

INTERNATIONAL MONETARY FUND



# **Staff Country Reports**

## **Republic of Palau: Selected Issues and Statistical Appendix**

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INTERNATIONAL MONETARY FUND

REPUBLIC OF PALAU

**Selected Issues and Statistical Appendix**

Prepared by Wafa Abdelati, Qaizar Hussain (both APD), and Yuko Kinoshita (INS)

Approved by the Asia and Pacific Department

February 1, 2006

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## I. PRESERVING BANKING SECTOR SOUNDNESS<sup>1</sup>

1. **Palau has a relatively large financial sector that lacks adequate regulation and supervisory oversight.** It began implementing its regulatory and supervisory framework in 2001, but the legal framework remains at a very early stage. This chapter describes Palau's financial sector and its recent performance, followed by developments in regulatory reform.

### A. Structure of Financial System

2. **The financial sector in Palau is large relative to its population of 20,000.** At present, there are eight licensed commercial banks,<sup>2</sup> a government-owned development bank, five insurance agencies, a number of credit unions, and twelve remittance agencies. The existence or non-existence of offshore banking activities has not been fully verified in light of scarce information.

3. **Foreign banks dominate the banking system.** The eight commercial banks have total deposits of \$112 million (79 percent of GDP) and total net loans (outstanding loans less provisions for bad loans) of \$67 million (48 percent of GDP) (Table 1). The three largest US-based FDIC insured banks (Bank of Hawaii, Bank of Guam, and Bank Pacific Ltd.) account for about 74 percent of deposits and 63 percent of net loans with Bank of Hawaii holding half of the system's deposits. These foreign banks are largely retail banks with small-scale commercial customers and funds in excess of bankable loan projects are typically deposited at their headquarters. The fourth foreign bank, First Commercial Bank, accounting for 4 percent of total deposits, is a branch of a bank based in Taiwan Province of China. The remaining four banks are locally chartered.

4. **The National Development Bank of Palau (NDBP) is a large government-owned bank with a primary focus on housing and small businesses.** The NDBP was established in 1982 with the objective to operate on a commercial basis. Its loan portfolio currently accounts for 10 percent of GDP. The Bank extends short-term loans (5–7 years) to agriculture, fisheries, and small businesses, and larger long term loans (15–20 years) mainly for residential housing and business facilities. Loans are typically collateralized through real estate property. The NDBP can assume the title of land in case of default (by contrast, foreign banks are prohibited by law from owning real estate). It also guarantees commercial loans up to 90 percent of their value for a fee. It does not accept deposits from the public. NDBP's main funding in recent years has included a \$5 million loan in 2004 from the a bank in Taiwan Province of China and approval to draw up to \$3 million from the Social Security Administration, of which only \$1 million has been drawn.

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<sup>1</sup> Prepared by Qaizar Hussain (ext. 37334).

<sup>2</sup> There were over 30 banks in the 1990s which declined to 12 in 2001 and to 8 in 2005.

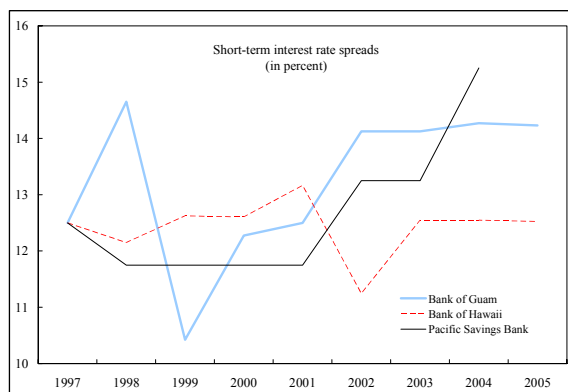
## B. Recent Performance

5. **Like other banking systems in the region such as in the FSM and the RMI,** systemic risks in Palau are mitigated by the dominant presence of foreign-owned banks. Local banks, however, continue to be subject to such risks. In addition to being large, the foreign-owned banks are supervised under the arrangements of their home countries, which subject them to fit-and-proper tests for bank licensing. However, this is not yet the case for locally-chartered banks in Palau.

6. **Banks are subject to a number of constraints.** Banks are generally constrained by a small market, weak infrastructure, governance problems, lack of deposit insurance in Palau, and inadequate regulations. These factors limit the scope to increase the deposit base and diversify the lending portfolios, most notably in rural areas. The bulk of the loans are short-term consumer loans which require payroll deductions or employment contracts for foreign workers while some larger loans are in the housing sector. Given problems with land ownership and illiquid markets for fixed assets, loans are often not secured by collateral reflected in high lending rates. As noted, foreign banks are prevented by law from acquiring real estate property. Weak audit practices in some banks may also have contributed to fraud, insider lending and improper reporting.

7. **Based on limited banking data, bank performance appears to be mixed.**

Available data suggests that banking operations are sound and slightly profitable and all local banks are capital solvent. High interest rate spreads (8–15 percent)<sup>3</sup> and a growing economy seem to have helped banks' profitability of foreign banks. Banks' interest margins to gross income are high at 85 percent. The reports show that the U.S. banks enjoyed the return on assets of 2.1 percent, while the remaining banks experienced a small loss. The banking system has expanded its lending over the years. During 2002–05 total net loans grew by about 20 percent and U.S. banks' lending share increased slightly. Although nonperforming data are unavailable, banks report that loan delinquency rates are a growing problem—rates currently range from 1½ percent to 10 percent. Although there is some variation within U.S. banks on the extent of problem loans, in general the problem seems to be more pronounced in non-U.S. banks. Finally, banks' liquidity risk seems to be high with the share of liquid assets in total assets as being only 10 percent.



<sup>3</sup> The statutory maximum lending rate is 18 percent.

8. **The performance of the National Development Bank has improved in recent years but a large fraction of problem loans remain on its portfolio.** On the positive side, its return on assets has been steady at around 5½ percent for the last four years. However, the Bank continues to be heavily concentrated in the housing sector, and has nonperforming loans (overdue by 180 days), amounting to \$2.3 million (15 percent of outstanding loan portfolio) arising from the slump in 2001/02. In addition, the bank has extended guarantees (for a fee) to commercial banks amounting to \$1.2 million which is backed by collateral, as the foreign banks cannot accept collateral under current legislation. The bank has recently increased its provisions for bad loans, intensified efforts to recover delinquent loans, strengthened its operating procedures, and its accounts have been externally audited.

### **C. Developments in the Regulatory and Supervisory Framework**

9. **Palau's banking system has come a long way since the 1990s when its banking system was largely unregulated and unsupervised.** As a result of reports in late 1999 and early 2000 that offshore banks in Palau had carried out money laundering activities, a few international banks banned financial transactions with Palau. In response, Palau established a Banking Law Review Task Force that recommended financial control legislation to the Congress in 2001. Upon reviewing the new legislation in September 2001, the Financial Action Task Force (FATF) decided not to list Palau among the non-cooperative countries and territories in the context of money laundering. Following this, Palau took several steps toward addressing financial security through banking legislation and supervision and putting in place a legal framework for an anti-money laundering regime. These reforms helped downsize the banking sector from 30 to 12 banks in 2001.

10. **The main reforms to the legal framework occurred in 2001 and 2002 with the passage of five laws to promote prudential and AML/CFT regulations and supervision.** The first law, the Financial Institutions Act (FIA), pertained to prudential regulation and supervision of the financial system while the second set of laws—(i) Money Laundering and Proceeds of Crime Act (MLPCA); (ii) Mutual Assistance in Criminal Matters Act (MLAA); (iii) Extradition and Transfer Act; and (iv) Foreign Evidence and Act—focused on AML/CFT issues.

11. **One main objective of the Financial Institutions Act, passed in 2001, was to provide for the establishment of the independent Financial Institutions Commission (FIC), responsible for licensing, supervising, and regulating financial institutions, defined as banks and security brokers and dealers (none exists at this time).** However, the contents of the FIA differed from the original bill submitted to parliament because of parliamentary disagreement on the powers of the FIC and prudential provisions, including capital requirements for local institutions, conditions to obtain a bank license, and authority to conduct regular on-site bank examinations. The original bill also did not provide FIC with sufficient resources to regulate and supervise banks, including the flexibility to charge fees in order to recover its expenses.



12. **Four years on, the FIC (Box 1) has made some progress, but it still lacks sufficient authority and resources to undertake its supervisory responsibilities.** At the time of its establishment, two voting members of FIC belonged to the banking industry (representing one domestic and one foreign bank) causing conflict of interest concerns. Subsequently in 2004, the composition of the Board was changed so that none of the members are from the banking industry. The FIC has also prepared 12 financial regulations to implement the laws (see below). Most banks have been providing balance sheet statements to the FIC since 2003, even though they are often incomplete and not in standardized format. It is reported that the FIC has successfully decommissioned some banks, in spite of lawsuits questioning its authority under the current legislation. Despite these advances, the FIA significantly constrains the ability of the FIC to raise sufficient resources to fund its operations and FIC's budget has to be approved by the Congress. Also, the FIC has received only one out of five recommended professional staff and a small budget due to concern by some legislators that the proposed FIA amendment could grant FIC's staff and Board excessive power that could be misused for political objectives.

**Box 1: Financial Institutions Commission**

The FIC was established in 2002. In addition to the Commissioner, there is an Executive Board consisting of five voting members, and the President of the National Development Bank of Palau, is ex-officio, the sixth non-voting member. The Board is semi-autonomous and consists of well qualified members. The appointment of the members is made by the President based on the initial selection by the Chamber of Commerce. Government employees cannot be members of the Board.

13. **The second set of laws passed in 2001 pertained to AML/CFT.** Four companion acts made money laundering a crime and created a Financial Intelligence Unit (FIU). They also provided for Palau's cooperation with foreign authorities including on extradition and related matters and for conditions under which information could be admitted as evidence. The FIU was formally set up in 2003 within the Office of the Attorney General and is headed by an Assistant Attorney General. However, it has not been separately funded, as proposed.

14. **In spite of progress in introducing legislation,** Palau was assessed in 2002 under the Fund's Offshore Financial Center (OFC) assessment program as non-compliant on 16 out of 25 Basel core principles. In order for prudential and AML/CFT supervision to be effective and to address the substantial aspects of the FATF 40+9 Recommendations, the amendments to the FIA and MLPCA would need to be adopted.

15. **Both the FIC and FIU's authority,** budget, and governance structures need to be further strengthened so that these institutions can fulfill their functions. While the passage of the amendments to FIA and AML laws, and the accompanying regulations (see below) will provide for greater powers for the FIC and the FIU, these agencies will also need to significantly improve their capacity through adequate and well-trained staff. External technical assistance can be helpful in this regard. Contingent on funding, the FIC expects to hire one examiner in FY2006 followed by another in FY2007.

#### **D. Pending Legislative Reforms**

16. **Critical financial legislation has been stalled in Congress since 2001.** The executive and the Congress have differed in their views on the speed of reforms. To take an example, in November 2003 the President vetoed legislation twice adopted by the Congress to reduce the minimum capital requirement from \$0.5 million to \$0.25 million, extend the FIA compliance period from 2003 to 2005, and reinstate all licenses revoked after the passage of FIA in June 2001.

17. **The FIA amendment was resubmitted to the newly elected Congress in January 2005.** The amendment aims to rectify the shortcomings of the original FIA approved by Congress in 2001 mainly related to the powers of the FIC and key prudential provisions, as noted above. However, no action has been taken until December 2005, when the Senate held a first hearing on it. If the amendment is passed, it would allow FIC to issue regulations without the approval of the Congress.

