

## II. ISSUES RELATED TO THE MACRO ECONOMY

### A. Introduction

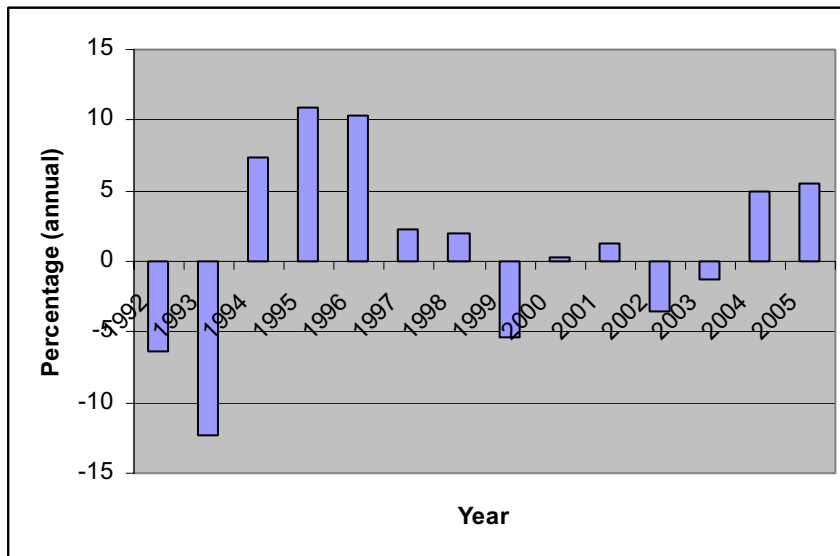
10. Palau's economy has some striking characteristics:

- (i) Government expenditure accounts for over 60% of total economic expenditure, with public administration accounting for about 26% of GDP.
- (ii) Migrant foreign workers, who number about 6,500, make up nearly one third of the population and over half the labor force.
- (iii) Over the course of a year, visits by tourists exceeds the total population of the country by a factor of three or four.
- (iv) Palau is situated near Asia, but uses the US dollar as its currency. As discussed in a later section, using the US dollar has several implications for managing the economy and impacts both investment and risk.

### B. The Growth of the Economy

11. Over the past 10–12 years, the economy appears to have expanded at an average rate of about 2% per year. However, the mean growth rate conceals marked swings: the economy expanded quite substantially in the first two years following independence (in 1994) and little thereafter, until the past two years, when an increase in tourist arrivals boosted growth. The expansion in real GDP is estimated to be 5% in both fiscal year (FY) 2004 and FY 2005. These are preliminary estimates, however, and are subject to revision. It should also be noted that the lack of reliable statistics results in estimates with wide variances, so specific figures should be treated with caution.

**Figure 3. GDP Growth, 1992–2005**



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

12. The initial growth spurt was the result of a very large rise in government expenditure, as Compact payments were disbursed in the 1994–1996 period. It also illustrates the problems of generating growth in economies dominated by the public sector. In very simplistic terms,<sup>5</sup> the sources of growth are labor, capital, and the application of technology. Once government employment has increased to a certain level, achieving additional growth through increases in the public sector workforce is not possible, because of government budgetary constraints. In addition, the returns from public sector employment decrease sharply; if a worker moves from the private to the public sector, GDP could actually decrease, although the worker may be paid more by the government.

13. Similarly, diminishing returns and budget constraints eventually place a ceiling on growth arising from public sector capital investment. In addition, government services typically lag behind private sector companies in applying technology to their outputs, in part because the government is a poor candidate for the widespread introduction of high technology processes due to what it supplies. As a result, economies that are dominated by the public sector are rarely, if ever, able to generate sustained growth. Only private sector investors and entrepreneurs have the ability to identify investment opportunities, apply their own capital, take on risk, and use knowledge, experience, and technology to generate high rates of return on their investments. These actions ultimately lead to sustained increases in output, not only for their own companies, but also for the economy as a whole.

14. Currently, technical assistance is underway to improve the quality of GDP statistics. Initial estimates from this exercise put per capita GDP substantially higher than was previously calculated. Whether these estimates will stand up to close scrutiny, however, will only be apparent toward the end of 2007.

