

EXECUTIVE SUMMARY AND POLICY PRIORITIES

Policy Choices Facing Palau:



How to Increase GDP Growth

Palau has had low growth since independence. Reliance on public sector-led development will not deliver future prosperity to Palauans. Palau needs the private sector.



How to Increase Productivity

Many existing policies promote inefficiency and have the opposite effect than was intended. Highly skilled Palauans can earn far more in other countries.



How to Promote High Value Tourism

Value added from tourists is low, with a large proportion of the revenues leaving the country.



How to Lower Costs

Inefficient state involvement in the economy raises the costs of doing business and increases the effects of isolation.

Palau Needs a Strong Private Sector. Achieving This Involves:

Less Involvement of the State in the Economy

- Economies where the state plays a large role in the economy generally experience low growth.
- Budgetary processes have funded employment more than investment in infrastructure, which the country needs in order to become more prosperous.
- Public administration is weak. Staff are under-qualified, and the systems of government are not strong. Too many ministries have responsibility for policies related to the economy.
- State ownership of utilities limits investment in infrastructure, which is needed for higher growth

A More Equitable and Simple Tax System

- The tax system is inefficient and distorts investment. It places very high burdens on some firms and almost none on others. Evasion is widespread.
- Many smaller businesses ignore tax rules and pay little tax, which unfairly burdens businesses that do pay.

Better Funding of Investment by Financial Markets

- Financial markets do not finance investment and entrepreneurship effectively, but supply large amounts of consumer credit.
- Interest ceilings are very damaging to an effective finance network and promote lending by loan sharks who charge interest rates of several hundred percent per year.
- Better regulation of financial institutions. The recent failure of the Pacific Savings Bank illustrates the dangers of weak regulation.

An Updated Legal System

- The commercial legal system is outdated. It relies on decades old precedents from the United States.
- Important parts of the legal system are missing. For example, there is no bankruptcy law or consumer protection law safeguarding privacy.
- Although courts are efficient, other parts of the legal system are weak. Registries are inefficient, unreliable or non-existent, which hampers the pledging of assets as security.
- Arbitration provisions are weak, which removes an important mechanism for the resolution of disputes.

A Less Onerous Foreign Investment Regime

- Currently, businesses in Palau operate under two different sets of business law: one for local businesses and one for foreign owned businesses. This is inefficient, raises uncertainty, and encourages low quality foreign investors.

- Foreign investment approvals, the reserved activities list, and reporting requirements all impose costs on foreign investors and harm Palauans. In many cases, skills required for reserved activities do not exist locally, encouraging cheating and limiting incentives for training.
- Reserved activities have led to the widespread existence of "fronts": businesses that are in practice owned and operated by foreigners. Reserving activities for Palauans increases rather than reduces foreign ownership.
- Tax and other investment incentives reduce revenue.

A Review of the System for Foreign Workers

- The presence of an unlimited number of foreign workers could change the nature of Palauan society and lead to a backlash.
- The existing system of bringing in workers limits benefits to the country because workers are often not employed in the most highly productive activities.

Secure Property Rights in Land

- The prohibition of 99-year leases by the courts will have a major impact in the future.
- A framework for long-term lease payments is needed.
- The large number of land disputes slows effective development.

Development of Up-market Tourism

- Tourism plays a major role in the economy. Improving tourism is a cross cutting issue. A new tourism policy is needed, which requires careful analysis and articulation.
- Package tours dominate the tourist sector. Much of this revenue remains offshore. Mass tourism risks diminishing the exclusivity of Palau.
- Transfer pricing reduces the benefits of tourism to Palau. This situation arises in part as a result of activities being reserved for Palauans and restrictions on foreign investment.
- Environmental protections and enforcement are not strong enough to protect the pristine beauty of the country from indiscriminate overdevelopment.

Recommendations:

Realigning and Streamlining the Role of Government in the Economy

- Action 1: Streamline the role of the state by limiting the government payroll. Government employment is crowding skilled workers out of the private sector.
- Action 2: Review the possibility of a public-private partnership for state owned provision of infrastructure services in road maintenance, water services and sewer treatment, electricity generation, and garbage collection.
- Action 3: Consider selling additional cellular, Internet, and cable TV licenses. This will increase competition and reduce prices.
- Action 4: Focus responsibility for economic policy making in core ministries: the Ministry of Finance, the Ministry of Commerce and Trade, and the Ministry of Resources and Development.

Undertaking Tax Reform

- Action 1: Abolish the gross receipts tax and replace it with a simplified form of value added tax.
- Action 2: Ensure that the new tax system taxes in-kind payments to reduce the possibility of transfer pricing.
- Action 3: Abolish tax incentives: make Palau attractive for foreign investors by transforming the country into a low cost place in which to do business.

A Complete Overhaul of Foreign Investment Regulations

- Action 1: The commercial laws governing economic activity need to be merged so that the same rules apply to local and foreign businesses to as great a degree as possible. The list of reserved activities needs to be abolished as it is harming the economy. It increases foreign domination of economic activity and reduces the benefits that Palau gains from tourism and other activities.
- Action 2: Some elements of the new Bill before the Olbiil Era Kelulau that repeals the Foreign Investment Act are a step in the right direction. However, further discussion and clarification of parts of the Legislation is necessary.
- Action 3: If Palau is going to limit foreign workers, the system for bringing them in requires review.

Review and Reform of the Legal System for Commercial Activities

- Action 1: Palau needs a new Companies Law, a Sale of Goods Act, a Bankruptcy Act, and a Consumer Privacy Act, which will allow credit bureaus to operate without fear of being sued.
- Action 2: Palau's commercial legal framework requires further thorough review, which sets priorities for reform.
- Action 3: Increase transparency by putting Palau's laws and decisions on the Internet.
- Action 4: Introduce an electronic transactions act, which will help offset some of the problems brought about by Palau's remote location.

Reforming the Financial Market

- Action 1: Reform the collateral framework to increase lending.
- Action 2: Strengthen the role of the Supervisor of Banks in line with International Monetary Fund recommendations. This will limit potential problems if the economy is subject to adverse external economic events.
- Action 3: Abolish interest rate ceilings on lending. Legitimate lending institutions in well functioning financial systems typically charge interest rates of 25% or more to high-risk borrowers. The ceilings encourage loan sharks, who lend to those to whom banks will not lend because they cannot charge enough interest. We strongly oppose interest rates set by administrative or legislative fiat.
- Action 4: Refrain from attempts to weaken creditors' rights, which will encourage more lending by loan sharks.
- Action 5. After consumer protection legislation has been passed, encourage the dissemination of credit information and the formation of a credit bureau.

Undertaking Land Reform

- Action 1: Clarify the legal basis for 99-year leases to avoid problems developing in the future.
- Action 2: Establish a formula for lease payments that is equitable for both lessors and lessees.
- Action 3: Accelerate the resolution of land disputes.

Articulating and Implementing a High-end Tourism Policy

- Action 1: Consider a substantial tourist head tax for package tours or trips arranged outside the country.
- Action 2: Centralize the selling of licenses for diving and the use of protected areas, and increase enforcement to ensure that fees are collected and that regulations are observed to preserve the environment.
- Action 3: Assist the Tourism Association in marketing high-end tourism.
- Action 4: Allow foreigners to operate as travel agents, booking agents, and tour operators to limit the formation of *fronts* that allow revenue to go offshore. Few Palauans currently have these skills.