18. **A draft amendment to the MLCPA of 2001 aims to strengthen the anti-money laundering regime was resubmitted to Congress in January 2005.** The amendment is needed to address the substantial aspects of the FATF 40+9 Recommendations, and to clarify the four AML laws, provide for a fuller regulatory coverage of financial institutions, including alternative remittance providers, mandatory reporting of suspicious transactions, and providing for a greater effectiveness of the FIU. No hearings have been held on this amendment to date.

19. **Twelve regulations are needed to implement the FIA and MLCPA.** These 12 financial regulations were prepared by the FIC during 2002–03 which cover various aspects of banking, including reporting, record keeping, know your customer, internal controls, and procedures, and other measures that financial service providers must put in place (see Annex for brief description on each regulation). The authorities have circulated these regulations to the banking industry in advance for information and some banks have begun to comply in anticipation of their adoption. The regulations are broadly in line with IMF advice and would go a long way toward introducing an adequate regulatory framework. As noted earlier, if FIA amendment is adopted, FIC can issue the regulations and modify them as needed—as had been intended by the original FIA.

#### **E. Conclusion**

20. **Palau has a relatively large financial system with a weak regulatory and supervisory framework.** While the systemic risk to the economy is, to some extent, mitigated by the dominant presence of foreign-owned banks, weaknesses in the financial system, nevertheless, impede growth and development goals of Palau. Though the authorities have taken initial steps for reform, much remains to be done in terms of improving the legislative framework as well as the capacity of the supervisory and regulatory institutions. At the same time, continued efforts are needed to strengthen the large and expanding lending portfolio of the development bank.

Table 1: Palau: Selected Bank Balance Sheet Data 1/

(In millions of US dollars)

	2002 2/			2005		
	FDIC-insured banks	Other banks	Total	FDIC-insured banks	Other banks	Total
<b>Assets</b>	83.7	35.6	119.2	61.3	39.3	100.6
of which: Notes and coins	2.0	3.5	5.5	1.9	1.3	3.2
Deposits due from other FIs	48.8	2.0	51.8	0.0	6.2	6.2
Net loans and overdrafts 3/	32.6	23.6	56.2	42.7	24.7	67.4
Net fixed assets 4/	0.2	2.6	2.7	0.1	1.1	1.2
Other assets	0.1	2.4	2.5	16.6	5.7	22.3
<b>Liabilities</b>	85.8	30.5	117.0	82.3	33.8	116.1
of which: Deposits	85.5	24.7	110.2	82.2	29.7	111.9
Other liabilities	...	6.8	6.8	0.1	0.6	0.7
<b>Capital 5/</b>	-2.1	5.1	2.2	-21.0	5.5	-15.5
(In percent of total)						
<b>Assets</b>	70.2	29.9	100	61.0	39.0	100
of which: Notes and coins	36.4	63.6	100	58.8	41.2	100
Deposits due from other FIs	94.2	3.9	100	0.0	100.0	100
Net loans and overdrafts 3/	58.0	42.0	100	63.3	36.7	100
Net fixed assets 4/	7.4	96.3	100	6.6	93.4	100
Other assets	4.0	96.0	100	74.6	25.4	100
<b>Liabilities</b>	73.3	26.1	100	70.9	29.1	100
of which: Deposits	77.6	22.4	100	73.5	26.5	100
Other liabilities	...	100.0	100	12.2	87.8	100
(In percent of GDP)						
<b>Assets</b>	69.3	29.5	98.7	43.2	27.7	70.9
of which: Notes and coins	1.7	2.9	4.6	1.3	0.9	2.3
Deposits due from other FIs	40.4	1.7	42.9	0.0	4.3	4.3
Net loans and overdrafts 3/	27.0	19.5	46.5	30.1	17.4	47.5
Net fixed assets 4/	0.2	2.2	2.2	0.1	0.8	0.8
Other assets	0.1	2.0	2.1	11.7	4.0	15.7
<b>Liabilities</b>	71.1	25.3	96.9	58.0	23.8	81.8
of which: Deposits	70.8	20.5	91.3	57.9	20.9	78.9
Other liabilities	...	5.6	5.6	0.1	0.4	0.5
<b>Capital 5/</b>	-1.7	4.2	1.8	-14.8	3.8	-11.0
<b>Memorandum item:</b>						
Net income after taxes (millions of US\$)	...	...	...	2.14	-0.02	2.12

Source: Financial Institutions Commission.

1/ Based on reports by 9 commercial banks for 2002 and 8 banks for 2005; include data that are audited to international standards.

2/ Rounding may result in some total not being exactly equal to the sub-aggregates.

3/ Gross loans and overdrafts less provisions for bad loans.

4/ Land and buildings less depreciation.

5/ Branches of foreign banks typically maintain their capital in their home countries.

## Palau: Draft Financial Regulations

**Regulation 1 (Computation of risk assets and minimum capital requirement; drafted 2002)** . Branches of foreign banks not subject to regulation. (i) Leverage capital ratio (Tier-1 capital/assets) of at least 6 percent; (ii) Ratio of Tier-1 capital to total risk weighted assets of at least 5 percent; (iii) Ratio of total capital and reserves to total risk weighted assets of at least 10 percent. If bank fails to comply, detailed plan to be submitted. Stiffer penalties if significant deviation (e.g., \$10,000/day) from FIA of 2001. Penalties are same as for most regulations.

**Regulation 2 (Asset classification, provisioning and nonaccrual of interest; drafted 2002).** Branches of foreign banks are subject to regulation. Asset grades and minimum provisioning required are: Pass 1%, Special mention (30–90 days) 5%; Substandard (90–180 days) 20%; Doubtful (180–360 days) 50%; Loss (more than 360 days) 100%. All banks to maintain provision for bad loans. Every loan classified as loss to be written off by debiting provisions for bad loans and every recovery previously written off shall be credited to provisions for bad loans account. At no time shall a loan ever be written off as a direct debit, or a loan recovery ever be recorded as a direct credit to retained earnings or any other capital account of a bank. The regulation provides significant discretion on part of FIC. Same penalties as for other regulations.

**Regulation 3 (Reporting of statistical and related information; drafted 2002).** Applies to all banks including branches of foreign banks which will be treated as separate bank. (i) Submission of balance sheet information within 30 days at end of each month; (ii) Income statement and reconciliation of capital accounts and provisions of bank loan account within 30 days at end of each quarter; (iii) Any additional information at request of FIC within 15 days; and (iv) Extension can be granted by FIC. However, if denied, no appeal. Same penalties as for other regulations.

**Regulation 4 (Computation of loan limits; drafted 2002).** Branches of foreign banks not subject to regulation. Maximum aggregate amount of loans to a person or group of interrelated persons shall not exceed 20% of bank's capital. In addition, maximum aggregate amount of loans to persons or groups of interrelated persons that exceed 10% of bank's capital is limited to not more than 800% of bank's capital. Bank's capital will be limited to Tier-1 capital. There are also rules regarding security for loans. Discretion on part of FIC. However, if denied, no appeal. Grandfathering of rules. Loans above limits prior to this regulation will be considered as nonconforming. Same penalties as for other regulations.

**Regulation 5 (Limitation and computation of open foreign currency positions; drafted 2002).** Branches of foreign banks not subject to regulation. No Palau bank shall permit to be outstanding as of close of business day: (i) an open FX position of more than 10% of bank's capital in any foreign currency; and (ii) an overall open FX position of more than 20% of bank's capital. Banks to compute these daily. Commissioner could ask for period reports. Banks to keep the record for at least 6 years. Same penalties as for other regulations.

**Regulation 6 (Acquisition of significant interest in a Palau Bank; drafted 2002).** Applicable to all Palau banks and any person proposing to acquire, either directly or indirectly, a significant interest in a Palau bank. Commissioner can approve or deny within 60 days. If denied, applicant can request hearing before Board within 15 days. No Palau bank can conduct transaction such that it results in one person or group owning 20% or more of capital. If it happens, penalty of \$1,000 could be imposed for each unauthorized transaction.

### Palau: Draft Financial Regulations (concluded)

**Regulation 7 (Bank licensing requirements; drafted 2002).** Applicable to all persons for the licensing of a Palau bank or a branch of a foreign financial institution to operate in Palau. It aims to (i) provide for the standardization of written applications and minimum information requirements for licensing; (ii) establish an investigation fee (\$4,500) to recover costs and expenses for review, analysis and investigation of applications; and (iii) assure public is fully apprised of proposed new banking institutions. Filing fee is \$500.

**Regulation 8 (Abstention and refusal of governing board members and effect upon action of the commission; drafted 2002).** Intended to prevent conflict of interest of FIC Board members. Member can abstain or refuse if there is conflict of interest.

**Regulation 9 (Foreclosed and other real estate owned and repossessed assets: accounting, valuation and classification requirements; drafted 2003).** Branches of foreign banks licensed to operate in Palau shall maintain their Palau accounts in accordance with requirements of this regulation for purposes of reporting to FIC. Purpose of this regulations is to follow GAAP and assets are properly and prudently recorded by bank. Also, proper accounting, valuation and classification of assets which the bank has acquired title to through foreclosure or repossession. Regulation also provides 4 criteria for classifying foreclosed real estate. Same penalties as other for regulations.

**Regulation 10 (Enforcement actions; drafted 2003).** Applicable to all banks licensed by FIC to operate in Palau. FIC can conduct informal or formal enforcement actions. Informal actions are “written agreements” containing plans to strengthen bank condition and performance. Formal actions are plans in form of written “Order” to correct noncompliance issues or unsafe conditions or practices of a serious or recurring nature. Order could take four forms: (i) Order for the assessment and collection of a financial penalty. Penalty could be up to \$10,000 per day; (ii) Order to cease and desist; (iii) Order of temporary suspension or permanent dismissal of an administrator; and (iv) Order of revocation of banking license and placement of bank under receivership. Order to cease and desist shall take effect only upon (a) written consent of majority of bank board; or (b) issuance by Trial Division of Supreme Court. Same penalties as other for regulations.

**Regulation 11 (Voluntary liquidation of solvent bank, cancellation of banking license, resumption of business prohibited; drafted 2003).** Applicable to all banks, including branches and subsidiaries of foreign banks, licensed by FIC to operate in Palau. Regulation provides for voluntary closure and liquidation of a capital insolvent bank and defines necessary procedures, documentation and other information required to be submitted to commissioner of FIC by a bank intending to voluntarily liquidate and close. Bank may purchase all or substantially all of the assets of the selling bank.

**Regulation 12 (Bank offices; drafted 2003).** Applicable to all banks, including branches and subsidiaries of foreign banks. Regulation (i) requires banks to conduct banking business only at locations as approved by commissioner; (ii) establishes procedures to locate, close, or establish a branch office, and a foreign bank may relocate its branch office; and (iii) establishes procedures for opening a loan production office in Palau. Commissioner would decide within 60 days of application. Appeal could be made to Governing Board of the FIC or to Trail Division of Supreme Court. Same penalties as for other regulations.

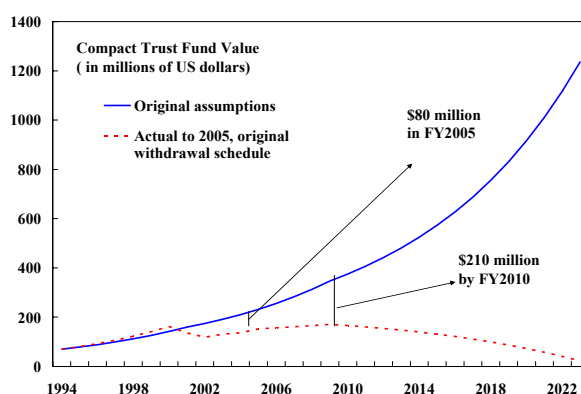
## II. FUTURE OF THE COMPACT TRUST FUND<sup>1</sup>

1. **The economy's long-term prospects depend on future policy objectives and the level of grant assistance.** This chapter considers illustrative scenarios of possible outcomes for public spending levels and growth under different assumptions with respect to future grants and the long-run value of government assets held in the Compact Trust Fund. Sensitivity of the results to the rate of return on assets is also considered.

