



## Strategy and Program Assessment

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# Palau: Policies for Sustainable Growth, A Private Sector Assessment

The report was prepared for the Asian Development Bank (ADB) by Dr. Paul Holden of the Enterprise Research Institute (ERI), USA. The report has not been formally edited, and the views expressed in this paper do not necessarily reflect those of ADB.

**Asian Development Bank**

**ABBREVIATIONS**

ADB	–	Asian Development Bank
FIB	–	Foreign Investment Board
FY	–	fiscal year
GDP	–	gross domestic product
IMF	–	International Monetary Fund
MAP	–	Management Action Plan
OEK	–	Olbiil Era Kelulau
PFTAC	–	Pacific Financial Technical Assistance Centre
PNCC	–	Palau National Communications Corporation
PRC	–	People's Republic of China
UCC	–	Uniform Commercial Code
US	–	United States

**NOTES**

- (i) The fiscal year (FY) of the Government of Palau ends on 30 September. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2000 ends on 30 September 2000.
- (ii) In this report, "\$" refers to US dollars.

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## 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 Promote High Value Tourism

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



#### 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 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

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### 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.

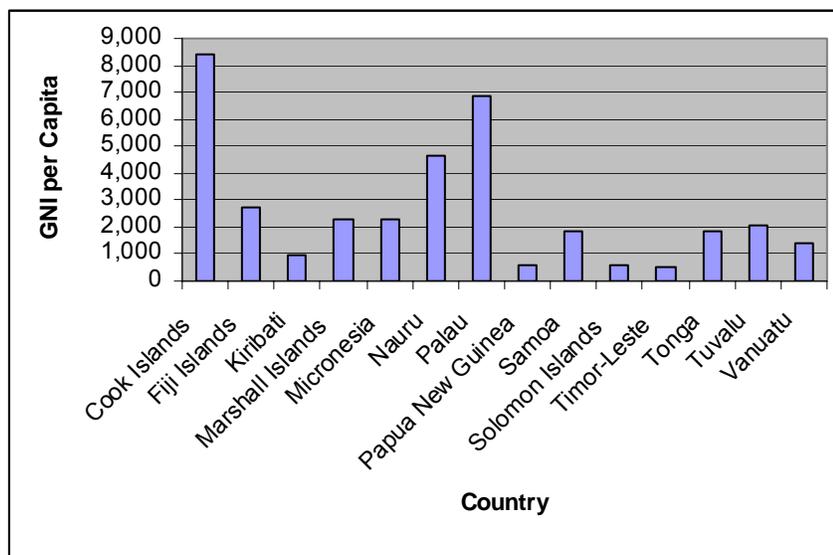
### Articulating and Implementing a High-end Tourism Policy

- 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.

## I. INTRODUCTION

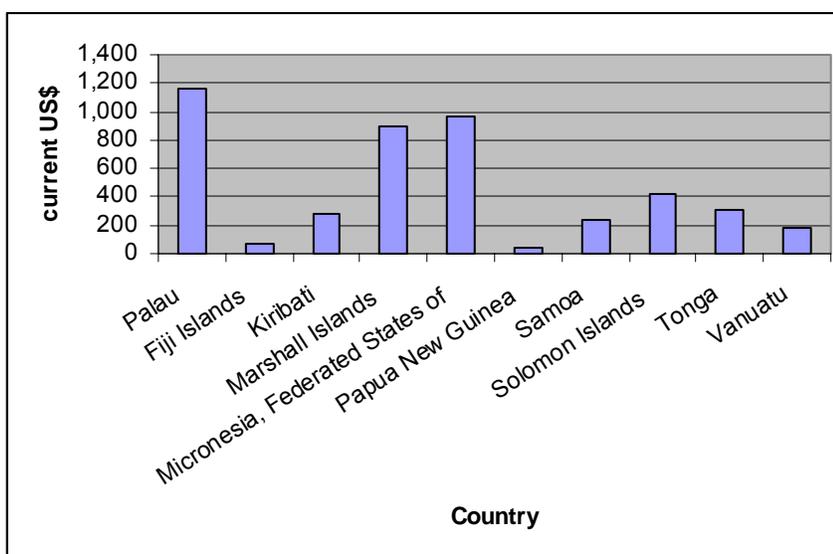
1. Palau lies in the western Pacific, with good air and sea links to several large Asian countries. Palau's total gross domestic product (GDP) is approximately \$120 million, making it one of the smallest economies in the world. It has a population of about 20,000 people, including over 6,000 temporary 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.

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<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>)

## II. ISSUES RELATED TO THE MACRO ECONOMY

### A. Introduction

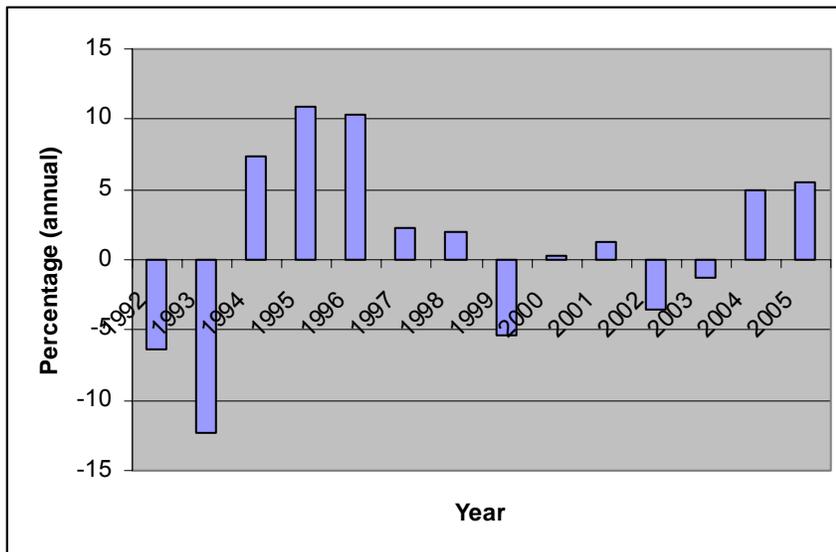
10. Palau's economy has some striking characteristics:

- (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.