### **C. The Vulnerability of the Economy**

15. Palau is an archetypical small open economy. As globalization continues, the potential for the country to be exposed to unanticipated external economic events, or economic shocks—with the associated likelihood of domestic economic repercussions—increases. Since the country uses the US dollar as its currency, it is a price taker, with inflation determined by the US dollar inflation rate. However, it is important to note that under any exchange rate regime, there would be little or no potential to use exchange rate policy to cushion the impact of external shocks.

16. Appropriate policy to minimize the impact of external developments on the private sector and the economy more generally therefore has two key features.

- (i) It is important that the impact of unanticipated external events be minimized. For example, parts of the financial sector are currently vulnerable. As the chapter on the financial system argues, foreign banks are well run and sound. However, the low liquidity of domestically owned banks could pose a threat in a period of crisis induced by adverse foreign events.
- (ii) Flexibility in the labor market is especially important. Palau has some cushion in this regard, as the supply of foreign workers could be an

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<sup>5</sup> These observations stem from issues associated with the external sector. With a balance of payments constraint added to a budget constraint, generating growth through the public sector becomes even more difficult.

instrument of labor market policy. However, as a later section explains, this would have important implications for output, since the large majority of working Palauans are employed in the public sector. Integration of Palauans into the commercial economy is a vital part of a strategy to ensure long-term stability.

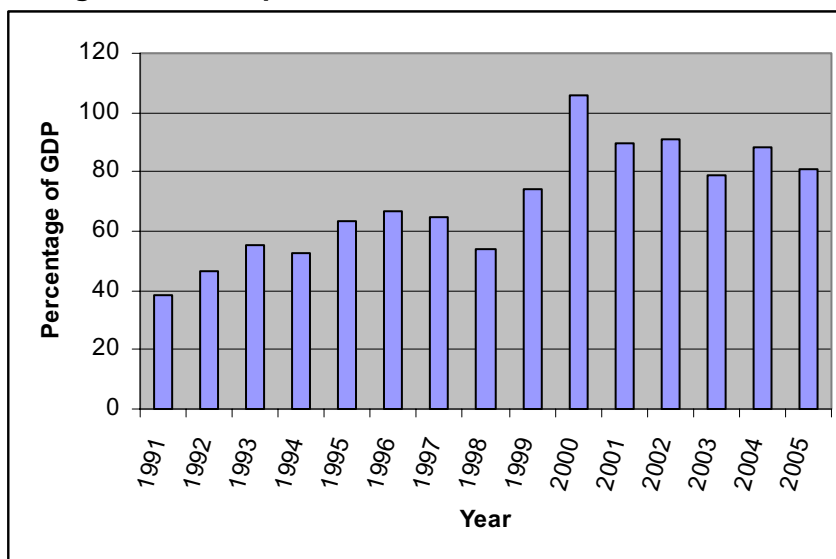
#### D. External Accounts

17. As is appropriate for a country of Palau's size, the vast majority of goods consumed are imported. Self-sufficiency, which in the past has been debated as a policy option, is not a viable alternative for any economy, particularly one as small as Palau. Economies of scale imply that domestic businesses will be concentrated in the service sector. While the potential for agriculture to supply the tourist sector probably exists, substantial agricultural surpluses must be generated for this arrangement to be viable.

18. Palau has a liberal trade regime: there are five tariff bands and most imports attract a duty of only 3%. There are some tariff exemptions that distort the trade system, but they are not extensive. Palau has a modern customs system with harmonized nomenclature; document filing takes place via the Internet. Licensing is required only for agricultural and health reasons. Nevertheless, inefficient regulation is hampering the operation of the trade regime. Quarantine rules require that agricultural and other goods requiring health clearance be imported only from the United States, which substantially raises the cost of some imported items.

19. The foreign sector of the economy is characterized by a large trade deficit offset by services income, remittances, Compact payments, and other official transfers, with the overall balance of payments registering surpluses in most years. Not surprisingly for such a small economy, virtually all manufactured goods are imported, and the value of imports is close to Palau's GDP. The minimal merchandise exports consist primarily of fish.