### A. Original Objectives of the Compact Trust Fund

2. **Palau benefits from substantial U.S. assistance under a Compact of Free Association.** The Compact was ratified in 1994, seven years later than the other Compact countries, following a long domestic debate surrounding its compatibility with the new constitution. The Compact provides \$600 million of grant assistance over 15 years and defense protection in exchange for the right to maintain U.S. military facilities on one-third of the territory, if needed, for 50 years. Grants have aimed to develop basic infrastructure and build a Compact Trust Fund (CTF) to enable Palau to become self-reliant after the scheduled cessation of the Compact's annual direct payments in 2009. Since FY2000, U.S. grants have averaged about 18 percent of GDP, of which one third comes from competitively-allocated federal grants outside of the Compact.

3. **The United States provided \$70 million between 1994 and 1996 to establish the Compact Trust Fund (CTF).** The stated purpose of the Fund is to provide a steady stream of income that would replace grants after 2009. By assuming average annual return of 12½ percent, the CTF was expected to allow withdrawals of US\$5 million inflation-adjusted between FY2000 and FY2009 to supplement the scheduled step-down in grants for current expenditure, and to provide \$15 million inflation-adjusted from FY2010. Preserving and increasing the Trust Fund value in real terms was seen as consistent with such withdrawals to 2044 under the assumed rate of return<sup>2</sup>. In case the assumed 12½ percent return is not realized, the agreement stated that "Any excess or variance from the agreed minimum annual distributions (\$15 million per year starting in 2010)...shall accrue or be absorbed by the Government of Palau unless otherwise mutually agreed...."



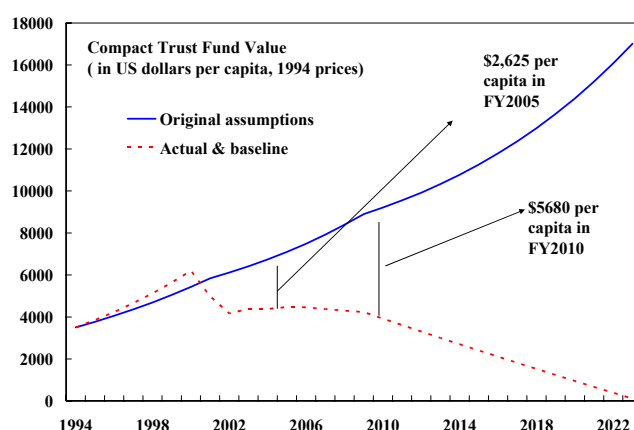
<sup>1</sup>Prepared by Wafa Fahmi Abdelati (ext. 37246).

<sup>2</sup> In fact, after such withdrawals, the real per capita value of the trust fund was expected to be 18 times the original value by 2044, or conversely, even higher withdrawals would not have compromised the real value of the trust fund for future generations.

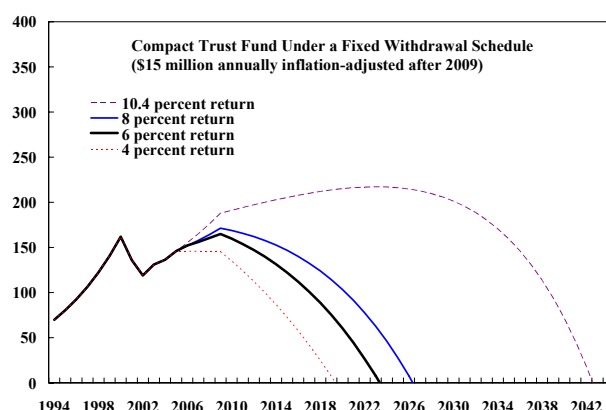
## B. CTF Performance

4. **The CTF is managed according to legislative guidelines.** The fund is managed by five international fund managers and one custodian manager who produces reports on its performance on a regular basis to the Board of Trustees. An investment consultant that reports to the Board evaluates performance of the fund managers. Reports are submitted by the Board of Trustees to the President, Congress, and the Public Auditor. The investment strategy, reporting, internal and external audit, and withdrawal authorization are governed by legislation. In the past, resources from the Fund (\$5 million annually) were transferred to the budget to finance current expenditure, while development expenditure was financed primarily from grants and a concessional loan. In the future, the withdrawals are intended to replace grants in financing capital spending and, as envisaged in the government's fiscal strategy, current spending would be met through domestic revenue generation.

5. **After initial double digit returns, the CTF posted double digit losses in FY2001–FY2002.** Annual returns have averaged 7.6 percent over the last 10 years. The end-FY2005 balance of \$152 million is \$80 million lower than had been expected under the original assumptions. With 6 percent annual return in the future, as assumed in the renewed agreements with the Republic of Marshall Islands and the Federated States of Micronesia (See Table 1 for comparison of the Compacts), the CTF value in FY2010 would fall short of the originally projected value by \$210 million. The real per capita value would be less than one half of what was originally projected by FY2010, and zero in 2024.



6. **The CTF could last longer under higher return assumptions.** With the original withdrawal schedule, the figure shows the depletion year of the CTF assuming 4 percent, 6 percent, and 8 percent return, respectively, after taking out an investment fee of 0.7 percent. For the CTF to last until 2043, the nominal rate of return would need to be 10.4 percent.



### C. Alternative Objectives

7. **Palau's longer-term prospects depend on the possible extension of Compact grants.** The economy faces substantial downside risks from the possible sharp reduction in U.S. Compact grants, federal services provided outside the budget, and merit-based awards from U.S. grantor agencies. The prospect of Compact grant renewal and/or continued eligibility for these extra-budgetary federal services and non-Compact assistance beyond 2009 is not known. While U.S. government officials underscore that there is no obligation to provide another grant package, and that Palau has not yet made specific proposals for additional assistance, Palau government officials expect extension of grants at levels consistent with current U.S. grants and replenishment of the Compact Trust Fund to the originally envisioned value. They consider renewal likely because the other two Compact countries had their Compacts renewed for another 20 years at higher levels than under their initial Compacts and are receiving annual contributions to a Trust Fund for 20 years. Initial discussions have begun in the context of bilateral economic consultations but a resolution is not expected soon.

8. **The required path of fiscal consolidation depends on the magnitude of future grants as well as policy objectives and other parameters.** To simplify the comparisons, it is assumed that in all cases domestic revenue will be raised by 5 percent of GDP with the objective of covering current expenditure, so that the scenarios would differ mainly in the speed and magnitude of expenditure adjustment. All scenarios aim to meet the objective of reducing current spending from 45 percent of GDP to about 32 percent of GDP, which is the level that can be supported by domestic revenue. For illustrative purposes, and without prejudicing upcoming negotiations, it is assumed that if the Compact is renewed, it would provide a similar level of budgetary assistance to that received in the last five years (about 18 percent of GDP) and replenish the CTF to its intended FY2010 value. The new Compact is assumed to end in FY2023, the same year that assistance will cease for FSM and RMI under their new Compacts. The assumed return on future investments is 6 percent less an investment fee of 0.7 percent.

9. **An important consideration is whether the CTF should be exhausted or its value preserved for the benefit of future generations.** Accordingly the profile of withdrawals could be front (back) loaded to finance higher (lower) capital spending. Preserving wealth per capita can be motivated from an intergenerational equity perspective since the Trust Fund was provided for the benefit of all Palauans.

### D. Illustrative Scenarios

10. **Since the terms of future U.S. grant assistance remains unknown,** staff discussed alternative illustrative scenarios for the medium and long term:

- In the case where U.S. assistance were to drop sharply to less than 2 percent of GDP in FY2010 in non-Compact aid, one possibility would be for the authorities to choose allowing the CTF balance to be depleted with the objective of preserving current



spending levels or at least easing the adjustment until the fund's depletion (Scenario A). A second possibility is for the authorities to gear policies toward preserving the CTF's real per capita value (Scenario B) consistent with the objective of inter-generational equity.

- On the other hand, if the Compact were renewed, expenditure adjustment can be extended over a longer time period at higher levels of capital spending (and growth) without jeopardizing the CTF's real per capita value (Scenario D, not elaborated below). Alternatively, the authorities may wish to aim for a higher CTF value that can generate an income stream to fund public capital spending in the absence of grants (Scenario C) which would be a more cautious or risk-averse approach. Scenario C is consistent with insuring against the risk of a future decline in spending as a share of GDP.

Illustrative Long-term Fiscal Sustainability Scenarios

	Compact Ends in FY2009	Compact Extended to FY2023
CTF depleted	A	
CTF preserved at per capita value FY05	B	D
CTF generates future income		C

### Scenario A: CTF is Depleted

11. **If CTF withdrawals were used to ease the adjustment in the absence of Compact renewal, the CTF would be depleted within 12 years.** U.S. budgetary grants would decline from around 24 percent of GDP in FY2006 to the scheduled 12 percent of GDP in FY2009, then to under 2 percent of GDP in FY2010, in addition to about 6 percent of GDP in grants from other countries. CTF withdrawals would mitigate the decline in current and capital expenditure, and initially, growth would only gradually decline to around 3–4 percent of GDP over the medium term. However, once the CTF is depleted, capital spending will have to be cut to below 4 percent of GDP and growth will likely turn negative in the following years.

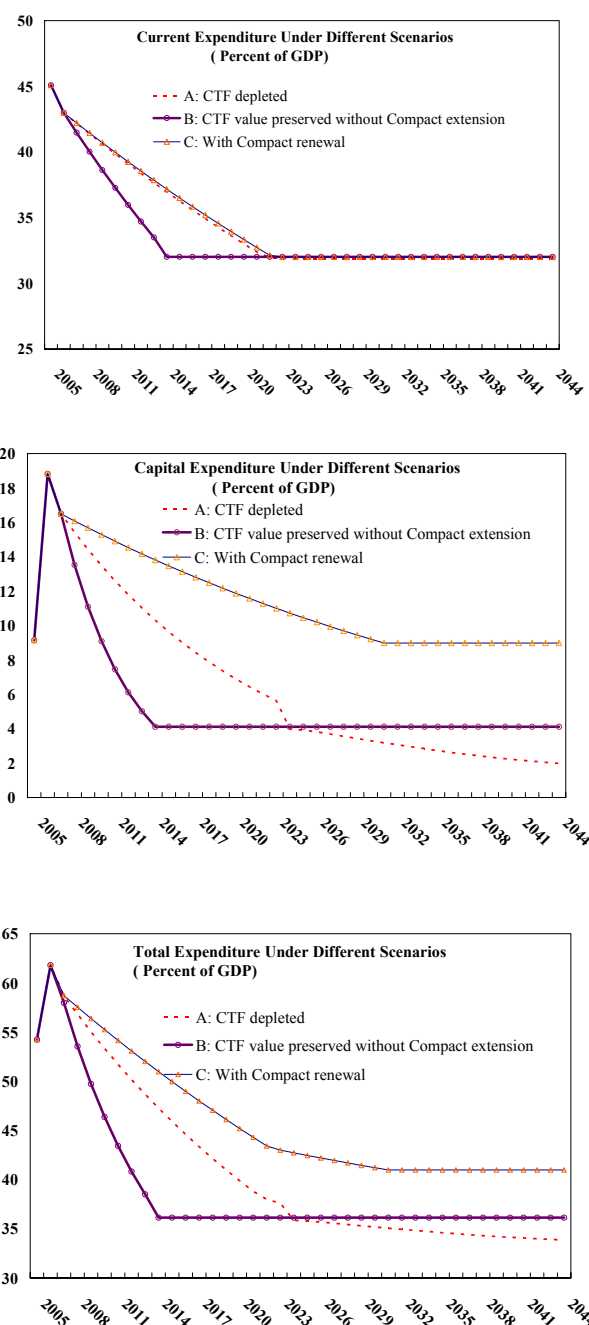
12. **In this scenario, there would be no reserve cushion for future generations.** Indeed, there would be no assets to meet unexpected external shocks and the objective of achieving financial independence would not be met. The authorities are keen to avoid this scenario in view of the experience of Nauru, which faced a sharp decline in the standards of living once its trust fund was depleted.

