

III. ISSUES RELATED TO EMPLOYMENT AND THE LABOR MARKET

A. The Structure of the Labor Market

32. Broadly speaking, Palau's labor market is structured such that the public sector employs Palauans, while the private sector employs primarily relatively unskilled labor, imported from the Philippines (which supplies the majority of imported labor), the People's Republic of China (PRC), and Bangladesh. Public sector employment has risen to about 4,500 workers, in a labor force of 13,000. There are between 6,000 and 7,000 foreign workers employed in the economy, with a majority working in construction and tourism. About 2,000 Palauans work (primarily as skilled workers) in the private sector.

33. There has also been substantial emigration of Palauan workers to neighboring islands in the former Trust Territories (e.g., the Federated States of Micronesia, the Republic of the Marshall Islands, and the Commonwealth of the Northern Mariana Islands), and to the United States, where Palauans have rights of entry and employment. The outflow of skilled workers is becoming a major concern. A particular issue is that many young Palauans who go to college in the United States on public scholarships find employment there and do not return; their newly acquired human capital is therefore lost, although in many cases they add to the flow of remittance income. Nevertheless, the cost to the country is known, while the benefits from possible remittances are uncertain. Many countries that send students abroad on scholarships require those who do not return to repay the value of any scholarships they received.

B. The Growth of Employment

34. In contrast to the low growth registered over the past decade, employment in the economy has been rising sharply, by 4.7% per year in the 10 years to 2004. This increase primarily reflects growth in the large number of temporary workers employed in Palau. Employment of foreign workers grew at nearly 10% per year over the 10 years to 2003, while that of Palauans increased by less than 2% per year, within the context of substantial emigration of skilled Palauans.

C. Labor Market Regulations

35. Hiring practices in Palau's labor market are regulated, but there are few regulations governing worker dismissal. The following are the most important regulations that apply to hiring in Palau.

- (i) There is a minimum wage for Palauans of \$3 per hour, which applies to the public sector and those working for foreign-owned firms. This does not apply to Palauans or foreign workers employed by locally-owned companies.
- (ii) Foreign companies that employ foreign workers have to pay an annual fee of \$500 per year. This fee does not have to be paid by Palauan firms or individuals who hire foreign workers.
- (iii) Foreign workers are required to arrive with a return ticket. However, private employers frequently insist that workers surrender their passports and tickets on arrival. There is anecdotal evidence that it is common for employers to cash in the tickets, resulting in some foreign workers having no ticket to return to their home countries.

- (iv) Foreign workers cannot change jobs unless (a) the company for which they work is sold to another company, (b) the company goes bankrupt, or (c) the employer dies (in the case of individual employers).
- (v) Permission to do business is conditional on foreign employers ensuring that at least 20% of their workforce is Palauan.

D. Labor Markets, Growth, and the Future of Palau

36. In practice, many of Palau's foreign workers are unskilled and employed in jobs that Palauans are unwilling or unable to undertake. The impact of the regulations governing foreign workers, however, has substantial implications for the economy. The manner in which foreign workers are recruited and brought into Palau reduces the potential benefits for the economy, and indirectly, for the greater welfare of Palauans. In addition, there are potential human rights issues: the inability of workers to change jobs, combined with the confiscation of return air tickets and passports that often occurs, leaves foreigners recruited in this way susceptible to abusive labor practices. In addition, the employers of many unskilled foreign workers do not provide medical insurance, so if a worker becomes ill and needs treatment, the cost falls on the state. There are additional issues inherent in the employment of large numbers of foreign workers that impact both the nature of Palauan society and the long term composition of the labor force (see Figure 6).

Box 1. Foreign Workers and Dubai: An Example

Dubai provides an illustration of what might occur in Palau if unrestricted importation of foreign workers continues. Dubai's population is 1.06 million, including about 200,000 citizens and 850,000 foreigners. Of the foreigners, more than 500,000 are unskilled Asian laborers, brought in to work on construction projects and at low wage jobs in service industries. The benefit has been explosive economic growth and diversification. The downside, however, has been the rioting of workers over poor pay and employment conditions and the growing feeling among Dubai's citizens that foreign employment has grown too large.