**Figure 4. Imports of Goods and Services, 1991–2005**



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

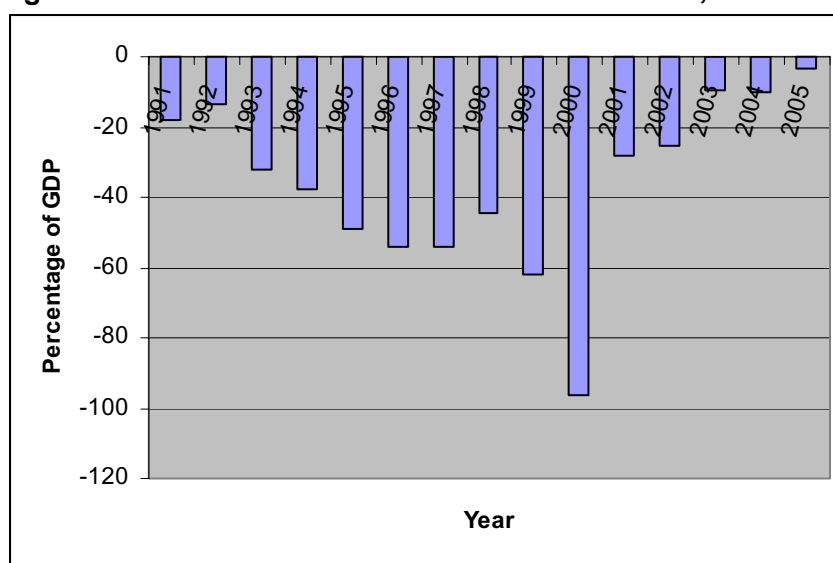
**Table 1. Balance of Payments, 1999–2005**  
(\$ million)

	1999	2000	2001	2002	2003	2004	2005
Current account	-62.4	-35.5	-9.4	-11.0	9.6	12.6	15.1
Balance on goods	-127.3	-115.6	-83.3	-76.4	-79.9	-101.4	-91.8
Exports	7.3	11.5	...	...	...	...	...
Imports	-134.6	-127.1	...	...	...	...	...
Services and income	48.6	44.0	53.9	51.5	72.7	93.7	90.7
Credit	58.9	58.7	...	...	...	...	...
Debit	-10.3	-14.7	...	...	...	...	...
Current transfers	16.3	36.1	20.0	14.0	16.7	20.2	16.2
Credit	...	...	...	...	...	...	...
Debit	...	...	...	...	...	...	...
Capital account	64.6	40.5	14.0	10.8	19.0	25.0	34.4
Financial account							
Direct investment	...	...	...	...	...	...	...
Portfolio investment	...	...	...	...	...	...	...
Other investments	...	...	...	...	...	...	...
Net errors and omissions	-26.9	-4.6	...	...	...	...	...
<b>Overall balance</b>	<b>-24.7</b>	<b>0.4</b>	<b>-25.1</b>	<b>-34.2</b>	<b>-3.4</b>	<b>-10.2</b>	<b>-5.2</b>

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

20. Various quarantine issues prevent large scale agricultural exports, even though Palau's climate is well suited for year round production of high value-added fruits and vegetables. The current account (including official grants) registers a deficit equivalent to about 8% of GDP in most years, with inflows dominated by tourism receipts and private transfers (remittances). There are sharp year-to-year fluctuations in most of the aggregates, which probably reflects data issues as well as timing of large "lumpy" receipts and expenditures, which have a substantial impact on such a small economy.

**Figure 5. External Balance on Goods and Services, 1991–2005**



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

## **E. Government Spending and the Budget Deficit**

21. Palau regularly records sizable fiscal deficits but there are wide swings in the shortfall between expenditure and revenue. In some years, the overall public sector deficit has been as high as 28% of GDP, while in others, it has fallen to no more than 3% of GDP. Payments under the Compact dominate the fiscal situation. The remarkable fluctuations in the public sector deficit is illustrated by the surplus of over 100% of GDP that was recorded in the first year of the Compact, when many grants due under the agreement were paid but the funds not disbursed, which virtually ensured that large fiscal deficits would be registered in later years. The draw-down of Compact Funds has commenced and various projections indicate that without a renewal of the Compact Agreement and the continuation of grants outside the Compact, the Government's ability to fund public sector expenditure at current levels will be seriously compromised. With a renewal, however, the ability of the Government to fund current expenditure and capital improvements over an extended period will be greatly enhanced.<sup>6</sup>

22. The largest single expenditure item in the budget is wages and salaries, which accounts for the equivalent of 23% of GDP, or 40% of public sector expenditure. Private sector operators report that there is a substantial difference between wages and salaries in the private and public sectors: the private sector pays about 20% less for an equivalent position, and requires employees to apply themselves to a greater degree. The result is that many capable trained Palauans are attracted to public sector employment.