### Scenario B. Preserve the CTF Real Value Without Compact Renewal

13. **To preserve the per capita value of the Trust Fund, a large fiscal consolidation is required.** The same 5 percent improvement in revenue collection to 32 percent of GDP and

the same level of U.S. grants and other country grants are assumed as in the previous scenario. But the bulk of the adjustment will need to be on the expenditure side, requiring cuts of around 2 percent of GDP annually until current spending reaches the level of domestic revenue. In the long run, sustainable CTF withdrawals (1.4 percent of the value of the Fund annually, derived from 6 percent assumed return less the rate of inflation, less the rate of population growth, less a management fee) would supplement a lower level of grants to cover sharply declining capital spending. Preserving the per capita value of the Trust Fund would entail lower capital spending and lower economic growth of about 1 percent of GDP in the medium term. However, the objectives of inter-generational equity and of generating a sustainable, albeit small, income stream would be achieved. Because of the lower capital base, growth will remain low (below 1 percent annually) over the long run.

14. **However, the implied expenditure adjustment is severe.** In principle, it can be smoothed out somewhat if the deficits in some years are offset by surpluses in other years (equating the NPV of resources and expenditure over the long term). There is very little scope to do so while preserving the real per capita value of the Fund. Clearly, such a sharp expenditure adjustment will likely be politically and socially difficult to implement.



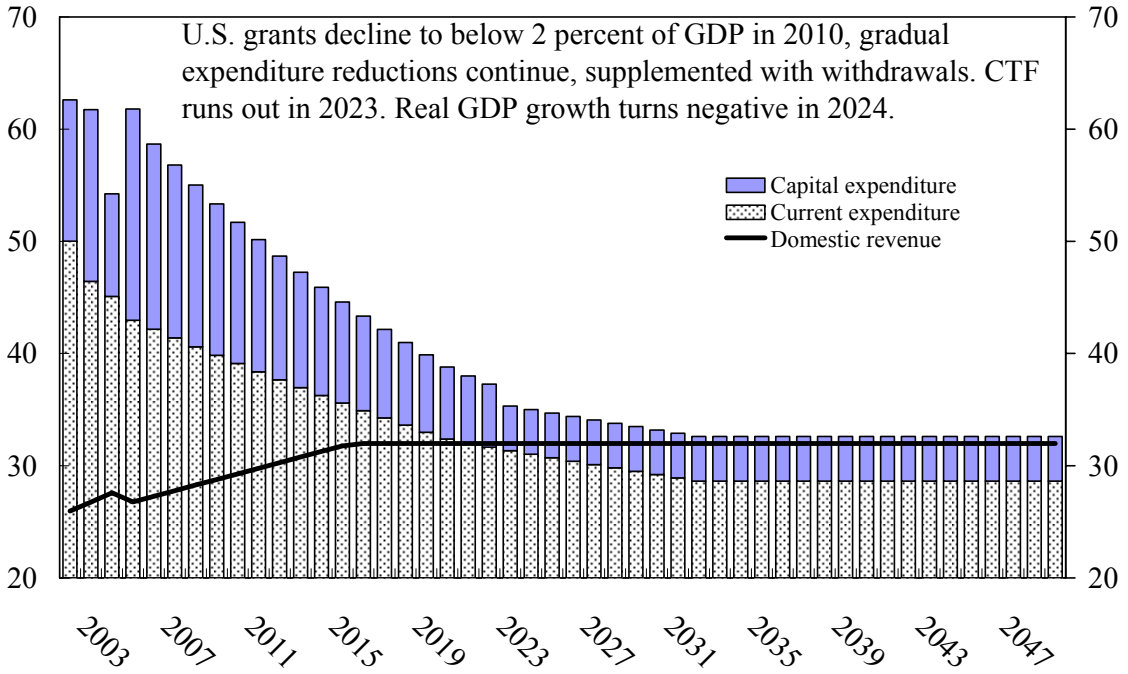
### Scenario C. Increase CTF Real Value under New Compact

15. **Compact renewal at similar levels to recent U.S. assistance would extend the fiscal adjustment over a longer period of time.** With augmentation, the Trust Fund could be built up sufficiently to replace grant financing in the future, as originally envisaged and sustain higher capital spending of nearly 10 percent of GDP. Depending on the size of the augmentation provided and Compact renewal terms, the value of the CTF in nominal and per capita terms may be similar to or much lower than was originally envisaged. At the assumed

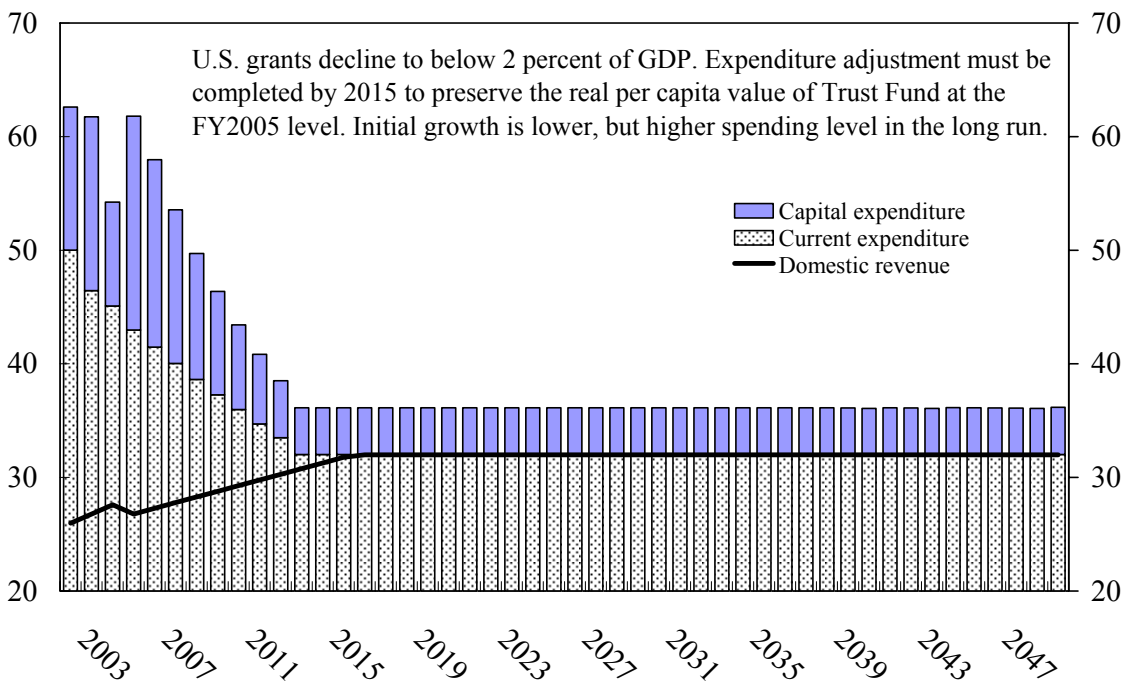
annual budgetary assistance of 18 percent of GDP and Trust Fund replenishment of \$210 million, the Trust Fund value would be about one fifth of the projected FY2044 value under the original assumptions. This level of grants allows expenditure reductions to be phased over 15 years and capital spending to remain at close to 10 percent of GDP, so that growth can be maintained around 3 percent of GDP in the long term.

16. **Alternative scenarios could be envisaged.** For example, the authorities could decide on lower targets for the real value of the Trust Fund. In this case, higher capital expenditure in the near to medium term financed by a drawdown of the Trust Fund, could possibly deliver higher growth in the long run and still allow for build-up of non-Trust Fund assets in later years. However, the returns on further investment in human and physical capital could take years to materialize, and are difficult to quantify. Some studies have shown that the returns on public investment are often low, and that investments in financial assets are more beneficial in generating future revenue to the government. Moreover, absorptive capacity constraints may make it difficult to further accelerate the pace of capital investment beyond the 10 percent assumed in the scenario above. Following such a strategy could be risky as higher growth may not be achieved and longer-run sustainability could be jeopardized. A risk averse government would likely engage in precautionary savings. On the other hand, if the renewed Compact package were larger in line with packages of the RMI and FSM, there would be greater flexibility for more gradual consolidation while maintaining the objective of intergenerational equity and adequate reserves without putting at risk long-term sustainability.

Scenario A. Revenue and Expenditure Paths if CTF is Depleted  
(In percent of GDP)



Scenario B. Preserve Real Value of CTF Without Compact Renewal  
(In percent of GDP)