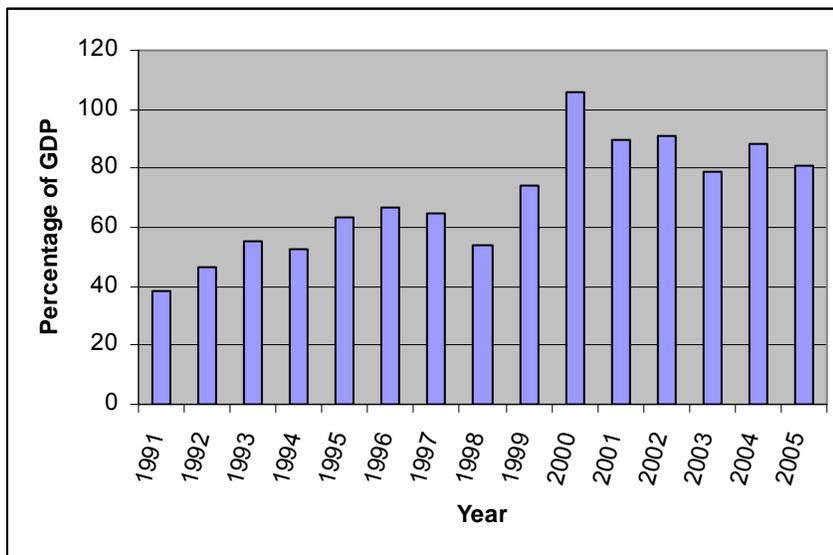
#### D. External Accounts

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>.

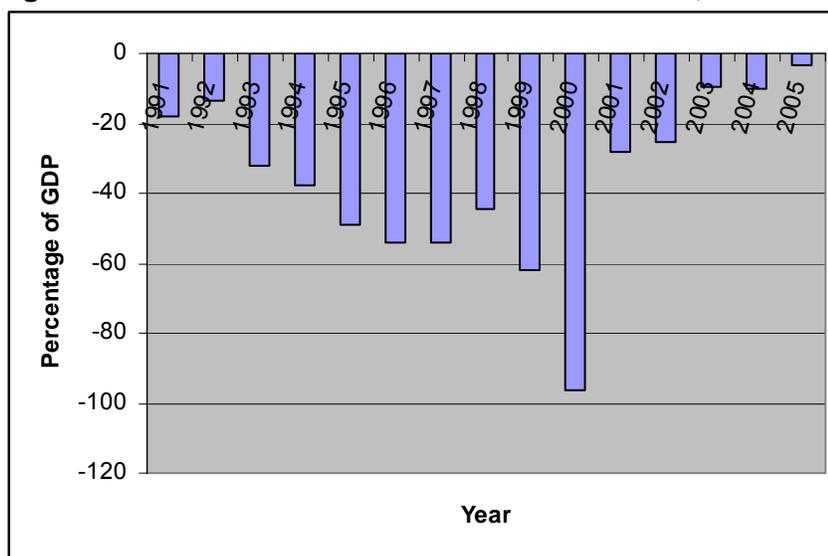
**Table 1. Balance of Payments, 1999–2005**  
(\$ million)

	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.

### **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.

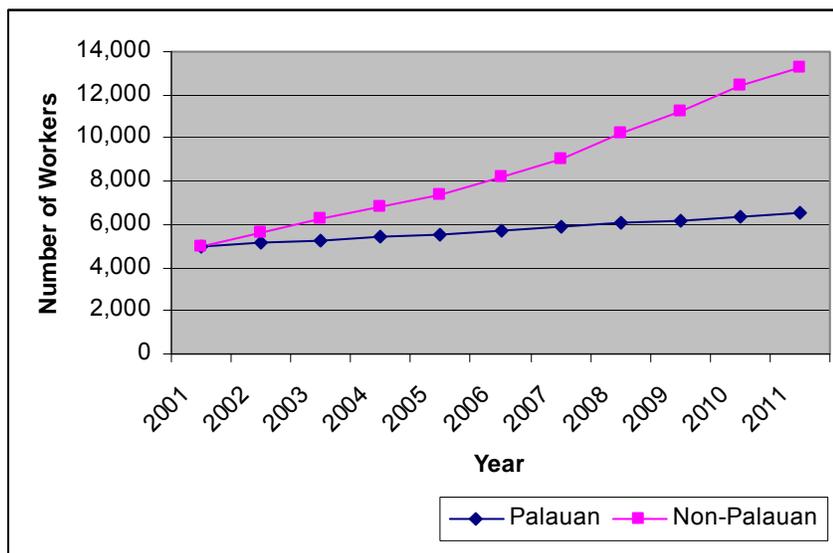
Palau must confront the same dilemma over the next decade if the growth in the number of foreign workers continues at the present rate (see Figure 6). Currently, the business environment in Palau does not promote investment and entrepreneurship. The country risks the worst of both worlds: having a large 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)<sup>8</sup> 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.

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<sup>8</sup> 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)<sup>9</sup> 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

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<sup>9</sup> 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.<sup>10</sup> 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.

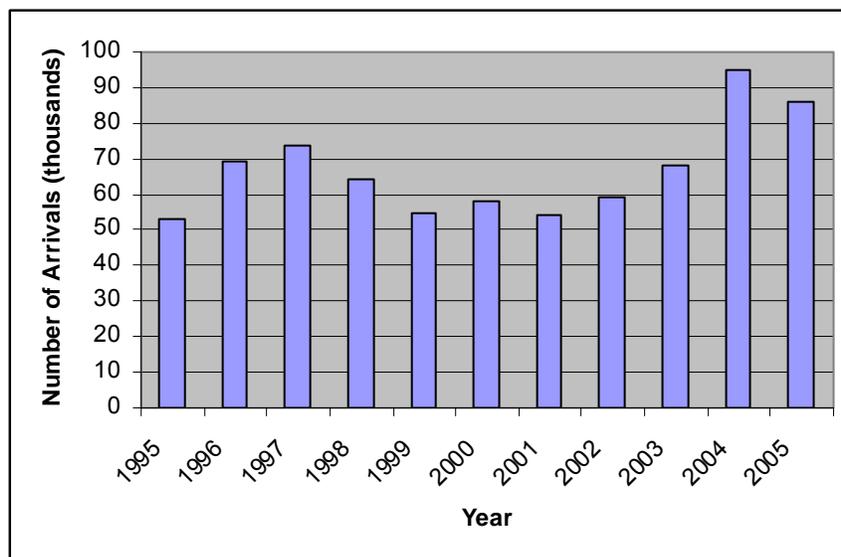
58. Investment projects of the magnitude being contemplated would have a profound impact on the economy. Such projects would undoubtedly be beneficial in terms of growth and prosperity, but they could also intensify existing debates regarding the desirability of growth, the distribution of the benefits 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.