Dubai's growth has brought great prosperity to its citizens, and the tiny country is now a dynamo of innovation and entrepreneurship. The question that it will face is how to continue to encourage investment and entrepreneurship while preserving the essential aspects of its society.

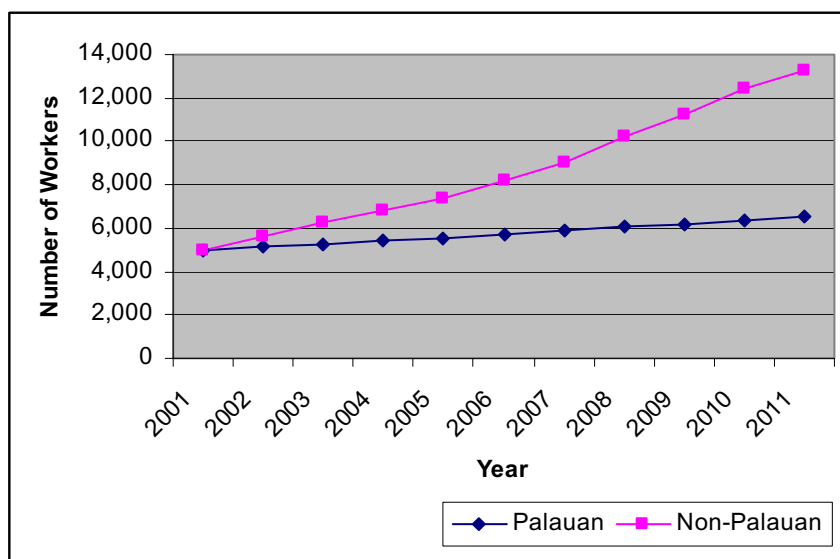
Palau must confront the same dilemma over the next decade if the growth in the number of foreign workers continues at the present rate (see Figure 6). Currently, the business environment in Palau does not promote investment and entrepreneurship. The country risks the worst of both worlds: having a large foreign work force and low growth.

37. A major concern expressed by Palauans, from individual citizens to members of the Government, is the increasing impact the large number of foreign workers is having on the character of the country. With about 30% of the population being foreigners working on contracts, this is a valid concern. Many of these foreign workers are unskilled; in an increasingly widespread practice, Palauans are hiring foreign workers as

domestic employees or as agricultural laborers, while employers complain of being unable to find skilled workers.

38. Under the current system, the size of the foreign workforce is increased by very low-skilled domestic workers employed by Palauans, who do not face the same difficulties or costs experienced by companies (particularly those that are foreign-owned) in importing workers. Growth and output are maximized by labor and capital inputs into the activities with the highest returns. Although precise data do not exist, it is extremely unlikely that domestic and low-skilled agricultural workers contribute significantly to the growth rate. If Palauans were content with continued growth in the size of the foreign workforce, the situation would be of little concern. If the number of foreign workers continues to increase at current rates, however, within 7 years foreign workers will outnumber Palauans in the labor force by a factor of two. At some point, there could be irresistible pressure to reduce the influx. In order to ensure that the country benefits to the greatest extent possible from foreign workers, the labor policy framework must promote efficiency.

Figure 6. Growth in Palauan and Non-Palauan Workers



Source: Author's estimates.

E. Foreign Workers and Productivity Growth

39. Under the current system, it is easier for Palauans to bring in low skilled domestic workers than it is for companies to import skilled labor. To the extent that work permits are limited, this negatively impacts productivity growth in the economy. Furthermore, existing regulations require foreign-owned companies, which are probably among the most productive in Palau, to pay more for workers than do individual Palauans or Palauan-owned companies.