### Scenario C. Compact Renewed and Higher CTF Income Stream Replaces Grants (In percent of GDP)

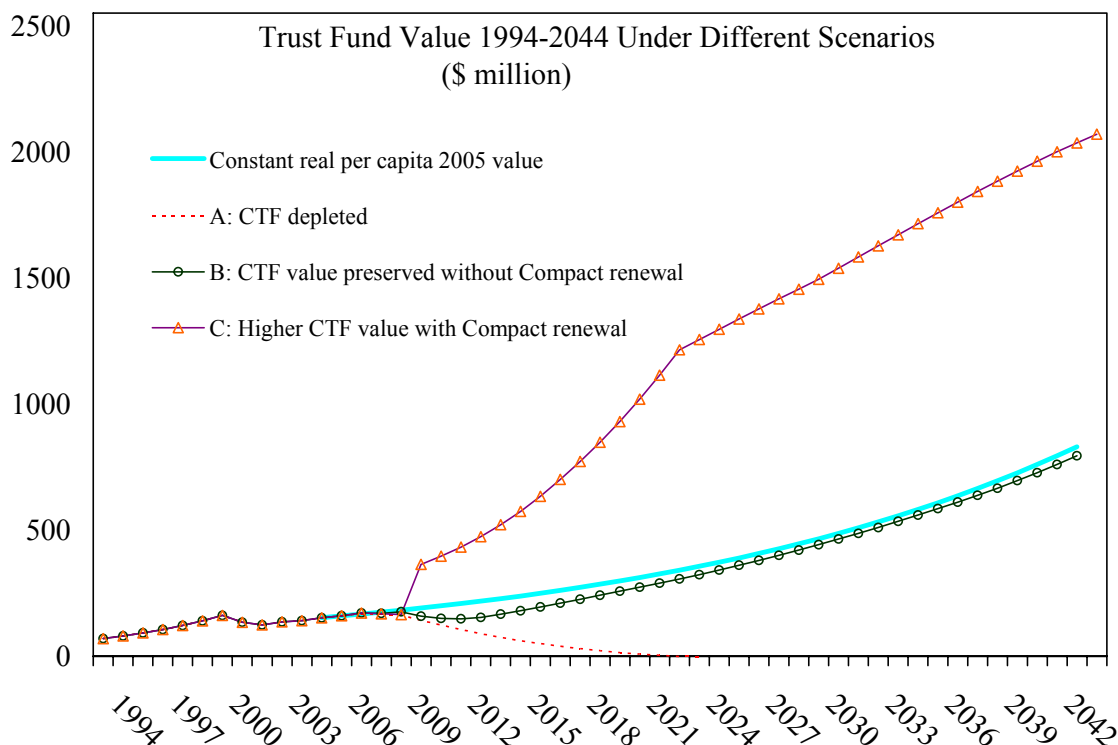
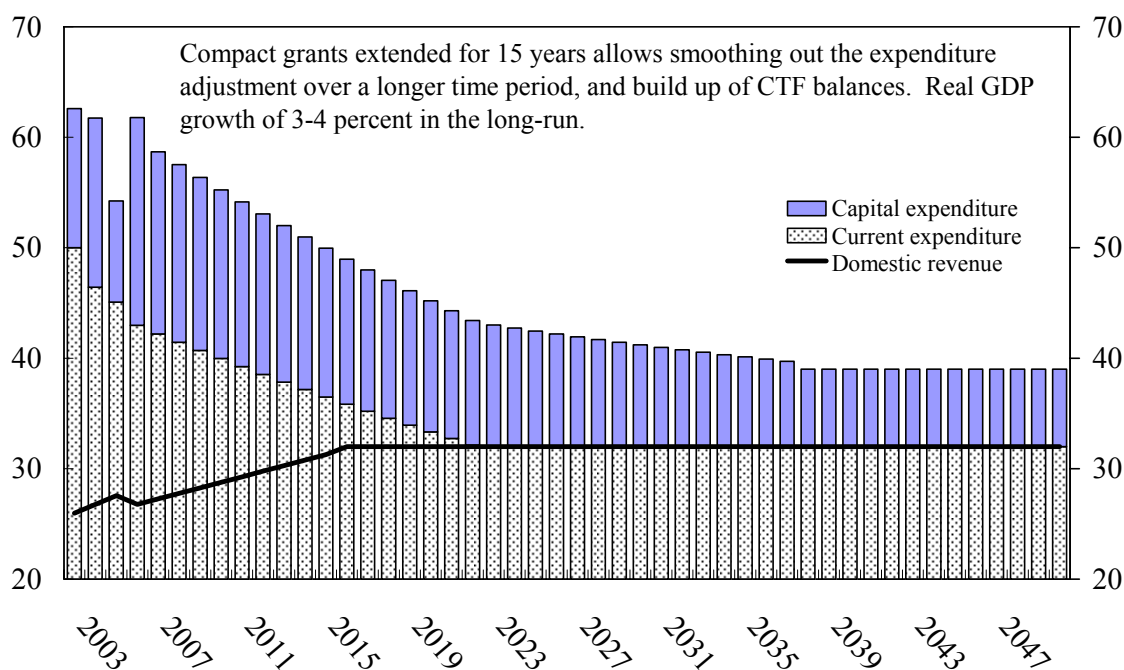


Table 1. Comparison with Other Compact Countries

	RMI(I)	FSM(I)	Palau	RMI(II)	FSM(II)
Number of years of the Compact	15	15	15	20	20
Start date	1987	1987	1994	2004	2004
First year Trust Fund contribution (\$ million)	...	...	66	7	16
Additional Trust Fund amounts (\$ million)	...	...	4 in 1996, zero in 1997-2009	Increasing by \$0.5m/year * 16.5 in last year	Increasing by \$0.8m/ year * 29.6 in last year
Trust Fund income assumption (percent)	...	...	12.5	6.0	6.0
Grants for current operations in first year(s) (\$ million) 1/	200 in first year	989 in FY1987-91	181 in FY1995	35.2	76.2
Additional operating grants (\$ milion)	831 in FY1988-2003	91.1 in FY1992-96; 79.2 in FY1997-01 98.8 in last year	120 in FY1997; average 15 per year	Decreasing by \$0.5m/year 27.7 in last year	Decreasing by \$0.8m/ year 62.6 in last year
Assumed withdrawal for fiscal financing	...	...	5 from1999; 15 after 2009 *	0	0
Reporting requirements	None	None	Annual	Quarterly	Quarterly
Audit requirements	None	None	Annual	Annual	Annual
Total nominal receipts from grants (\$ million)	1,040	1,538	596	569	1,402
Per capita (\$ million)	0.03	0.02	0.03	0.01	0.01
As a ratio of initial GDP	18.9	13.2	7.1	4.2	6.2
As ratio of initial per capita income (annual average)	52	79	8.2	15	33
			<u>Original 1/</u>	<u>Projected</u>	
End-of-Compact Trust Fund value (\$ million)	...	...	390	180	495
Per capita (\$ million)			0.02	0.01	0.01
As a ratio of initial GDP			4.7	2.2	3.7
As ratio of initial per capita income			80	37	267
Combined receipts (at end of Compact, \$ million)	1,040	1,538	776	1,064	2,262
Per capita (\$ million)	0.03	0.02	0.05	0.02	0.02
As a ratio of initial GDP	18.9	13.2	9.3	7.9	10.0
As ratio of initial per capita income	779	1,190	160	574	1,079
Memoranda items:					
Population (initial year)	41,270	90,310	17,225	57,659	108,021
GDP (initial year, \$ million)	55	117	84	135	226
Per capita income (initial year, \$)	1,336	1,292	4,849	1,854	2,096

1/ Includes capital and current grants. In the case of Palau, grants were specified for specific projects or type of expenditure. No formal specification for RMI (I) and FSM (I).

\* amount is inflation adjusted annually.

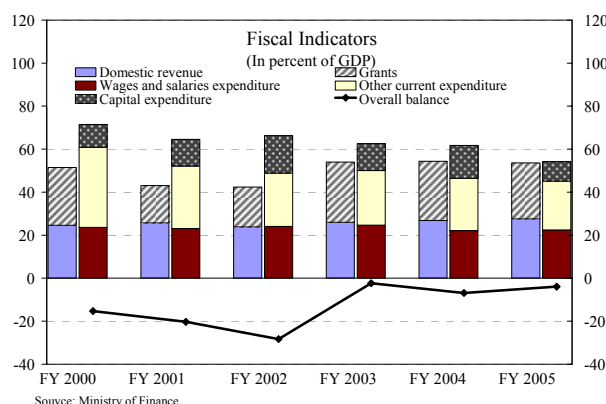
### III. FISCAL ADJUSTMENT: PROGRESS AND REFORM AGENDA<sup>1</sup>

1. **In spite of remarkable progress, achieving fiscal sustainability remains an enormous challenge for Palau.** This chapter covers recent fiscal performance, revenue and expenditure reforms under consideration, and some financing issues.

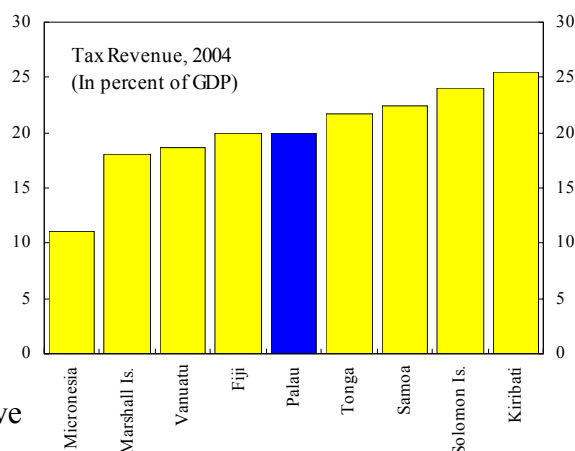
#### A. Recent Fiscal Developments

2. **Palau's fiscal position has significantly improved in recent years.**

The overall fiscal deficit (including grants) declined from 21 percent of GDP in FY2000–02<sup>2</sup> to under 5 percent of GDP in FY2003–05 (Table 11 of the Statistical Appendix). At the same time, the current balance (domestic revenue minus current expenditure) improved by 8½ percent of GDP mainly stemming from expenditure savings in non-wage expenditures. Tax collections also strengthened, although to a lesser extent.



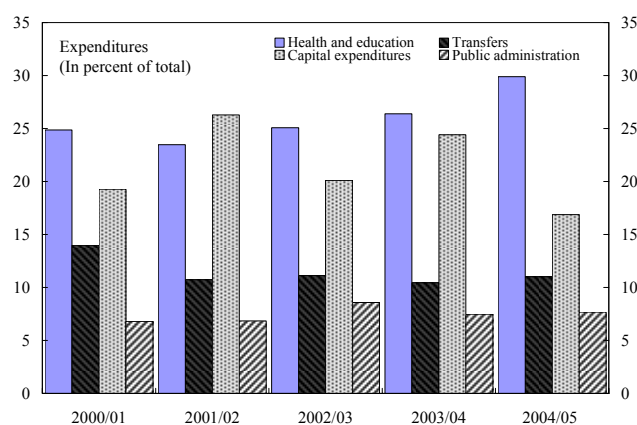
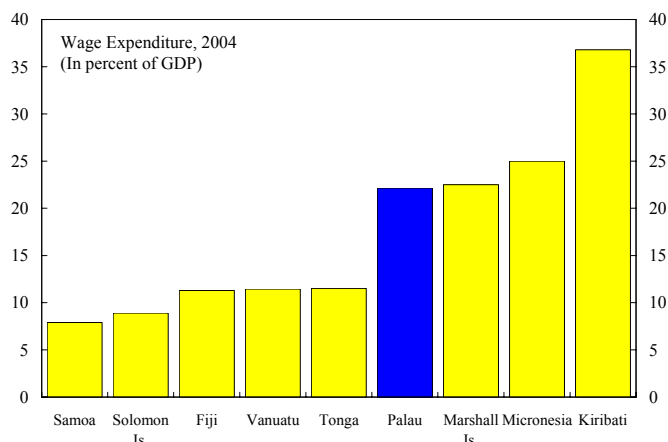
3. **Revenue collection relative to GDP has risen to a level similar to other Pacific islands.** Total revenue, excluding grants, at 26 percent of GDP is around the regional average. Tax revenue at 20 percent of GDP is higher than in the other Compact countries, the Federated States of Micronesia (FSM) and the Republic of Marshall Islands (RMI). The increase in tax revenue in the past three years reflects the re-instatement of excises on tobacco and alcohol in late 2003 and 2004, and a stronger economy growing at 5 percent. However, license fees, foreign labor permit fees, and traveler's head tax have not performed as well despite robust economic activity and tourism. Weak collection efforts may be partly responsible. In the case of the traveler's head tax the recent assigning of collection responsibility to the airlines may have resulted in higher transitional administrative costs that reduced collections.



<sup>1</sup> Prepared by Qaizar Hussain (ext. 37334).

<sup>2</sup> Fiscal year runs from October to September.

4. **Palau has managed its expenditures well over the past three years.** Both current and capital expenditures declined in terms of GDP, but capital spending is almost entirely foreign-financed and determined by implementation capacity and grant availability. Current expenditure significantly declined across expenditure categories, from 50 percent of GDP in FY2003 to 45 percent of GDP in FY2005. However, it remains high and, in particular, the government wage bill is among the highest for Pacific island economies (41 percent of expenditure; 22 percent of GDP). Subsidies and transfers have been sustained at around 6 percent of GDP; however, while subsidies to public enterprises and transfers to the community college and other state institutions declined slightly, grants to state governments have risen to 3¼ percent of GDP.<sup>3</sup> The largest transfer to the Palau Community College (1½ percent of GDP) is likely to continue for some time. Debt service has been low given prudent debt management and the availability of grants.