23. The October 2005 budget projects a deficit of nearly 5% of GDP. The 2005 Article IV Mission of the International Monetary Fund (IMF) urged the Palauan authorities to reduce the deficit substantially and suggested that expenditure be reduced, a suggestion in keeping with recent efforts by the Government to limit spending. In addition, the IMF is projecting higher tax revenue than budget estimates. If the forecast is correct and the expenditure reductions are successful, it is possible that there will be a significant improvement in the fiscal situation. However, one of the methods utilized to reduce spending involves holding back payments to suppliers.

## **F. Tax Policy**

24. Tax collections from all sources in Palau equal approximately 20% of GDP. Most tax collections come from three sources: a narrowly-based income tax on wages and salaries (about 5% of GDP); import duties (about 6% of GDP); and a gross receipts tax (about 6% of GDP). The IMF reports that the efficiency of collection of all three taxes is low.

25. From a private sector development perspective the gross receipts tax of 4% is especially distorting. It "cascades" because the tax is on the gross amount of any transaction, and does take into account taxes already paid. Thus tax is paid on tax, with the following effects:

- (i) It penalizes high turnover, low profit margin businesses. For example, for a high margin retailer, the sale (for \$100) of a single item that has a profit margin of 50% would incur a gross receipts tax payment of four dollars, or

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<sup>6</sup> The IMF prepared a detailed analysis of the implications for Palau of various scenarios surrounding Compact renewal. See IMF. 2006. *Republic of Palau, Staff Report for the 2005 Article IV Consultation*. Washington, D.C.

8% on profits. A low margin retailer such as a grocer, however, faces a very different tax rate: profits on groceries are typically 10%, and the gross receipts tax on a \$100 sale thus attracts a tax rate of 40%. If the grocer's inputs were bought from a wholesaler, they already contain a 4% tax, so the effective tax rate is even higher.

- (ii) It encourages evasion, especially by low margin businesses.
- (iii) It distorts resource allocation away from high volume businesses, which typically are patronized by poorer members of the community. The gross receipts tax is therefore even more regressive than most taxes on expenditure: it falls especially heavily on those with low incomes.

26. As a result of the above factors, tax reform is an urgent priority. However, the government has decided not to pursue modernizing the tax system until 2008–2009 due to the lack of skilled personnel to implement new tax collection measures. It would be better if Palau could accelerate this process and begin preparing for a new system as soon as feasible. Assistance from the Pacific Financial Technical Assistance Centre (PFTAC) is recommended.

#### **G. State Ownership of Utilities**

27. Government-owned businesses supply water, sewage, electricity, gas, and communications services. The electricity and communications suppliers are government-owned corporations, with Boards of Directors. Water and waste disposal services are supplied by government departments. The state owns the port, but it is run by a private company.

28. The Palau Public Utilities Corporation is responsible for supplying electricity to all consumers in the country. It is a corporatized government-owned utility operated as a commercial enterprise. There is a relatively small amount of cross subsidy between consumers and businesses.<sup>7</sup>

29. Telecommunications services in Palau are provided by the Palau National Communications Corporation (PNCC). Palau has a high rate of telephone penetration and there is a full range of services, including Internet access, cable television, and cellular phones. PNCC is an autonomous agency of the Government. During the 1996–1999 period, it received \$39 million from the US Rural Utilities Service to modernize the national communications network. A little over \$30 million of this amount is still outstanding, with repayments of \$190,000 per month being made. It now funds its investments from internally generated cash flow. It is mandated to supply universal access to all Palauans, with cross subsidies being the norm. There are private competitors in the supply of Internet services, and approval has been given for a company from Taipei, China to supply cellular services. By Pacific region standards, the cost of international calls is relatively low, at \$0.35 per minute.

30. There is no effective regulation of the price and service standards of any of the utilities. The new competition in the telecom sector, however, should result in more competitive pricing. One option for regulation of these sectors would be to ask the US Rural Utilities Service for assistance. Similarly, there is no effective regulation of stevedoring charges at the port or the airport. Regular fixed term contracts that are subject to open public auction would reduce the potential for monopoly pricing in this area.

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<sup>7</sup> For the first 500 kilowatt-hours.

31. The constraints of the public sector deficit place a ceiling on the amount of investment that the Government can provide with respect to utility services. Further investigation of this issue is required, but there appears to be significant potential for improving infrastructure service delivery through such vehicles as public–private partnerships. Further work on the potential for alternative utility operation is strongly recommended.