40. Changing the circumstances under which foreign workers are brought into Palau, and how such workers may change jobs, would serve to limit their potential exploitation and improve the efficiency of the labor market. This could best be accomplished by requiring all employers to post a bond with a financial institution, which covers the cost of the return ticket to each worker's home country and the cost of medical insurance during their stay in Palau. The bond should be posted when the work permit is issued.

Furthermore, foreign workers should be allowed to change employment on the condition that the original employer is reimbursed for the ticket and that the new employer assumes the bond under which the worker's work permit was issued.

41. If the number of workers is to be limited, productivity would be enhanced by introducing a system for auctioning visas for foreign workers. Employers prepared to pay the most for a work permit will be the ones using foreign labor most effectively.

F. Foreign Investment Regulation

42. Like most Pacific island economies, Palau has a comprehensive system of foreign investment regulations, which are specified in the Foreign Investment Act. The main features of the system include the following.

- (i) The requirement that all foreign investment and foreign investors go through an approval process when starting a business enterprise in Palau. Applications must be submitted to the Foreign Investment Board (FIB)⁸ for review. Successful applicants are issued a foreign investment approval certificate.
- (ii) The Act contains a substantial list of activities in which foreigners may not engage. Business that are reserved exclusively for citizens of Palau include: wholesale and retail trade; land transportation; water transportation; tour businesses, including all guiding; travel and tour agencies; equipment rental, including equipment for tourism; and the manufacture of any products being produced by Palauans.
- (iii) The Act specifies that in order to obtain approval, the minimum foreign investment should be \$500,000, or the business must have at least 20% of its workforce consisting of Palauans.
- (iv) The Act requires a very extensive business plan, financial projections, details regarding employment generation, and justification that such skills are not available locally.
- (v) The Act requires that foreign-owned businesses submit a quarterly report to the FIB of activities and earnings. The FIB has an ongoing regulatory function to monitor compliance with the Foreign Investment Act.
- (vi) Permission to operate foreign businesses is granted for a fixed time period, thereby shortening the investment time horizon.
- (vii) One of the criteria adopted by the FIB is to review whether foreign business proposals might impact future investment by Palauans. The Board does not have the skills for such evaluation; in addition, if Palauans could start such businesses they would have already done so, given that it is already easier for local investors to establish businesses.
- (viii) In addition to obtaining the requirements outlined above, foreign investors must also obtain environmental and state permits, and be incorporated, with all corporation charters signed personally by the President. All foreign-owned companies that employ foreign workers must pay an annual fee of \$500 per worker.

⁸ The Board consists of seven members, who are residents of Palau. They are appointed by the President with the "advice and consent" of the Senate, and may only be removed for cause. The term of appointment is 3 years. The Board meets at least monthly, but more often if necessary.

43. The justification for these requirements is to prevent the economy from being dominated by foreigners. This goal was articulated explicitly in the recent communiqué from the National/State Leadership Symposium, which stated: “there must be recognition of the need to retain local ownership and prevent foreign domination of our economy” (see footnote 3). It is, therefore, worthwhile to examine briefly whether these goals are being met by the current system and what changes might be necessary.

44. This paper maintains that these goals are not being achieved. A visitor to the country quickly learns of the large number of “fronts” that have been established to bypass existing restrictions on foreign investment. These “fronts” occur in all areas nominally reserved for Palauans.

45. While the desire to promote Palauan participation in certain activities is understandable, forbidding foreign participation has the opposite effect from what is intended. The most important negative effects are:

- (i) **The establishment of front businesses that are nominally owned by Palauans but are in fact controlled by foreigners.** The problem with such fronts is that they generally lack (a) succession plans, (b) plans for increasing Palauan participation, or (c) the aim of allowing Palauans to buy out the foreign owner. As a result, the nominal owners of front business receive no training and skills, and one of the critical benefits of foreign investment—the transfer of skills—does not occur.
- (ii) **Business control of fronts is vested outside of Palau.** The control of many front businesses is vested outside Palau. Transfer pricing is used to minimize tax, denying revenue to the Government and reducing value added in Palau.
- (iii) **Fronts have no vested interest in Palau.** Since these businesses operate at the margin of the law, the nominal owners do not have a commitment to the country, nor to the economy. Since there is always the risk of businesses being closed down, fronts operate for short-term gain, moving their earnings offshore to prevent seizure in the event of business closure. Reinvestment of earnings is low.
- (iv) **Foreign workers are often “borrowed.”** The payment of fees for foreign workers results in many foreign-owned companies “borrowing” workers from local companies.