5. **One of the reasons for high government spending is the priority given to public funding of health and education.** Education is provided free of charge, including in remote areas, and at the Community College. Almost 30 percent of government spending is on health and education, primarily comprising salaries to health workers and teachers. This high level of spending has helped sustain relatively high social indicators but is not affordable over time. Fees collected by the state hospital for health services to non-Palauans and for non-basic services cover less than 10 percent of total health costs.

6. **Financing requirements have been primarily met through external grants.** With a high level of grants (26 percent of GDP), Palau has been able to limit its reliance on external borrowing. External debt amounts to 13 percent of GDP, much lower than RMI and

<sup>3</sup> Palau has three main semi-autonomous public enterprises: the Palau Utility Corporation (PUC), Palau National Communication Corporation (PNCC), and Palau Housing Authority (PHA). Of the three main enterprises, only the PHA receives subsidies of about 1 percent of GDP from the government and the authorities are considering privatizing it in FY2007 or combining it with the National Development Bank.



FSM whose ratios are 70 percent and 25 percent, respectively. Palau has also drawn \$5 million per year from the U.S. Compact Trust Fund (CTF) since 2002.

## **B. Fiscal Reform Agenda**

7. **While recent fiscal performance has been noteworthy**, Palau faces a number of key challenges in the period ahead. With the possible decline in U.S. Compact grants in 2009, Palau will need to bolster revenues, but more importantly, the bulk of adjustment will have to fall on expenditure reforms, particularly containing the large wage bill and spending on goods and services. In particular, as noted in the previous chapter, the total fiscal adjustment required is around 17 percent of GDP from revenue increases and expenditure cuts if the government were to succeed in achieving its objective of covering current spending from domestic revenue.

8. **To this end, the authorities have developed a medium-term fiscal program as part of their broad economic development strategy.** The objectives of the strategy are outlined in the government's Management Action Plan of 2001, the Public Sector Investment Plan of 2003 and the Cost Reduction Plan of 2003. The strategy aims to strengthen the private sector while reducing government involvement in domestic economic activity. To achieve this, one objective is to move toward attaining balanced current budgets by ensuring that the growth of expenditures does not exceed the growth of revenues. The fiscal strategy described in these documents identifies four key elements for public sector reform: (i) streamlining government institutions; (ii) restructuring governmental personnel; (iii) outsourcing government services; and (iv) improving accountability and productivity of expenditures. Revenue growth is to be accomplished through: (i) strengthening collection of government taxes and fees; (ii) expanding the revenue base through comprehensive tax reform; while (iii) continuing to pursue overseas development assistance.

### **Current Tax System**

9. **Although revenue performance is in line with similar countries, the current tax system is inequitable and inefficient.** The tax system is described in Table 13 of the Statistical Appendix and was for the most part established during the period 1994–1998. The specific shortcomings of the tax system are:

- **Narrow base of the wage and salary tax.** The tax does not cover nonwage income of employees and is not applied to self-employed persons. Inefficiencies arise mainly from the very high frequency of payments, 26 times per year, contributing to the administrative burden for both businesses and the authorities. In addition, processing small tax refund claims by a large number of employees for deductions to non-profit corporations and schools is an added administrative burden, but one which would be politically difficult to eliminate.
- **The cascading effect of the gross receipts tax.** This effect (like a sales tax) is harmful to the growth of businesses because it is based on turnover rather than

profitability. Also, foreign investors may find it incompatible with their own countries' net profit tax systems, and therefore the current regime precludes them from taking advantage of certain tax breaks in their own countries. And third, since 2002, the tax identification numbers (TINs) are assigned for each business, implying that a single corporation or a sole trader involved in many different businesses will be required to have as many TINs as the number of their businesses or branches. Consequently, some corporations have up to 40 TINs which undermines efforts to target nonfilers.

- **Import tax exemptions.** Exemptions apply to food items and medical supplies as well as non-commercial and government imports.
- **Weak tax administration.** The tax compliance rate is estimated at less than 50 percent and, the penalty system is weak, and the tax and customs divisions often do not share key taxpayer information. Appropriate penalties also do not exist for the misuse or failure on the use of TIN. The recovery of past tax arrears has been slow.

## Tax Reforms Under Consideration

10. **To address these shortcomings, the authorities have been examining various comprehensive tax reform proposals.** In the 1990s, they requested Fund assistance in drafting legislation for a more modern and efficient tax system. These reforms, described in Box 1, would aim to:

- Replace the current wage and salary tax with an individual income tax.
- Replace the current gross receipts tax with a business income tax.
- Replace the import tax, gross receipts tax, and the hotel and vessel cabin tax with an import and supply tax (IST), similar to a VAT.

11. **To ensure revenue neutrality, a higher VAT tax rate would be needed.** The proposed rate of 3 percent is significantly lower than in comparable island economies which range from 10–15 percent, and could reduce tax collections unless the rate were raised. It is worth noting that Samoa and Fiji have successfully introduced a VAT and it has become an important source of revenue for them. FSM and RMI are considering introducing a VAT.

Tax Rates in Selected Pacific Island Countries

	Personal income tax 1/	Corporate income tax	Sales tax or VAT	Custom duty 2/	Gross revenue tax
Solomon Islands	40	30 3/	15 4/	15	...
Fiji	32	30	12.5	8	...
Kiribati	35	25	0	19	...
PNG	47	30	10	6	...
Samoa	29	29	12.5	10	...
Vanuatu	...	...	12.5	14	...
Tonga	10	30	15	15	...
Palau	12	0	0	3	4
RMI	12	...	...	9	3
FSM	10	...	...	4	3

1/ Highest income bracket.

2/ Simple average.

3/ Corporate tax rate for non-residents is 35 percent.

4/ Sales tax rate for rice is 5 percent and other consumption goods is 10 percent.

12. **However, the authorities have decided to postpone comprehensive reforms. While opting to first strengthen collection through adjusting some tax rates and strengthening tax administration.** Intermediate tax policy measures under consideration over the next 2–3 years include:

- **Eliminate exemptions on import duties, including on food items.** These changes would not pertain to the “sin” items such as alcohol and tobacco, and consumer goods. The removal of exemptions on imported foodstuffs is considered by the authorities to be beneficial from the public health standpoint while also promoting the domestic agricultural sector. To this end, some headway has been made in the reform of the import tax regime, including through the conversion of valuation from f.o.b. to c.i.f. as part of the FY2006 budget.
- **Increase the import duty from 3 percent to 5 percent as a revenue generation measure,** but staff cautioned this would be a reversal of the open trade regime and inconsistent with the envisaged VAT rate. Hence, there is merit in removing exemptions but not raising the general tariff rate.
- **Adjust the reference price for the hotel room tax.** The authorities are proposing to change the tax base to the published rate or set reference prices for different hotel categories for the hotel room tax, allowing the growing tourism sector to contribute more fully to domestic revenue.
- **Improve revenue administration.** Given the low compliance rate, the authorities see considerable scope in improving collections under the current tax system. They expect to benefit from greater computerization, improved coordination between tax and customs divisions, increased capacity, and strengthened compliance.

13. **A number of measures are under way as part of the Tax and Customs Modernization projects, with PFTAC assistance.** On the tax administration side, an additional auditor has been assigned while plans are under way to introduce an electronic system in FY2006 for the payment of wage and salary tax and gross receipts tax. In customs, the following measures have been recently introduced: (i) a post audit unit since 2004 to strengthen enforcement; (ii) a harmonized system nomenclature for imports; and (iii) an on-line document filing to expedite process of trade transactions. In the near future, a computer based information sharing system, so-called PC trading, is expected to improve enforcement by sharing information between units.

14. **Other administrative measures can only be introduced through amendment of the tax law.** Among these, measures that could be introduced in the near future include introduction of a full self-assessment system, a single TIN for each taxpayer, and strengthened monitoring, audit and penalty systems to improve the compliance rate.

## Expenditure Reforms

15. **Deeper expenditure reductions will be needed over time.** The government's fiscal strategy and Cost Reduction plan, outline the following specific expenditure reform measures:

- **Contain the wage bill through rationalizing and downsizing the public sector.** Despite political sensitivities to downsizing the public sector, and limited employment opportunities at similar wages in the private sector, the authorities are considering laying off at least 4 percent (100 employees) of redundant staff in FY2006, and further downsizing in the subsequent period. An ongoing reclassification of the civil service structure will cost about \$0.6 million per year but is expected to create a more transparent structure over the medium term. The reclassification includes a reduction in salary scales from 30 to 18 and an increase in steps within the scales from 10 to 14.
- **Rationalize and contain social spending on health and education.** As noted above, government spending in these sectors is one of the highest in the region (30 percent of budget, 16 percent of GDP, about equal for both sectors). Basic public health services are provided free of charge to Palauans while visitors and non-Palauan workers have to pay for them. The Health Ministry is considering a new fee schedule which would raise user fees for medical care, including for referral services. The government's proposal to remove import tax exemptions on imported canned goods is aimed at improving the public diet. The Ministry of Education is placing greater emphasis on vocational programs as a way to attract Palauans to these professions and it is believed to be less costly since these programs would hire mainly part time teachers. The Ministry is also considering consolidation of three remote elementary schools that cater to very few students in eastern Palau given improved road access to nearby schools, and discontinuation of the school food program which would save about \$600,000 annually (0.4 percent of GDP).
- **Transfer some of the activities of the public sector to the private sector.** Measures being contemplated over the next 2–3 years include outsourcing water and sewerage system billing to the Public Utilities Company (although PUC is not in favor of this proposal since it would add to their workload), outsourcing of public works, privatizing school lunch programs and hospital meals as noted, security and janitorial services, road repair to allow reduction in staffing of public works, and the management of airport facilities.

## C. Other Issues

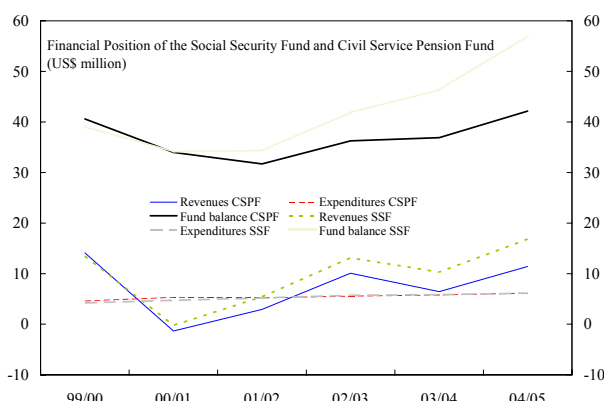
16. **As part of its medium-term strategy, Palau should continue to rely largely on grant financing for its spending needs.** The possible decline in U.S. Compact grants would pose a serious challenge as nearly one third of current spending is currently covered by grants. Outside the CTF, Palau only has small amount of usable reserves (less than 1 month

of imports) since a bulk of reserves are earmarked for specific projects. It would be wise to aim to build a cushion of usable reserves, possibly from unused CTF withdrawals, given Palau's vulnerability to shocks and the need for timely debt servicing, and to avoid external borrowing and potential contingent liabilities.

**17. Payment arrears to public enterprises must be avoided to avoid jeopardizing their financial operations.** The PUC and PNCC report delayed payments on utility bills of the government in the last two years together averaging \$1–1½ million annually (0.7–1.1 percent of GDP), although some of these arrears have now been cleared. As the public enterprises do not receive subsidies, timely payment is important to ensure that they remain self-reliant. The government also incurred arrears in FY2003 to fuel suppliers and plans to repay these arrears over the next 2–3 years.