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<sup>10</sup> 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

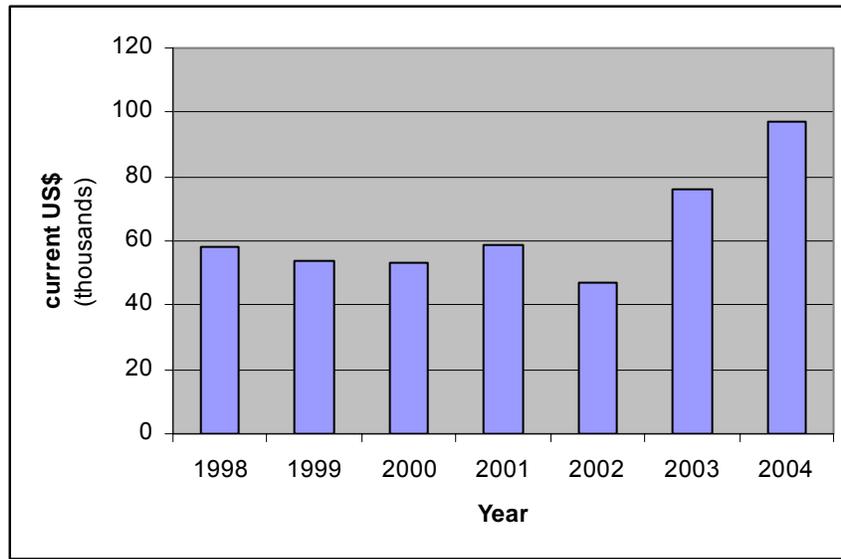
60. Currently, Palau's tourist industry is one-dimensional, with the large majority of tourists coming for diving activities, for which Palau is justly renowned. The current restriction on who may undertake tourist-oriented businesses results in a substantial number of fronts operating in the tourist 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.<sup>11</sup> 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.<sup>12</sup>

### 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.

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

<sup>12</sup> 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.

## IV. ISSUES RELATED TO THE FINANCIAL SECTOR

### A. The Structure of the Financial System

66. As Palau uses the US dollar as its currency, it has no Central Bank and no scope for monetary policy. The money supply is determined by the balance of payments, and the rate of inflation is closely tied to that of the United States. A further implication of the use of the US dollar is that there is no lender of last resort in the event of a banking crisis, a factor that makes adequate supervision of the banking system especially important.

67. There are eight banks in Palau, plus the Development Bank of Palau. Four of the commercial banks are foreign-owned, and dominate the financial system, holding about 80% of total deposits. These deposits are insured under the FDIC. Local banks account for 25–30% of banking system assets, with the majority being in the form of small loans.

68. The financial status of the Development Bank has improved markedly over the past few years. It had been basically insolvent, but was restructured in 1999. Additional capital was injected in 2004 and it is now run on a professional, commercially-oriented basis. Its main business is lending for housing; the outstanding loan portfolio is now some \$12 million, equivalent to about 10% of GDP. It has a healthy profitability, and although there are still a substantial number of non-performing loans (about 15% of its portfolio), there is improved provision and losses should be limited by the fact that most of the loans are collateralized.<sup>13</sup>

69. Data on the extension of credit to the private sector do not exist, so it is difficult to judge the extent to which the banking system is financing investment and entrepreneurship in the economy. Currently, the Financial Institutions Act does not require banks to provide audited balance sheets to the Supervisor of Banks. The Bank Regulator estimates that there is about \$80–85 million in bank loans outstanding, about 20% of which are to the central government and about \$55 million to the state governments and public utilities. Interviews with bankers revealed that a substantial part of commercial bank lending to the private sector consists of consumer credit, secured by salary deductions.

### B. Lending and Debt Repayment

70. Bankers describe the culture of debt repayment in Palau as very weak. Borrowers often strenuously resist repayment of their loans and not infrequently bounce checks. Knowingly writing a check with insufficient funds is a criminal offense in Palau, but lawyers in Palau could not recall a recent instance of prosecution. However, lawyers involved in debt collection claim that a substantial number of people in Palau have been sued for non-payment of debt.

71. One of the consequences of legal action to collect debts is high legal fees. Under common law, the debtor is deemed to be liable for fees to collect the monies that they owe, resulting in very high legal bills. For example, if debtors who owe no more than a few hundred dollars fail to pay, a judgment can be lodged against them, with legal fees easily equaling the amount owed. If they are then delinquent on subsequent occasions, additional legal fees could accrue, amounting to thousands of dollars. As one attorney

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<sup>13</sup> This improvement in the solvency of the Development Bank will not continue, however, if periodic efforts to control lending rates legislatively are successful. This paper strongly opposes the implementation of any ceilings on interest rates being charged.

interviewed observed, “the law allows debtors to be pursued to the grave.” Concerned about the impact of legal fees on small debtors, the OEK passed a law limiting legal fees on any debt due to 25% of the original principle. This has been proven ineffective, however, due to loopholes in the law that still allow for high legal fees to be imposed. This penalizes smaller borrowers. As with any law that tries to directly influence economic behavior, there are unintended consequences, which could include a reduction in loans to small borrowers by the formal financial system. In many cases, this forces all small borrowers to resort to loan sharks, who lend at far higher interest rates and often use unpleasant methods of debt collection.

72. A far preferable system for dealing with chronic overburdened debtors is bankruptcy, a process that discharges debtors from at least part of their liabilities but which restricts their ability to borrow in the future. If combined with an effective means of recording credit information, such a system reduces legal fees associated with credit default by discharging debt once and for all. This issue is raised in a later chapter.

### **C. The Collateral Framework in Palau**

73. Interviews with bankers, regulators, and businesses indicated that there are many deficiencies in the collateral framework that impact negatively on the ability to borrow and increase the risks of lending. Deficiencies exist in all phases of the process of collateralization: creation, prioritization, perfection, and enforcement. The result is that pledging collateral is expensive, and lenders insist on substantial excess collateral to secure loans. As the appendix discusses in detail, reform of the collateral process could substantially enhance the ability of businesses to borrow and reduce the incentive to default.

### **D. Credit Information**

74. Credit information, which provides lenders with a means to assess the risk of lending to a company or to an individual, is an important component of a well-developed financial system. Without a means to evaluate lending risk, lenders tend to over-collateralize loans to those with assets and refuse lending to those without assets, forcing poorer borrowers to borrow from loan sharks.

75. The lack of credit information harms the lending framework in Palau. US-owned banks have a competitive advantage because US credit bureaus supply these banks with credit information on potential borrowers, which is not available to Palauan banks because of consumer privacy protection. The competitiveness of US banks is further increased by the international nature of the system: if a borrower leaves the country and goes to a former Trust Territory, or the US, the adverse information will be on record if they attempt to obtain credit in their new place of residence.