46. The overall effect of the regulations is thus to encourage “get rich quick” schemes rather than long-term investment. The observation that this is happening is supported by many anecdotes, including (i) abandoned buildings, (ii) newly arrived investors approaching politicians for concessions and “seed funding” for projects that they claim will bring millions of dollars to the economy, and (iii) the nominal owners of front businesses being left standing with debts incurred by the real operators who have fled the country.

47. A limited number of Palauans have the required skills in areas such as tour booking agencies, travel agencies, and tour operation, especially at the higher end of the tourist business where specific expertise (as well as substantial capital) is needed to satisfy high paying clients. Such clients typically have strong expectations regarding the quality of service they receive, which are justifiable given the high prices they are charged. A few Palauans may have learned these skills as the tourist industry has grown, but their number is relatively limited. Fronts have the general effect of limiting the

spread of training. This in turn results in mass tourism, rather than high-end tourism which pays high prices for the very best in service and facilities.

G. Reform of Foreign Investment Legislation

48. The Government is aware of some of the difficulties caused by the current foreign investment legislation. The Olbiil Era Kelulau, (OEK, Palau's national legislature) is considering reforms to existing legislation and a draft bill has been tabled. In addition, the FIB has made a number of suggestions for changing existing legislation.

49. The bill before the OEK (House Bill No. 7-46-2, HDI)⁹ proposes a complete overhaul of the system of approval of foreign investment, while the changes proposed by the FIB envisage a reform of the existing Foreign Investment Act, while leaving the essential mechanisms untouched. The preamble to the House Bill states:

The Foreign Investment Act is a hindrance to investment in the Republic of Palau. Bureaucratic restrictions hamper the inflow of capital, though there is not enough local money to fully develop the Republic's resources. The complicated and burdensome system for foreign investment approval certificates has induced abuses such as false filings and front businesses, and has continued to discourage foreign investment.

50. The preamble thus recognizes problems with the existing legislation, which is currently failing to achieve its aims of promoting investment and entrepreneurship within the country.

The main elements of the Bill include:

- (i) Transferring the Office of the Registrar of Corporations to the Ministry of Finance and the transfer of employees of the Foreign Investment Board to the Office of the Registrar of Corporations.
- (ii) The revocation of the regulations implementing the Foreign Investment Act.
- (iii) A clarification to exempt franchises from the provisions of the Foreign Investment Act, provided that franchisors do not engage in other businesses in Palau.
- (iv) Allowing foreign investors to obtain 50-year permits to operate businesses in the country.
- (v) The merging of the Office of the Corporate Registrar, the Foreign Investment Board staff, and the current staff of the Division of Revenue and Taxation (which issues and processes business licenses) into a new Bureau of Commercial Licensing. All applications and registrations for domestic and foreign corporations and other business enterprises would be filed at the Bureau. The Bureau would also issue foreign investor permits, which would be referred to as "Authorization to Conduct Business in the Republic of Palau."
- (vi) The reserved list of activities would be reduced to: wholesale importing of goods; wholesale distribution of goods; retail importation, sale and

⁹ As of February, 2007 no action has been taken on this bill, which has been in the Legislature for nearly a year.

distribution of goods; gift and handicraft shops; bakeries; land and water transport; commercial fishing; and fishing in territorial waters in each state. However, the draft bill states that if a citizen of the Republic of Palau has 25% of the equity and is entitled to 25% of the profits of any company engaged in the preceding list, the business may have foreign ownership of the remaining equity in the business and engage in the prescribed activities. This step should reduce the number of front businesses and result in greater formal participation of Palauans in formal business activities.