**18. Transfers to state government will need to be contained and reversed in the coming years and their reporting improved.** This is likely to be politically difficult. Transfers have risen to around 3 percent of GDP, and the states also raise their own revenue, but have not provided a complete accounting of their income and expenditures since 1999.

**19. Potential contingent liabilities of the Social Security Fund (SSF) and the Civil Service Pension Fund (CSPF) could make it more difficult to attain fiscal sustainability.** Both the funds are relatively large (SSF at \$57 million or 37 percent of GDP and the CSPF at \$42 million or 27 percent of GDP). The SSF, set up under a law enacted in 1991, is self-financing by law and is funded by employee and employer contributions (each of 6 percent on all remuneration paid up to a maximum of \$3,000 per quarter). The fund covers employees of public and private employers in Palau, and benefits include old-age insurance benefit (available after the age of 60), disability insurance benefit, and survivor insurance benefit. About 30 percent of total contributions are paid by foreign workers who have renewable employment contracts. The fund has invested 65 percent of its portfolio in U.S. stocks and 35 percent in fixed income securities. Half of its receipts are derived from collections and the other half from investments. The CSPF, set up in 1987, provides retirement, death, and disability benefits to civil servants and their families. It is financed by contributions from government and employees at 6 percent each.



**20. The financial positions of SSF and CSPF have strengthened recently, helped by higher investment gains on the funds, but contingent risks remain.** During FY2005, the market value of SSF grew by 23 percent and for CSPF by 14 percent. These funds do not receive any transfers from the central government (CSPF received transfers until FY2002). The two funds have regained profitability after incurring large losses during 2000–02. The benefit payments have been successfully restrained in recent years only growing in line with

the cost of living adjustment. However, there are plans to increase maximum eligible taxable wages for the SSF from \$3,000 per quarter to \$4,000 per quarter and to \$5,000 per quarter in FY2007. Although recent figures on contingent liabilities are unavailable, it is likely that the combined value for the two funds seems to have declined from \$45 million in net present value terms reported in 2004.

#### **D. Conclusion**

21. **Palau's fiscal performance has improved in recent years but deeper reforms are needed in the medium term.** The authorities recognize the need for reforms on both the revenue and expenditure side. The government's own fiscal strategy already identifies reforms needed to achieve fiscal sustainability, and many of these are already under way. Concerted efforts will be needed to push ahead with the politically unpopular restructuring of the public sector and containing excess spending on health, education and state grants. Without more aggressive efforts in the medium term, the country will face serious strains in adjusting to a lower level of grants in the future.

### Box 1. Comprehensive Reform of the Tax System

Palau's current tax system consists of four main taxes:

- (i) **Wages and salaries tax (WST).** Levied on employees at 6 percent on first \$8,000 of gross income and 8 percent above \$8,000;
- (ii) **Gross receipts tax (GRT).** Levied on businesses at 4 percent of gross revenue;
- (iii) **Import duty.** Levied at 3 percent on most items, 5 percent on vehicles, and 25 percent on alcohol and tobacco and some luxury items, and exemptions on food stuffs and medicine; and
- (iv) **Hotel room and vessel cabin tax.** Levied at 10 percent of net room charge.

To improve the efficiency and equity of the system, **comprehensive reforms** would aim to:

**Replace the current wage and salary tax with an individual income tax** to be levied on individuals and small businesses. Being a final withholding tax, the current deductions for contributions to nonprofit corporations and schools would be eliminated. The structure would be more progressive than the WST having three income brackets than the current two and will blend in with the proposed business income tax (see below). The rates proposed in the draft law would be: 0 percent rate for taxable income under \$2,000, 5 percent for income between \$2,000–\$8,000, and 11 percent for income over \$8,000 plus a fixed \$300 tax.

**Replace the current gross receipts tax with a business income tax.** To remove the cascading nature of the GRT, the business income tax would be levied at the rate of 11 percent of taxable gross income which is estimated to yield about the same revenue as the current GRT at 4 percent of gross receipts. Meanwhile, businesses would be allowed to deduct up to 10 percent of their taxable income for charitable contributions.

**Replace the import tax, gross receipts tax, and the hotel and vessel cabin tax with an import and supply tax (IST).** The IST would be a VAT-like consumption tax and have the following features: (i) 3 percent rate on each taxable transaction; (ii) zero rating for exports; and (iii) annual turnover threshold of \$150,000. Those below this threshold would meet their liability through input tax on all their imports and purchases, where applicable, and those above the threshold through output tax on their supplies less input tax paid on their business inputs. The credit refund process would work through the submission of invoices by registered suppliers.

**Tax bills** that are under consideration and that were drafted with PFTAC and Fund assistance include:

**Bill No. 5-266 of July 1998** would essentially replace the existing WST and GRT with a personal income and business income tax, and introduce a VAT-like consumption tax, the Import and Supply Tax. It includes measures to reform tax and customs administration such as self-assessment. It has not been resubmitted to the newly elected Congress and would likely require additional drafting assistance.

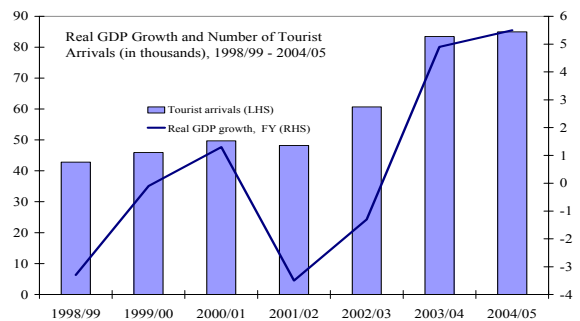
**Bill No. 7-110 of October 2005**, aims to reform the import tax system by changing valuation from f.o.b. to c.i.f., conversion to metric units, raising import duty from 3 percent to 5 percent on most goods except “sin” goods such as alcohol and tobacco, and removing exemptions. It also includes accompanying measures to reform customs administration. This bill passed its first reading in Congress in October 2005. Some headway has been made by including the conversion of valuation from f.o.b. to c.i.f. as part of the FY2006 budget.

#### IV. DETERMINANTS OF TOURISM FLOWS AND FUTURE PROSPECTS<sup>1</sup>

1. Tourism has been an important source of growth in Palau but ensuring sustainability will require a shift in government strategy. This chapter reviews recent developments and performance of tourism in Palau, examines the main factors affecting tourism expenditures in small-island economies (SIEs) using a gravity model, and discusses the prospects and policy issues relevant to further development of tourism in Palau.

##### A. Recent Development of Tourism

2. **As in a number of other small-island economies, tourism has played a prominent role.** It has enabled Palau to overcome the limitation of a small domestic market by providing volume demand as tourists are drawn from the global market. Global competition in the tourism industry provides incentives to pursue sound domestic policies that promote competitiveness in the local economy. A number of cross-country studies have found that tourism and other services sectors can contribute to higher growth and productivity in small economies.<sup>2</sup> The tourism sector has contributed to higher growth in Palau through employment generation and spillovers to related activities. Rough estimates suggest that a 1 percent increase in arrivals leads to 0.5 percent increase in tourism-related employment. Over one third of foreign direct investment is concentrated in tourism service-related sectors between 1998 and 2005.



3. **The number of tourist and business arrivals in Palau has steadily increased.**

Arrivals picked up after a dip in 2001/02 due to the 9/11-related events. The main source markets, Japan and Taiwan POC, account for over 70 percent of total tourist arrivals. The number of Taiwanese tourists almost tripled between the period 2000/01 and 2004/05 owing to the introduction of direct airline service from Taiwan POC and a new large Taiwan-owned hotel. However, the contribution to the domestic economy from this increased

**Tourist Arrivals by Source Country**  
(number of tourists, percentage shares in parentheses)

	2000/01	2004/05
Japan	22,959 (46%)	25,574 (30%)
Taiwan POC	12,347 (25%)	36,542 (43%)
United States of America	8,015 (16%)	9,425 (11%)
Europe	951 (2%)	2,229 (3%)
Philippines	735 (1%)	767 (1%)
Others	4,724 (9%)	10,467 (12%)
Total	49,731 (100%)	85,004 (100%)

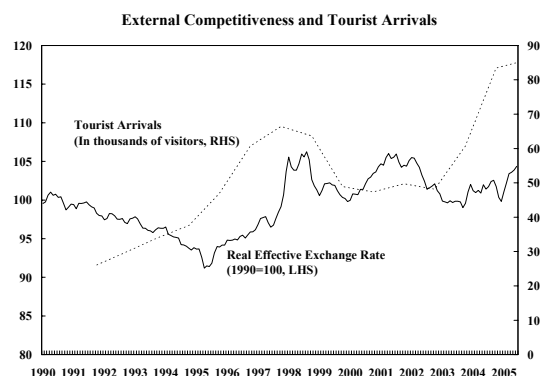
Source: Palau Visitors Authority.

<sup>1</sup> Prepared by Yuko Kinoshita (ext. 35442).

<sup>2</sup> See Vanegas and Croes (2003) for evidence of a positive relation between growth and tourism in small-island economies, and Easterly and Kraay (2000) for wealth and higher productivity in service-based small countries.



activity has been somewhat limited as these competitively priced all-inclusive group tour packages that benefit from discounted air-fares generated little revenue for domestic businesses. The increase in tourist arrivals from other markets has been more modest: 11 percent and 17 percent increase in tourists from Japan and the United States, respectively.



4. **Palau's tourism industry appears to be relatively competitive.** The real effective exchange rate has been relatively stable since 1990 and tourism competitiveness indicators are relatively robust: (i) compared to similar countries, Palau has adequate infrastructure as noted below; (ii) the World Bank's *Doing Business* survey ranks Palau as among the best performers and the cost of doing business is relatively low comparable to Jamaica and Mauritius; and (iii) it has one of the most open trade regimes with a low average tariff rate contributing to lower domestic prices. In any case, diving visitors and business travelers attending international meetings may be less price sensitive than for other destinations in view of Palau's pristine marine environment and unique opportunities for ecotourism.

5. **Tourism receipts are estimated to amount to about 45 percent of GDP;** the second highest after Maldives in the sample of SIEs. This high dependence on tourism is also reflected in the large number of visitors relative to the total population; the number of tourists have been almost three times the population, second only to the Bahamas.

Competitiveness Indicators  
(2004, unless otherwise indicated)

	Fiji	Jamaica	Mauritius	Palau	Tonga	Vanuatu
Paved roads (in percent of total roads)	48.1	68.8	95.0	50.0	27.0	23.4
Literacy rate	93.0	85.3	82.5	91.0	99.0	34.0
Telephone mainlines ( per 1000 people) 1/	92.6	139.4	178.0	159.0	80.0	28.1
Number of days to start a business (2005)	46	9	46	33	32	39
Cost of starting a business (percent of income per capita) (2005)	28.4	8.3	8.8	10.2	11.7	65.6
Average unweighted tariff rates 2/	7.4	8.6	18.3	2.9	15.0	13.8
Government wage bill (in percent of total expenditure)	39.9	33.6	25.2	41.0	44.0	53.5

Sources: World Bank, *World Development Indicators 2004*; World Bank, *Doing Business 2005*; and Fund staff estimates.

1/ Palau data for 2000.

2/ Mauritius and Vanuatu data for 2002, Tonga data for 2001 and Palau data for 2005.

6. **Palau's tourism infrastructure and other indicators compare well to other small-island economies.** The overall accommodation capacity is comfortable, as proxied by the number of hotel rooms; there are 39 hotel rooms per thousand population, the second highest after the Bahamas. Expenditure per capita and expenditures per room are the highest in the Pacific region and more comparable to those in the Bahamas and Barbados.