### **E. Lending on Land**

76. Mortgages on fixed property are available in Palau. The legal basis is the Deed of Trust system that was introduced in the 1950s. Typical mortgage loan terms are based on 75% of the assessed value of the property for a 15–20 year term and at a fixed interest rate of 10% for the life of the loan.

77. Restrictions on land holdings limit the number of lenders who are prepared to lend using land as security. As non-Palauans may not own land, repossession becomes complicated and expensive for foreign-owned lenders in the event of default on mortgages. A foreign-owned lending institution cannot directly repossess a property on

which there is a mortgage default, but must apply to the courts to be allowed user rights until a purchaser can be found. This is not the case for locally-owned banks and the Development Bank. The latter dominates mortgage lending. Locally-owned banks are a minor supplier of mortgage, probably because their liquidity problems make them reluctant to tie up their loanable funds in long term assets.

## **F. Bank Regulation in Palau**

### **1. Problems with the Regulatory Framework**

78. The regulatory framework for bank regulation in Palau is weak. Until comparatively recently there was no bank supervision. The Financial Institutions Act now provides for regulation, but does not assure adequate funding for the Office of the Supervisor of Banks, which is staffed only by the Supervisor and a secretary. Although banks pay a fee for financial supervision, the collected funds go into general government revenue rather than to fund the Office of the Supervisor.

79. Banks are required to maintain a minimum capital of \$500,000. This very small amount would not be acceptable to most bank regulators around the world. Even so, there are reports of strong lobbying by local banks to relax the enforcement of this requirement.

80. Severe gaps in the regulatory framework remain, including the fact that although banks are required to report to the Supervisor of Banks, they are not required to submit audited balance sheets. As a result, the basic tools of bank supervision are not in place, and the public has no way of determining the financial soundness of banks.

81. Supervision problems are partially ameliorated because foreign banks are subject to supervision in their home countries, which have more comprehensive regulation. Local banks are, however, under-regulated. When combined with their under-capitalization, this could lead to severe moral hazard issues. Local banks probably operate under the assumption that the authorities will not allow them to fail, which could result in risky lending practices.

82. There are grounds for concern regarding the liquidity of some banks, especially those that are owned locally. The IMF reports that local banks are not retaining sufficient capital to meet withdrawals. There are, in addition, numerous anecdotes regarding cash shortages. Several depositors recounted that they are often not able to withdraw cash at will if the amounts are over \$2,000. When they ask for withdrawals, they are told that the bank does not have enough in their vaults to pay them immediately. Customers are asked to return a few hours later (the term used by the locally-owned banks is "we need to buy some money"). The domestically-owned banks also offer substantially higher deposit rates for larger amounts of money than do the foreign-owned banks, with rates being negotiated with individual depositors.

83. The Pacific Savings Bank went into receivership in late 2006. The bank has been closed, with smaller depositors being guaranteed a repayment of \$2,500 each, which is being financed by a soft loan from Taipei, China. In spite of political opposition to the closing of the bank, it continued to be wound up as of the end of February, 2007.

### **2. Tightening Regulation**

84. Attempts are being made to tighten regulation. There are 12 regulations governing the implementation of the Financial Institutions Act, pending approval by the

OEK.<sup>14</sup> These relate to a range of issues, such as Capital Adequacy Requirements and the reporting obligations of financial institutions. There are also money-laundering provisions among the amendments that have not been passed. Because these statutes are not yet incorporated into the law, some foreign financial institutions (such as Deutsche Bank, Hong Kong and Shanghai Bank, and some Dutch banks) will not deal with Palauan banks, and this is having a negative effect on the tourist industry. However, legislative action has not been taken, and in the future no regulations relating to financial institutions can be passed without a joint resolution from both houses in the OEK.

### **3. Lending, Cultural Issues and Private Sector Development in Palau**

85. Palauans have extensive family commitments, which require many to regularly contribute what may be substantial sums to relatives and friends within their social network. While these obligations are difficult for outsiders to understand, they can often result in excessive borrowing, beyond the means of a borrower to repay. This partially explains the high default rate on bank loans, indicating that while the structure of interlocking social commitments provides a safety net, that net is not without cost. Some Palauans are perpetually in debt.

86. As an analysis of Palauan enterprise observed:

To succeed, modern enterprise needs the understanding and cooperation of all its enterprise constituencies. The struggle between cooperation and competition and between the vested interests of the traditional and modern together fashion a changing set of values and expectations that greatly influence whether or not indigenous enterprise can survive and if so in what form. Modern society needs enterprise and this enterprise needs the support of its constituents but if these constituents succeed in demanding more immediate distributions of enterprise profits, cash flow will suffer and enterprises may not succeed.<sup>15</sup>

87. The transition from a traditional subsistence economy, in which surpluses are distributed as cultural obligations, to a modern cash economy, in which retained earnings are reinvested in businesses, is a gradual process. Certain changes, including those discussed, for instance, in the sections on collateral reform, credit information, and bankruptcy, will contribute to this modernization process. Various other factors are working against this evolution. The learning process of adapting to new social and commercial realities will be slowed if the Government—rather than business and commerce—is regarded as the traditional employer of the Palauan community. Learning tends to be greatest in companies owned by foreign investors, and encouragement and expansion of foreign investment will contribute greatly to the modernization of Palau's economy.

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<sup>14</sup> These were identified in the Financial Institutions Act.

<sup>15</sup> Pollard, Stephen. 1995. *The Culture of Successful Palauan Enterprise*, Pacific Islands Development Series, No. 8. Honolulu, Hawaii: East-West Center Working Papers.

## V. ISSUES RELATED TO PALAU'S LEGAL SYSTEM AND PROPERTY RIGHTS

88. The first part of this chapter briefly discusses some legal issues governing commercial transactions in Palau. This is not meant to be a comprehensive review, and does not undertake an in-depth analysis of the commercial legal system; instead, some of the constraints relating to private sector development resulting from the outdated and incomplete nature of the existing legal structure for commerce are highlighted. The second part of this chapter discusses some issues related to property rights in land in Palau.