(vii) Penalties for the operation of front businesses would be increased.

51. A vigorous debate is underway regarding the new legislation. In many cases, the business community in Palau opposes provisions of the draft House Bill. There is no doubt that parts of the legislation will serve to intensify the competition existing businesses face. Although not welcomed by existing businesses, in the longer term it will promote economic efficiency. Furthermore, experience in other countries has shown that well run, efficient businesses ultimately thrive on competition, and it is likely the same would be true in Palau.

52. This paper recommends a substantial reduction in the list of reserved activities. Limiting some business sectors to Palauans in the name of protection does not mean that Palauans will in fact engage in these activities, as the numerous front businesses attest. One argument put forth for preserving the list is to encourage lending to Palauan entrepreneurs (currently, financial institutions lend to few Palauan entrepreneurs). This, however, suggests that no investment is preferable to investment by those with non-Palauan nationality, a position that this paper does not support.

53. There are a number of problems and ambiguities with the House Bill, the most significant of which is the replacement of the Foreign Investment Board with the Bureau of Commercial Licensing. This carries the danger that bureaucratic procedures would be intensified rather than reduced, particularly if there are delays in issuing implementing regulations. In addition, the wording of the Bill could lead to unintended outcomes. For example, the Bill indicates that if business has not commenced within a year of a license being granted, the license could be revoked. In the case of hotels and larger investment projects, this could result in the withdrawal of a license even though investment is underway. Similarly, under the House Bill, fishing within the territorial waters of each state is illegal; the bill should make it clear that *commercial* fishing is illegal, while recreational fishing is allowed.

54. This paper encourages further debate on the proposed foreign investment legislation, in line with the recommendation that a far-reaching discussion of the economic future of the country is essential if future development goals are to be clearly defined, with the goal of gaining the general support of major elements of Palauan society.

H. The Impact of Large Investment Projects on Palau

55. Currently, two large investment projects totaling several hundred million dollars (and possibly as much as \$400 million, by some estimates) are being evaluated; one for a retirement village and one for a hotel and golf course. The potential impact of these projects on Palau's economy is an important issue that should be considered.

56. The value of the projects is equivalent to several years of Palau's GDP. Even if a substantial portion of the investment is imported, relative to local output, the investment still constitutes close to one year of GDP. While under construction, the projects will have a very large impact on the local economy. The effect will be to increase the cost of labor substantially, not only in the sector in which the investment takes place, but also in the economy as a whole, as higher labor demand will spill over into other sectors. If large numbers of foreign workers are not brought in, there will be a substantial rise in wages throughout the economy. Since the foreign labor supply is already very large, raising the number of foreign workers in Palau could occur without much effect on local wages and salaries. There would, however, be a very large increase in the size of the foreign workforce. In addition, the projects would probably bring a significant increase in the cost of construction: local construction firms would raise their prices in response to the new demand, while the cost of local managerial staff with knowledge of local conditions would increase in response to bidding by foreign companies.¹⁰ Existing infrastructure would come under pressure because of demands on roads and ports.

