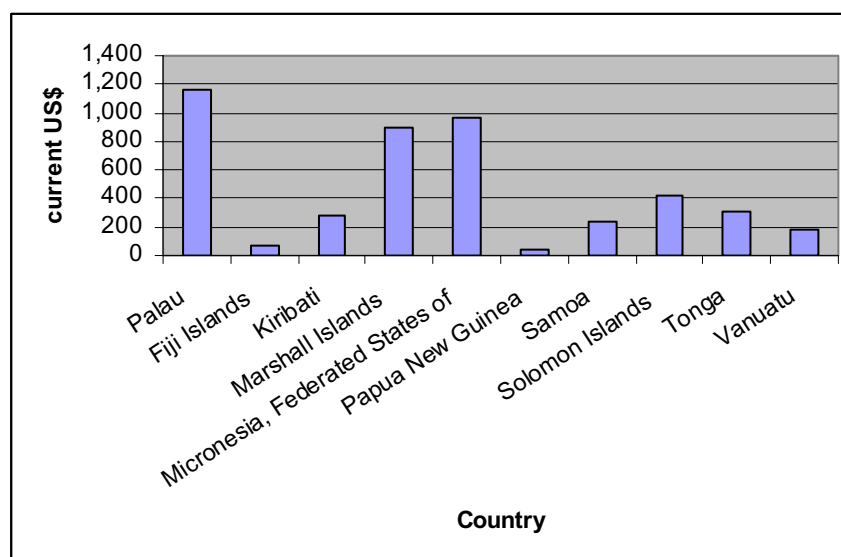
1. Palau lies in the western Pacific, with good air and sea links to several large Asian countries. Palau's total gross domestic product (GDP) is approximately \$120 million, making it one of the smallest economies in the world. It has a population of about 20,000 people, including over 6,000 temporary foreign workers. Palau has developed a substantial tourist industry, which provides the bulk of its export earnings. It relies primarily on imports for almost all traded goods.

**Figure 1. Comparative Gross National Income per Capita, 2004**



Source: ADB. 2006. *Key Indicators 2006*. Manila.

**Figure 2. Comparative Aid per Capita, 2005**



Source: World Bank. 2007. *World Development Indicators*. Available: <http://devdata.worldbank.org/dataonline>.

2. On a per capita basis, Palau is the most prosperous of the Pacific island economies with an income per head of approximately \$6,800 per year [Figure 1]. Palau receives more per capita aid than any other independent Pacific state, and is one of the largest recipients in the world in terms of aid per person. Aid comes primarily, though not exclusively, through payments made by the United States under the Compact of Free Association (the Compact) with Palau. On average, each Palauan resident receives over \$1,000 per year under the current Compact, which is due to expire in 2009. Even without these payments, however, income per head is substantially above other independent countries in the Pacific region, with the exception of Cook Islands. The public sector dominates the economic life of the country: public expenditure accounts for over 60% of GDP, which fundamentally shapes the country's economy, as well as the opportunities available to the private sector.

3. Palau has no visible poverty, has a strong tourist trade, and is a recipient of substantial aid. There are strong concerns, however, both within Government and among Palauans more generally, regarding the country's economic sustainability and long-term future. These concerns are reflected in the vigorous debate at all levels regarding the role of government in society, the desirability of foreign workers, the role of tourism in the economy, environmental preservation, the degree to which Palauans actually benefit from their high income levels, and whether more vigorous growth is desirable. This paper explores these issues and analyses the role that the private sector can play in resolving some of the policy dilemmas inherent in the challenges that lie ahead.

4. Despite Palau's small size, it faces a range of complex economic problems relating to economic globalization, which require careful resolution if Palau is to experience the benefits of global economic expansion. Many of the current laws and regulations implemented to help and protect Palauans in actuality hinder adjustment to the international economy, and reduce the potential gains that could be obtained from Palau's commercial interactions with the rest of the world. This is a central theme of the analysis that follows.

5. The Government has prepared a number of planning documents and processes for policy formulation and implementation. The most important of these are:

- (i) **The Palau 2020 National Master Development Plan.**<sup>1</sup> The Plan establishes policies and strategies to: (a) build and fund infrastructure in a self-sustaining manner; (b) increase the performance and competitiveness of the economy; (c) implement a public sector investment program that involves not only investments in key public infrastructure, but also improved prioritization and monitoring of public investment.
- (ii) **The Management Action Plan<sup>2</sup> (MAP).** The MAP is a strategic road map to reform government administration, build economic institutions, develop infrastructure, and strengthen tourism. Preserving the environment is also an important policy aim. The MAP emphasizes the need to reduce the size of the public sector and the importance of private sector development for the future of the country.

<sup>1</sup> Palau National Master Plan Task Force. 1995. The Palau 2020 National Master Development Plan. Koror, Republic of Palau.

<sup>2</sup> Adopted in 2001. Available: <http://www.palau.gov.net/president/managementplan.html#intro>

- (iii) **The National/State Leadership Symposium.**<sup>3</sup> The Symposium brought together prominent members of Palauan society and the economy to discuss the country's needs over the next decade. It issued a communiqué that emphasized improving education and training, the labor market, the availability of health care for all, and the enforcement of laws, rules, and regulations. The Symposium also engaged participants in a vigorous debate about the future of Palau and the role of development in the country. It created a long list of action items for various government sectors to undertake in each of the identified areas.

6. This paper is informed by the issues raised in these various planning documents. The primary focus has been on the probable impact of existing policies and the role the private sector can play in increasing prosperity in Palau. The paper also addresses the implications of untrammelled development and suggests ways in which its worst pitfalls could be avoided.

7. This report discusses the various challenges associated with promoting economic development in Palau over the next 10 years, and examines how existing policies are affecting the degree to which Palauans are benefiting from economic development as it is currently perceived. The paper also analyses the current public sector-led economic model, and the impact of major policy measures now being implemented—in the areas of labor and financial markets, tourism, foreign investment supervision and the commercial legal framework—on private sector development.

8. There has been recent in-depth discussion of the structure of the economy,<sup>4</sup> and the description here is therefore kept brief. The paper commences with an examination of the impact of macroeconomic issues on investment and entrepreneurship. It draws on available data, the results of interviews and analysis of the current state of development to highlight the economy's main features and the central policy challenges that confront policymakers in managing the macro economy. It then examines (i) employment and the labor market from the perspective of private sector development and (ii) the implications of current policy for the evolution of the economy. There is a discussion of foreign investment regulation and tourism, which is the most important sector of the economy. Issues relating to the financial system are examined to assess the degree to which it finances private sector activity. A section on the legal system and property rights in land examines the extent to which the commercial legal framework provides a foundation for private sector development in Palau. An appendix analyses in detail the collateral framework and includes suggestions for reform.

9. The overall conclusion is that the many existing barriers to investment and entrepreneurship are exacerbated by the Government's current policies. The paper suggests that in several cases, there is a wide gap between the stated goals and actual impact of specific policies. For example, there is intense debate regarding the extent to which policy should reflect a "Palau for the Palauans" approach to economic development, but there are differing interpretations of what this means in practice, and several existing policies have opposite impacts. While the overall goal may be valid, it will be hard to achieve with the current approach to economic development.

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<sup>3</sup> Communiqué issued February 9, 2006. Available: <http://www.palauembassy.com/Documents/CommuniqueNationalStateLeadership.pdf>

<sup>4</sup> ADB. 2005. *Country Economic Report: Republic of Palau, 2005*. Manila., and International Monetary Fund Article IV Consultations in 2004 and 2005. (Available: <http://www.imf.org/external/country/plw/index.htm>)