### A. Some Issues Related to Palau's Commercial Legal System

89. Palau's legal system is based on its Constitution, customary law and common law as understood and applied in the United States.<sup>16</sup> An in-depth analysis of contract law in the North Pacific states that:

The statutory elevation of the Restatements to the level that the Restatements are the rule of decision is a unique regional development and a remnant of the Trust Territory Code, 1 TTC 103. This regional adoption is unique because in the United States, the Restatements of Law are not the rule of decision.<sup>17</sup>

90. In the absence of written law or local customary law, the courts of Palau apply common law.<sup>18</sup> In practice, much commercial law is based on common law because neither the Constitution nor customary law address commercial issues to any great degree. This situation causes significant practical problems. In the United States, commercial transactions are governed by the Uniform Commercial Code (UCC), which was adopted in 1953. Palau has no equivalent of the UCC. Therefore, courts are forced to search for precedents in the United States among decisions that were taken prior to the adoption of the UCC. Since commercial practice in the United States has evolved substantially over the past 50 years, Palau's commercial legal system is hampered by having to rely on outdated precedents. Legal practitioners in Palau reported that there is a draft bill in the OEK to abolish the use of US common law and precedent, although they indicated that it would probably not be passed. They strongly opposed the draft legislation, on the grounds that it would result in "chaos" in the application of the law.

91. Additional gaps in the commercial legal system exist. For example, there is no specific legislation governing the sale of goods in Palau. The lack of a bankruptcy statute for individuals or companies has significant effects on the cost of doing business.

#### 1. Sale of Goods

92. Free exchange is an essential building block of private sector development because it permits trade and the gains that stem from specialization. In most countries, the legal framework for the exchange of goods is governed by a "Law of Sales," which provides for freedom of contracting and may be used to set up a variety of transactions, including sales. A country can benefit from having laws that explicitly identify the rights and obligations of parties to contract as these serve to reduce the costs of contracting.

<sup>16</sup> The common law of contract as set out in The American Law Institute *Restatement (Second) Conflict of Laws*, §188, 1981. This sets out the principles in terms of which contract law is applied and interpreted.

<sup>17</sup> Ryan, D.P. 2005. *Essential Principles of Contract and Sales Law in the Northern Pacific*. New York: Universe, pp. xxxv,xxxvi

<sup>18</sup> However, local customary law or written statutes supersede common law.

93. Ordinary business deals would require contracts extending to many pages if they could not rely on a legal system with clearly defined rules and precedents. Parties using such contracts would have concerns about the possible interpretation of the contract's clauses by other parties and the court. In Palau, where there is reliance on outdated US precedent, it is natural that case law is incomplete with respect to several aspects of any given contract. Therefore, transactions that rely on case law are risky, and that risk raises transactions costs for private sector contracts and business dealings.

94. Laws governing sales—an essential area where even the most ordinary statutes could include basic principles providing security and enforcement—do not exist in Palau. In the absence of sales-related legislation, issues such as the rights and obligations of parties and damages in case of breach of contract, warranties of merchantability, or fitness for a particular purpose must rely on outdated US precedent. Merchant liability is important in increasing economic efficiency, as businesses that are liable for production mistakes will be forced out of the market. Product liability reduces transactions costs by lowering risks. Without such liability, a buyer only feels comfortable buying from a seller with a well-established track record. If a new competitor enters the markets, buyers are slow to purchase from that competitor, even if prices are lower, because other product quality aspects are unknown. This legal gap in Palau limits competition, efficiency, and market growth; the situation should be rectified.

## **2. Bankruptcy Issues in Palau**

95. Efficient economies require means for firms not only to enter but also exit the market; in other words, to go through bankruptcy. By means of bankruptcy, resources that were tied up in an inefficient firm can be released to more efficient purposes, thus increasing economic dynamism and stimulating private sector growth.

96. Bankruptcy is distinct from secured lending because it serves a different economic purpose and social end. Bankruptcy cancels debt collection and replaces other penalty systems for defaulting debtors—of which some can be draconian. Secured lending, on the other hand, facilitates debt collection. It works by improving security and information. Borrowers can then more readily prove their creditworthiness. Lenders can make loans with less risk and collect them more easily. This in turn makes lenders more inclined to lend, which allows for business investment, financial market development, and ultimately, economic growth.

97. The original gain from bankruptcy arose from ending practices perceived as socially damaging. An imprisoned debtor not only produced nothing, but also required feeding. Originally, bankruptcy had no direct effect on the position of the secured lender: the secured lender's first recourse was the collateral for the loan. Only if that collateral was insufficient did the bankruptcy system apply to the balance (that which exceeded the sale of the collateral).

98. In general, legislation dealing with bankruptcies can be classified into two categories:

- (i) Those affecting individuals.
- (ii) Those governing the insolvency of entities, particularly companies.

99. Palau lacks a legal framework for bankruptcy, which presents some important drawbacks. The proof of debt procedure is also long and complicated for the average debtor or creditor. Even when only insignificant sums are involved, legal practitioners must be employed to assist clients in navigating through the complex maze of

procedures. As pointed out in the chapter on financial markets, debtors who cannot afford lawyers are still faced with large legal bills from the creditors' lawyers. There is no means by which any debts can be discharged, so that many people have no hope of getting out of debt. A bankruptcy law could help resolve this, although any legislation must protect the rights of creditors.

### **3. Company Formation**

100. It is not difficult to form a company in Palau, although the President signs every corporate charter personally. But there are a number of other requirements that increase the burden of the process. For example, in addition to the company charter, a national business license is necessary; some states, such as Koror, require a state business license. There are yearly reporting requirements for every corporation that is domestically held and quarterly reporting requirements for foreign-owned corporations. Companies must provide financial and other information regarding directors. The requested information repeats much of the information contained in tax filings, and in general the information requests are very intrusive.

101. Foreign-owned corporations face additional burdens. There are essentially two separate commercial law systems in the country: one for Palauans and one for non-Palauans. The law for the latter is determined by the Foreign Investment Act, but its application is very subjective. The FIB requires a statement of no objection for the transfer of shares in foreign-owned corporations, a requirement that impacts the ability of corporations to do business. Finally, as is true in other Pacific countries, in Palau the prescribed activities attract many untrustworthy individuals.

102. Foreign business licenses are of limited duration, with terms ranging from 10 to 30 years, and this limit can serve counter to Palau's interests. A recent example is provided by a Japanese tour booking company, whose 10-year license expired. A 2-year extension was granted, but there will be no further extensions. Legal practitioners in Palau speculated that the business will almost certainly continue to operate by using a front, with much of the revenue moving offshore, a situation that does not benefit Palau in any way.