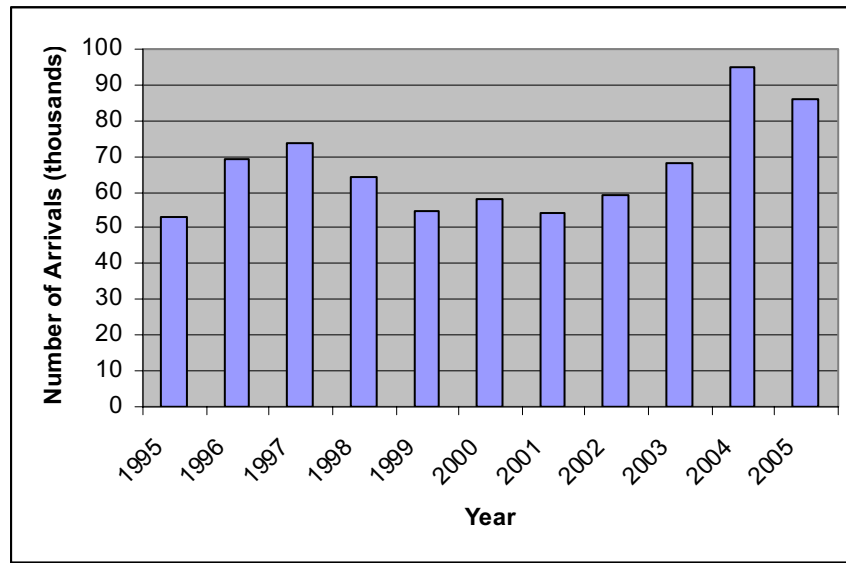
57. A different type of effect would be felt once the projects are completed. First, the foreign workers brought in for the projects would either require repatriation, or would have to be absorbed into other jobs in the economy. Second, the projects are aimed at retirees and tourists—groups whose spending would likely have a positive impact on the economy in terms of employment, spending, and prosperity.

58. Investment projects of the magnitude being contemplated would have a profound impact on the economy. Such projects would undoubtedly be beneficial in terms of growth and prosperity, but they could also intensify existing debates regarding the desirability of growth, the distribution of the benefits of growth in the economy, and how many foreign workers should be part of Palau's labor force. These questions need to be resolved well in advance of the implementation of these projects.

I. Tourism

59. Tourism in Palau is remarkable in that the equivalent of over three times the population of the country visit each year, amounting to 85,000 visitors in both 2004 and 2005. Most visitors are from East Asia, in particular PRC, Japan, and Taipei, China. On the basis of the contribution of travel receipts to GDP, tourism contributes about 45% of total value added, making it the most important activity in the economy by a substantial margin. In terms of the number of tourist arrivals per capita among small island economies, Palau ranks second only to the Bahamas, which is closely located to the very large US market.

¹⁰ The requirement that foreign companies have a workforce that is at least 20% Palauan would lead to higher salaries for skilled Palauan workers.

Figure 7. International Tourism, Number of Arrivals, 1995–2005

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

1. Salient Issues in the Tourist Industry

a. The Impact of Reserved Activities on the Tourist Industry

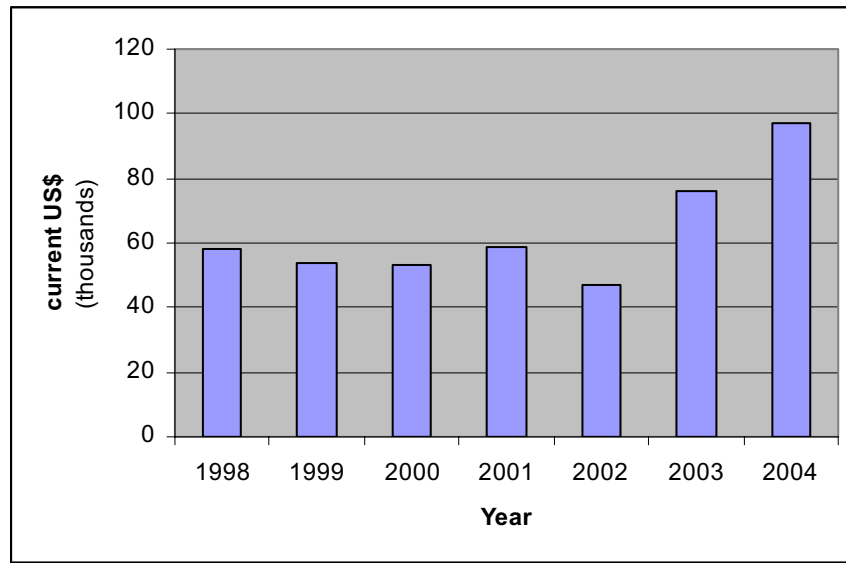
60. Currently, Palau's tourist industry is one-dimensional, with the large majority of tourists coming for diving activities, for which Palau is justly renowned. The current restriction on who may undertake tourist-oriented businesses results in a substantial number of fronts operating in the tourist industry. Tourist activities reserved exclusively for Palauans are car rentals, tour guiding, fishing guiding, dive guiding, all forms of water transportation, booking services, and tour and travel agencies.¹¹ This prohibition applies not only to businesses that are foreign owned, but also to non-citizens who are in partnership with Palauans. The future growth of high-value tourism depends on the abolition of these fronts. While the proposed revisions to the Foreign Investment Act contain provisions for severe prosecution of fronts, this paper strongly recommends the abolition of restrictions in the first place, rather than the prosecution of fronts. Palau needs expertise; restrictions prevent such expertise from being disseminated.¹²