### **4. Arbitration**

103. Arbitration is a form of alternative dispute resolution that allows for the resolution of commercial disputes outside the court system. When both parties agree to arbitration, they present their arguments to an arbitrator, who may be a legal practitioner or an expert in the area that relates to the disputed contract. Arbitration frequently allows for settlement of contract disputes at a much lower cost than is possible using the courts. Therefore, expanding arbitration involves working with a legal framework where the costs outweigh the benefits, especially for sole proprietorships and small and medium enterprises.

104. Currently, there is no legislation governing arbitration in Palau. Furthermore, the courts have ruled that provisions in contracts that allow for future arbitration in the event of disputes are not binding on the parties to the contract. In practice, this problem has been overcome in Palau by using external jurisdictions for agreements. However, such provisions can only apply to large companies and are of little use to small businesses and sole proprietorships, which could most benefit by the introduction of arbitration in Palau. What is needed in Palau is an arbitration system that is available for smaller businesses and transactions; a system that follows customary dispute resolution

mechanisms with formal legal standing and enforceability outside a closed community network.

## **5. Enforcement**

105. While legal practitioners described the judiciary as the most efficient branch of government in Palau, issues exist with respect to enforcement, especially in relation to debt. To execute on debt default can take several years. This is not necessarily related to enforcement issues per se, but rather to the legal framework itself. As the preceding discussion illustrates, in many cases, the laws in Palau are outmoded and not suited to modern business practices. Modernization will help significantly in reducing enforcement problems.

### **B. Issues Related to Land and Fixed Property Rights**

106. Only Palauan citizens can own land, but foreign individuals or foreign-owned corporations can lease land from a Palauan citizen. Legislation allows for 99-year leases, but a court decision has held that this amounted to *de facto* ownership, and set a limit of 50 years on leases. Currently, there are attempts to pass legislation to extend leases to 99 years, but the issue is controversial within Palau.

#### **1. The System of Landholding in Palau**

107. The history of land ownership in Palau is unique among the Pacific islands. Palau became a German colony in 1899, and the concept of individual property was introduced. "Land Book" recording began using a metes and bounds survey system.<sup>19</sup> In 1926, during the period of Japanese colonization, a survey of the entire country commenced. By the Second World War, there were both complete surveys and Land Record Books for most states. However, during the war, the records for four of the states were destroyed. Both the complicated colonial history and the destruction of records have resulted in a large number of land disputes.

108. Currently, the Land Court is creating a new system of land recording and registration, and there is an ongoing program to register all land in the country. At this time, the Land Book is still used as evidence to prove ownership. A drawback with land law, however, is that it makes no distinction between legal and equitable title. In practice, this implies that the owner of a parcel of land cannot legally assign the use of it to someone else. The failure to distinguish between types of holdings weakens the validity of leasehold title. Foreign investors indicate that difficulties and uncertainties with land lease holding are major problems associated with doing business in Palau.<sup>20</sup>

109. Land holdings are complex. In the past, lineages, clans, or villages owned most of the land. Inheritance was and remains matrilineal. More recently, individual ownership among Palauans has spread rapidly, as the value of land parcels has risen, particularly as new houses have been constructed. Several knowledgeable observers in Palau indicated that as private ownership has spread, the care, development, and cultivation of land has improved. Estimates put the number of private land parcels in the country at about 20,000, of which approximately 10,000 are registered. The Government owns a

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<sup>19</sup> A system for recording the boundaries of properties identified by directions and bearings of the compass. In Palau, this initially consisted of rough sketches (called the Tochi Daicho).

<sup>20</sup> The World Bank Doing Business Indicators accord Palau a very high ranking in terms of the ease of registering property. However, detailed investigation reveals that this ranking is spurious. There are many uncertainties in land dealings in Palau, as the accompanying discussion indicates.

significant portion of the land in Palau, but because much of this ownership is derived from the colonial past, a large portion of land in government possession is being disputed.

110. Although some states have taken over their land administration, the Land Court has jurisdiction over land disputes for public lands. It meets regularly to hear cases and to hand down judgments, but there is a substantial backlog of cases because of the complexity of the issues.

## 2. Lease Issues

111. The way land leases are structured has a powerful influence on the willingness of landowners to lease their land, their satisfaction with lease arrangements, and the term and type of investments that lessees will make. Essential elements of lease structures that promote both lessor satisfaction and confidence in lessees are:

- (i) **Long-term leases.** The length of the lease becomes increasingly important as the time of the lease proceeds. While 50-year lease terms are not a constraint at the outset of the lease, as time proceeds, expiry dates become increasingly important.
- (ii) **Terms of the lease for the lessor.** Lessors must have a mechanism for the adjustment of lease payments that reflects the success of the lessee. If all windfall benefits accrue to the lessee, lessors will feel that they have been taken advantage of.
- (iii) **Ability of the lessee to renew a lease.** If lessees are successful but unable to renew their leases under circumstances in which lessors are sharing in the success of a project, investment will be reduced.

## VI. CONCLUSIONS

112. This paper examines various issues related to the relationship between private sector development and Palau's future economic growth. It analyses current policy measures within the context of the debate among Palauans regarding the future of the country, the benefits of growth to Palau, and the structure of Palauan society. It concludes that many issues are holding back development of Palau's economy by restricting growth while failing to contribute to achievement of Palau's societal goals. In particular, a number of policy measures being implemented by the Government with the aim of helping Palauans play a greater role in the economic life of their country are in reality having a negative effect, and are hindering the development of Palau as a modern vital economy.

113. The Executive Summary outlines a list of reform measures, including: (i) reducing the role of the state in the economy through trimming of government payrolls; (ii) opening infrastructure services to public private partnerships; (iii) modernizing the legal system; (iv) strengthening the financial system, including introducing a modern framework for collateralization; (v) focusing on high-end tourism; (vi) improving the system for employing foreign workers; (vii) making the framework for landholding more investor friendly; and (viii) overhauling the system for attracting foreign investment. These changes will enable Palau to raise its potential growth rate, in spite of its small size. With an appropriate policy mix, there is no reason why the country cannot achieve levels of prosperity that rival those of the industrial countries.

114. With little effort, Palauans have the potential to combine prosperity, preservation of their way of life, and conservation of the country's natural resources. It requires, however, that the Government engage its citizens in a constructive debate to resolve the uncertainty regarding Palau's future direction, and then establish laws and incentives that reflect modern economic realities, and which allow Palau to meet the global economic challenge that even very small countries face. All elements of Palauan society will need to work together to achieve these ends, but future possibilities are bright if this can be achieved.

## THE COLLATERAL FRAMEWORK IN PALAU

1. Interviews with bankers, regulators, and businesses indicated that there are many deficiencies in the collateral framework that impact negatively on the ability to borrow and the risks of lending. This Appendix outlines in detail some of the deficiencies of the secured transactions framework in Palau and makes suggestions for reform.

### A. Elements of a Properly Functioning System of Secured Transactions

2. For borrowers to be able to pledge movable property as security for loans and for lenders to be able to accept such property as collateral, the secured transaction system must provide for the following essential functions.

- (i) **Creation.** Creation is the process by which the creditor establishes a security interest in property (the collateral). Creation must cover all economically important property and transactions in such property; agents and the law must permit creation at a low cost relative to the value of the transaction.
- (ii) **Priority.** A properly functioning system must provide for the unambiguous ranking of priority rules—by which the lender establishes the priority of the security interest against all other claims in property—and protect the secured party from hidden claims of third parties, including other secured creditors, unsecured creditors, a trustee in bankruptcy, some purchasers of the collateral, labor claims, and government tax claims.
- (iii) **Registration.** A legal process must be in place that makes public the ranking of the priority of the security interest. It must let a potential lender establish a ranking of priority in collateral by filing a notice of the security interest in a publicly available archive or registry. It must also let a potential lender search the archive easily, quickly, and inexpensively to determine whether other claims exist against a borrower's property.
- (iv) **Enforcement.** The enforcement process—by which, upon the debtor's default, the creditor will seize and sell the collateral to satisfy the secured claim—must take place quickly relative to the economic life of the property, and cost little relative to the value of the transaction secured with such property.

3. The legal framework in Palau for secured transactions does not provide for these essential economic and legal functions. In every area, problems prevent the secured transactions process from functioning in a way that gives confidence to lenders that in the event of default they can seize the property and sell it to satisfy the debt. These problems are analyzed below. The secured transactions framework in Palau requires a new law, a new way in which to register security interests, a new way of enforcing repossession in the event of default, and the abrogation of clauses in other laws that could adversely affect the functioning of a secured transactions system. Partial reform of the secured transactions framework in Palau will have little impact on improving access to credit. The system must be reformed at each of the critical stages that determine whether lenders can take security interests in movable property with the expectation that in the event of default, the assets can be repossessed quickly and sold at relatively low cost, in a manner that will allow the repayment of the debt. This requires drafting a comprehensive statute, regulations, and filing system governing the entire process.

## **B. The Creation of Security Interests**

### **1. Problems**

4. Legal practitioners specializing in debt collection described the process of creating security interests in Palau as “chaotic.” There is no requirement in the law for registration of security interests. As a result, courts have refused to authorize repossession based on the registration of property as collateral for lending. Since there is no requirement for the registration of security interests, there is no way that they can be assigned. This eliminates the potential for using assets such as accounts receivable as collateral.

5. Legal issues outside the realm of pledging security also affect secured lending. The Usurious Interest Act sets interest rate ceilings on loans at 18% per annum. While this may seem high, other work<sup>21</sup> has found that for smaller and micro loans, interest rates of 2.5% per month (or 30% per year) are necessary to cover risks and transactions costs. For example, a highly successful microcredit program in Vanuatu charges interest rates of close to 50% per year and evaluations report substantial borrower satisfaction. The Palau interest rate ceilings prevent the development of such programs, however. To be fully effective, any reform should repeal such ceilings.

### **2. Solutions**

6. A properly functioning system of secured transactions integrates all functionally identical security devices (leasing, trust, pledges, mortgages, hire purchase, and assignment of rights) into one comprehensive legal framework and filing system. This broader concept—a functional approach—organizes security interests along the lines of what actually serves as an instrument of security. The most beneficial economic impact is assured when the law includes a broad coverage of all property, transactions, and lenders, with minimal restrictions on lenders or descriptions of collateral. Either individuals or companies should be able to create security interests. To permit and facilitate inventory financing, the legal framework should permit parties to choose a security interest against “generally described” collateral. The law should not require that the security agreement or the court be required to identify items of collateral specifically. To meet standards for fast collection, crucial for the greatest economic benefit, the law should permit continuation in proceeds and set out clear rules for their recovery; these should supersede old narrow rules for the tracing of proceeds.<sup>22</sup>

## **C. Prioritization of Security Interests**

### **1. Problems**

7. Priority plays an essential role in a secured transactions system: it establishes the order in which the enforcement procedure will satisfy claims against the property serving as collateral. The creditor with the first priority will have its claim satisfied, on sale of the collateral, before a creditor with second priority. Priority problems lie at the

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<sup>21</sup> See Holden, Paul, Sarah Holden and Jennifer Sobotka. 2003. *Policies Towards Micro Credit Institutions: What do the Data Tell Us?* Washington, DC: Multilateral Investment Fund.

<sup>22</sup> As with all good legal drafting, the new law must rule as inapplicable or derogate all procedural and other rules that conflict with this principle. In those derogations, it must address the other public policy issues that arise when amending those laws. It must also add enforcement rules consistent with this principle.

heart of a legal system for secured transaction because they present insurmountable difficulties in determining the value of the property as collateral. In a fragmented framework, the existence of different laws concerning security interests provide unclear information regarding registries and priorities. Where ambiguity or conflicts of priority exist, secured financing will not take place at all.<sup>23</sup> Typically, recording a notice or filing of the lender's security interest in an office of recordation where the notice is publicly available will establish priority through the date and time of the record.

8. Palau has not adopted any of the provisions of UCC 9, which in the United States governs the framework for secured transactions. Since there is no requirement for registering security interests, there is no way in which the priority of any pledged assets can be determined.

## 2. Solutions

9. To remove ambiguity regarding priority, any reform should place the priority rules in one law that applies to any and all interests in property. This arrangement should cover all types of security interests, including financial leases, consignments, and sales with retention of title. It will also establish clear and unambiguous priority among existing special instruments.

### D. Publicity (Perfection of Security Interests)

#### 1. Problems

10. Due to the chaotic nature of recording security interests, publicizing them in Palau is virtually impossible. Lenders have no sources to refer to in order to determine whether there has been a prior registration. A number of issues must be resolved in order to reform the system.

11. **Registry versus notice filing archive.** Within a framework of making public a security interest, differences exist between an approach that registers the agreement, and one using a notice filing archive. In a system that registers the agreement, a lender registers the entire security agreement or a lengthy abstract of it. The registry staff will typically undertake some check of the agreement's legal correctness. In practice, however, this check is of little value, because registry staff members lack the skills necessary to detect irregularities in the documents. By contrast, in a system of notice filing, the lender files only a "notice" of the existence of the security interest. The notice filing archive takes responsibility only for correctly entering the information provided by the lender in the notice, and for maintaining the database and public access to it. The parties to the security agreement are responsible for the correctness of the underlying document and for keeping copies of any agreements.