b. Mass Market vs. High-end Tourism

61. Tourism policy must confront the issue of the number of tourists that can be sustainably accommodated. There is already evidence that the large number of tourists are beginning to strain the country's environment, which is its main attraction. Environmental degradation would affect the primary motivation of most tourists for visiting Palau, and the industry would enter a state of decline, with severe consequences for growth and employment.

¹¹ Proposed revisions will eliminate the restrictions on tour operators, tour agencies, booking services, and tour management services.

¹² If restrictions were lifted, it is very likely that "fronts" would disappear.

Figure 8. International Tourism Receipts, 1998–2004

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

62. A number of factors encourage mass tourism.
- (i) Allowing charter flights into Palau promotes the sale of low-cost package tours.
 - (ii) The existence of front businesses encourages offshore selling by front owners and transfer pricing of funds.
 - (iii) The use of vouchers in tourist hotels simplifies transfer pricing and allows operators to escape paying gross receipts taxes.
 - (iv) The lack of an effective hotel rating system reduces the attractiveness for individual high-end tourists.
 - (v) The lack of a coherent tourism policy that has the specific objective of promoting up-market tourism.

63. Simultaneously, low-end tourism promotes over-exploitation of natural resources, which reduces the attractiveness of Palau as a high-end destination. This includes crowding at renowned dive sites, which could threaten the viability of the industry in the long run and thereby negatively impact Palau's economic growth. Dealing with these issues must be an urgent priority if tourism is to evolve in a way that maximizes revenue and economic growth for Palau.

2. Issues Related to High-end Tourism

64. Deciding on a direction for the tourist industry and the extent to which it is either predominantly mass-market or high-end is part of the debate that is highlighted in other parts of this paper. Undoubtedly a dilemma exists, with the very nature of Palau and its economy part of the outcome. The two ends of the tourism spectrum have differing policy implications. While this paper fully acknowledges that only Palauans can make this decision, it urges that the process begin without delay. Furthermore, the mass-tourism option requires little change in the current policy. In the view of this paper, without specific government action, over the next decade Palau tourism will evolve

inevitably away from high-end tourism. If the high-end alternative is chosen, some of the following policy actions will be necessary.

- (i) Obtain support from development partners for the formulation of a high-end tourism master plan. The plan must ensure that the inherent economic incentives of any measures encourage high-end tourism.
- (ii) Support high-end marketing by the tourism association.
- (iii) Establish a hotel rating system that specifies standards at each class level.
- (iv) Discourage charter flights, unless all operators offer business class services.
- (v) Eliminate restrictions that require booking agents, travel agents, and tour operators to be Palauan.
- (vi) Strongly enforce environmental regulations.
- (vii) Impose a head tax on tours booked through package tour operators.
- (viii) Count vouchers as invoices for taxation purposes, which will reduce the ability of operators to undertake transfer pricing to avoid taxes.

65. Ultimately, the tourism industry is critical to the country's economic growth. Therefore, the Government must place a high priority on developing a vision for the industry and obtaining consensus within Palauan society on the industry's future.