12. A new law of secured transactions should eschew requirements that call for filing of the entire agreement. Registering the entire agreement is more costly, and costs are not standard; checking is complex and time consuming. Moreover, because so much

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<sup>23</sup> In default, loans without priority will become portfolios of uncollectible loans unless the assets of the business, when sold, are sufficient to allow all creditors to be paid. Indeed, a secured loan by definition cannot have a conflict of priority. Without resolution of priority, even a loan that the law defines as a secured loan is, in economic terms, unsecured.

information is filed, both filers and administrators have incentives to restrict public access. This defeats the purpose of the filing system: making such data public.

13. **Private versus public operation.** There are many ways to organize the management of a filing archive that records security interests. Many different examples exist around the world, ranging from management by a consortium of private operators to those operated entirely by the state. Hybrid management systems also exist in which the management of the filing archive is operated by a non-profit user group that includes associations (e.g., an association of banks, a chamber of commerce, and an association of lawyers), which is then overseen by the Ministry of Justice. This approach has been followed in Romania and Colombia with great success. Canada has experimented with a monopoly private franchise with less success. The United States has kept a state-operated core with many private points of entry, which allow lenders to check whether security interests have been registered against property that is being pledged as collateral. While many management options exist, all registries or filing archives should meet certain core criteria for effective operation.

- (i) Information on the existence of a security interest should be readily available at low cost, both for particular assets and for particular persons, organizations, or companies.
- (ii) It should be simple to record security interests in collateral.
- (iii) The system should easily and reliably rank priority over pledged assets.
- (iv) The information should be available remotely over the Internet.

## 2. Solutions

14. Any reform should introduce an electronic filing archive as described in the preceding sections. For example, an association of banks and lawyers could establish and run an archive. A relatively inexpensive notice-filing system requires only that creditors file a notice of the existence of the security agreement. The law should require simple and standardized information so that simple databases can readily store it and make it accessible to registered users over the Internet. Potential lenders can then check existing security interests and other encumbrances on property by searching the filing system themselves.<sup>24</sup>

## E. Enforcement

### 1. Problems

15. The ability of the creditor, in the event of default by the debtor, to repossess and then sell the property that the debtor gave as collateral lies at the heart of any system of secured transactions. Any rational lender or credit seller will focus on the value of collateral after the costs of sale and seizure, not on its nominal market value when it is pledged. Lenders who face slow and expensive enforcement will simply adjust the size of the loan downward relative to the value of collateral realized after the costs of sale and seizure. Alternatively, lenders will not make loans under circumstances where repossession is overly costly or uncertain.

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<sup>24</sup> Where lenders find notices filed, they can ask borrowers for evidence of the relevant security agreements or for authorization from the borrower to gather information directly from the debtor's other creditors.

16. Enforcement of contracts in Palau currently takes place through the court system. Cases involving sums of \$5,000 or less are heard in the Court of Common Pleas, with all other claims heard in the High Court. In practice, there are few delays. Even so, enforcement of judgments in commercial cases is not rapid.

17. Currently, the schedule for processing unpaid debts is as follows:

- (i) A judgment can be obtained 20 days following failure to respond to a demand for payment. A pre-judgment attachment can be obtained when the lawsuit is filed.
- (ii) A writ of execution can be obtained 14 days after the judgment. Attorneys report that there is reasonable accommodation in debt collection, in that bailiffs (Public Safety) do cooperate in repossession to enforce judgments.
- (iii) If repossession is resisted, it can take 3–8 months to obtain a motion of summary judgment; this may extend to 2 years if a trial is involved.

18. Lawyers in Palau report that there is growing opposition within the political and legal communities to creditors' rights.

## 2. Solutions

19. Any new law should permit non-judicial repossession (when possible without disturbing the peace)<sup>25</sup> and specify rapid "ex parte" court orders for forcible repossession. If the borrower agrees to non-contested repossession, or if it could be done without disturbing the peace, such activities should be carried out by private agents. If the circumstances under which repossession takes place could lead to violence, then the involvement of law enforcement officials is necessary. These methods should be administered by the courts, but can be carried out with a minimum of delay and without recourse to judicial hearings or other procedures that could slow down execution.

20. Collateral must be saleable through creditor-administered sales conducted under commercially reasonable standards.<sup>26</sup> However, there should be no prohibition on any form of sale, as long as there is no collusion in the selling process. Creditors that have repossessed property should have the right of private sale without the need to advertise, and should not have to go through court mandated procedures such as auction, compulsory valuation, use of court specified sellers, and other mechanisms that are common in unreformed secured transactions systems. The essence of reform of the sale of repossessed property is quick and inexpensive collection mechanisms. However, consumer protection principles should be observed in such seizure and sale. Critical criteria for this process are as follows.

<sup>25</sup> Called "harmless repossession" in reformed systems

<sup>26</sup> Suitable measures, when properly drafted and explained, include: legal instructions for summary court judgments (ex parte court orders); harmless repossession, wherein the lender can repossess collateral without court intervention; expanded private authority for repossession; and expansion of public services to include some private incentives and competition. Suitable measures include penalties against public officials who do not carry out duties in conformity with law; these might be personal or they might involve automatic compensation from state funds for delays (e.g., a credit against taxes equal to the interest foregone on the uncollected debt). These elements provide a legal framework for creditor-administered sale, sanctions for creditors that abuse that process, and a workable way to enforce those sanctions. That legal framework should cover the rules of commercial reasonableness, rules for notification of debtors, specification of rights of redemption, and conditions under which the secured party may undertake strict foreclosure (seizing and keeping the collateral).

- (i) In the event of default, creditors should be able to obtain the pledged collateral rapidly and inexpensively.
- (ii) There should be no legally mandated process for the sale of the collateral. For example, the law should not specify that the property should be auctioned or that the sale has to be publicized.

21. Penalties for the abuse of repossession and sale should be severe in order to strongly discourage the abuse of the secured transactions framework by unscrupulous lenders.

22. Weakening creditors' rights in Palau would be a severe step backwards. The effect would be to sharply reduce lending by the banking system and would result in a large increase in business for loan sharks, who charge rates of interest that amount to several hundred percent per year. Such lenders flourish in systems where creditors' rights are weak. Pending legislation in Palau requires careful consideration of this issue.