Tourism Indicators in Small-Island Economies  
(1993–2003 average)

	Tourism share of GDP (%) 1/	Tourist arrivals per thousand population 2/	Rooms per thousand population	Tourist expenditure per capita (US\$)	Tourist expenditure per room (US\$ '000)	Main markets 3/
<b>Caribbean</b>						
Bahamas	35	5.0	45	4,853	107	US
Barbados	28	1.8	22	2,454	111	UK, US
Dominica	18	0.9	10	577	56	French W.I., US
Jamaica	20	0.5	7	444	62	US
<b>Pacific Islands</b>						
Fiji	22	0.4	7	322	48	Australia, New Zealand
Palau	45	2.9	39	3,300	85	Taiwan POC, Japan
Marshall Islands	3	0.1	5	56	11	US, Japan
Micronesia	7	0.1	4	127	33	US, Japan
Tonga	6	0.3	7	105	16	Australia, New Zealand
Vanuatu	27	0.2	25	260	10	Australia, New Zealand
<b>Africa</b>						
Maldives	53	1.3	24	947	40	Italy, UK
Mauritius	18	0.5	6	424	67	France, UK
Seychelles	34	1.5	28	1,517	54	France, UK

Sources: World Tourism Organization, Compendium of Tourism Statistics; and Fund staff estimates.

1/ Share of travel receipts in GDP, average of 1999–2003.

2/ Population is measured in mid-year 2002.

3/ Main markets between 1999–2003.

## B. Determinants of Tourism Expenditures in SIEs?

7. **This section explores the main determinants of inbound tourism to SIEs using panel data of 13 host countries and 11 source countries over the period 1991 to 2003.** The pairs of countries and data are described in the Annex. We identify factors that contribute to an increase in tourism expenditure of a small-island country such as Palau. We use the extended gravity equation to model inbound tourism to small-island economies as recently done by Durbarray (2001), Matias (2004), and Zhang and Jensen (2005). The gravity model has been used to analyze a variety of trade-related issues. A common application is to assess whether countries “undertrade”, or in this case, if tourism numbers or receipts are below model predictions. The basic form of the model typically relates trade between two countries to the product of their incomes, size (typically proxied by population), and to the costs of trade (proxied by the distance between them). Dummy variables are included to control for geographical distance, cultural affinities, common language, and free trade agreements. Using the gravity model has the advantage of taking into account both demand and supply-side forces for explaining trade and services flows over the use of a single demand equation.<sup>3</sup>

8. **In this case, real tourist expenditures by residents of the source country in the host country ( $X_{ijt}$ ) is the variable under examination.** The equation is represented as:

$$X_{ijt} = \alpha_0 Y_{it}^{\alpha_1} Y_{jt}^{\alpha_2} D_{ij}^{\alpha_3} P_{ijt}^{\alpha_4} \theta_{ij}^{\alpha_5} z_{it}^{\alpha_6} \quad (1)$$

<sup>3</sup> See Bayoumi (1999) for further discussion of the advantages of estimation based on the gravity equation. For the theoretical pinning of the gravity framework, see Deardorff (1998), Frankel and others (1997) and Andersen and Van Wincoop (2000).

Where  $X_{ijt}$  is real expenditure by tourists from the source country  $j$  (service importer) to the host country  $i$  (service exporter) in year  $t$ .  $Y_{it}$  is real GDP of the host country  $I$ , which is associated with the supply capacity of the host country.  $Y_{jt}$  is real GDP of the source country  $j$ , which is the demand generating capacity of the source country.  $D_{ij}$  that is a distance between the capital cities in countries  $i$  and  $j$ . A better indicator would have been airfare or traveling time, but we could not readily obtain data and therefore we implicitly assume that the travel cost is positively related to physical distance between the two countries.  $P_{ijt}$  is the bilateral real exchange rate or a proxy for the price of tourism.  $\theta_{ijt}$  is a country-pair specific factors such as colonial ties and common language, and  $Z_{ijt}$  captures other supply-side factors relevant to tourism such as the percentage of paved roads and the number of hotel rooms. Taking the log of (1), we will get the operational form:

$$x_{ijt} = a + \alpha_1 y_{it} + \alpha_2 y_{jt} + \alpha_3 d_{ij} + \alpha_4 p_{ijt} + \alpha_5 s_{it} + \alpha_6 z_{it} + D_i + D_j + e_{ijt} \quad (2)$$

where small letters represent the logarithm forms and  $D_i$  and  $D_j$  are dummies to control for host and source country attributes, respectively.

9. **The regression results show that the host economy's size or supply capacity is one of the most important factors in explaining tourism expenditure** (Table 1). In particular, the coefficient of the host country's export capacity proxied by real GDP is large ranging from 0.6 to 0.9 suggesting that supply capacity, as measured by real GDP is an important determinant of tourist flows. Similar results were obtained in past studies such as Kimura and Lee (2004) who find the point estimates for GDP of the service exporter are around 0.8 for the sample of OECD countries. However, the large coefficient on the host country's real GDP might be subject to a bias arising from endogeneity: tourist expenditure can also affect real GDP of the host country. We perform the instrumental variable (IV) estimation by using the log of the host country's population as an instrument (Wei, 1996). Although the IV estimation yields a smaller size coefficient on the host country size, as expected, overall results remain qualitatively similar to those in OLS.

10. **Interestingly, the change in foreign income does not necessarily affect demand for tourism in SIEs.** The source country's income elasticity of demand for tourism is relatively small (.06 or less) and statistically insignificant.<sup>4</sup> This result may reflect the fact that most SIEs have more specialized tourist markets and that its demand is inelastic with respect to a change in foreign income. However, this result should be interpreted with caution as foreign income is measured here as average income level of the source country, not the income level of visitors in a specialized high-end market. Specifically, all source countries in the sample have relatively high incomes. Lack of variation of the source country income may understate the income elasticity in the regressions.

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<sup>4</sup> This contrasts with the findings of Senhadji (1997) that income elasticity of demand for goods trade is around 0.5 to 1.5. See Goldstein and Khan (1985) for a comprehensive survey of the literature.

11. **Although remoteness did not appear to be a significant factor, this should be interpreted with caution.** The coefficient for distance is small and insignificant. This is probably due to the use of physical distance instead of cost or travel time, due to lack of data availability as noted. The number of direct flights and the number of competing airlines are usually important determinants of tourist flows. In this case, however, cross-country data on travel time and cost were not readily available.

12. **Real exchange rate movements appear to have a somewhat limited impact on tourism.** A one percent appreciation in the real exchange rate vis-à-vis the source country leads to a fall in tourism expenditure by 0.2 percent. The price elasticity is measured here as CPI-based real exchange rate, defined as the relative price of the host country vis-à-vis that of the source country. In analyzing tourism in the UK, Durberry (2001) finds the price elasticity of demand for tourism in the UK to be around unity. Our result shows that tourism demand for SIEs is less sensitive to price changes than that for the UK, perhaps highlighting the limitation of using the model for specialized tourist markets.

13. **Infrastructure such as roads and hotel rooms appear to be important factors that help increase tourism expenditures.** These supply factors measured by paved roads and bridges that facilitate transportation and the volume of hotel rooms for accommodation appear to encourage tourism. The coefficients for both are positive and significant.

14. **On the other hand, cultural distance does not necessarily hinder tourism flows to SIEs once we control for other demand and supply factors.** The absence of a common language does not appear to be much of a hindrance to inbound tourists in SIEs as the coefficient is negative and significant. One reason may be that although tourists prefer language familiarity, they may not be too reluctant to visit exotic destinations where foreign language is spoken.

15. **When applying the model results to Palau, a number of caveats are in order.** Palau's pristine marine ecosystem gives it an absolute advantage to attract more tourism and higher expenditures that is not incorporated into the model. Similarly, the model looks to the average level of income of tourists to explain tourist flows instead of the income level of visitors to Palau and other islands, a small fraction of the host country's population.

Palau's Tourism Performance Relative to its Potential by Source Country/Region

	Africa	Australia	China	Europe	Japan	New Zealand	Philippines	Taiwan
1999	2.12	2.36	2.99	3.71	1.43	2.66	4.04	3.39
2000	1.95	2.18	2.66	3.45	1.27	2.47	3.81	3.03
2001	2.20	2.45	2.88	3.81	1.44	2.76	4.26	3.39
2002	1.81	1.95	2.30	3.03	1.17	2.16	3.42	2.74
2003	2.11	2.24	2.76	3.52	1.41	2.46	4.18	3.34
avg 1999–2003	<b>2.03</b>	<b>2.23</b>	<b>2.71</b>	<b>3.49</b>	<b>1.34</b>	<b>2.49</b>	<b>3.93</b>	<b>3.17</b>

Sources: World Tourism Organization, Compendium of Tourism Statistics; and Fund staff estimates.

Notes: Positive numbers indicate that actual performance exceeds predicted performance.

16. **The model results can shed some light on relative performance between source markets for Palau.** The result shows that Palau's actual tourism receipts surpass the model's predicted value in all markets. This stems from the fact that the model predicts tourism receipts from the host country's size or supply capacity and competitiveness indicators. It may be more useful therefore to consider for Palau the model's predictions of relative performance between source markets. For example, relative performance in Japan is very low and it is the highest for the Philippines. This seems to suggest that performance is lowest in the high-end market (Japanese, European and U.S. tourists to Palau tend to spend more per tourist) than in the lower-end markets. However, the high relative performance in the Philippines should be discounted as the large flows suggest that due to misclassification of visitors, the data may include employment-related visitors from the Philippines. In the case of European tourists, the high relative performance may be a sign of reaching maturity in that higher-end market.

17. **Accordingly, there seems to be more room for Palau to tap into the Japanese high-end market as shown in a relatively smaller magnitude of the performance indicator.** This may be partly because most Japanese tourists are more specialized tourists such as divers. There have been efforts to foster high-end tourism markets in Palau as part of a strategy of sustainable tourism development, which is discussed in Section C.

### C. Prospects for Tourism in Palau

18. **Future near-term prospects are promising and suggest rising expenditure per tourist.** Tourism flows are expected to increase further in 2005/06 following completion of the airport renovation and three hotels that opened in 2005. In late-2007, the luxury hotel chain Aman Resort is scheduled to open a new resort and considering other sites. The possible addition of airline routes from Singapore and Japan would help recovery of recent decline of Japan tourists.

19. **Over the longer run, however, Palau will need to consider ways to diversify its production base beyond tourism to reduce environmental risks and vulnerability to volatility of tourist receipts.** Faria (2005) found that Caribbean countries like the Bahamas faced a similar challenge of reaching maturity in the tourism sector. There are some signs of degradation of aqua environment from the road construction. Achieving a balance between conservation and development through environmentally compatible activities is one of the urgent tasks. The authorities hope that shifting toward more high end-tourism would help preserve the pristine marine environment. To promote preservation, they plan to introduce an institutional framework that allows coordination between the central and local governments as well as authorities, the industry operators, and local communities.

Daily Expenditure per Tourist (US\$)	
	Daily expenditure per tourist 1/ 2/
Bahamas	137
Barbados	168
Dominica	81
Fiji	94
Jamaica	98
Maldives	85
Mauritius	116
Palau	176
Seychelles	145
Vanuatu	124

Source: World Tourism Organization,  
*Compendium of Tourism Statistics*.

1/ 2004 for Palau, 2003 for other countries.

2/ Computed as (total expenditure)/(no. of  
tourists) x (average length of stay).

20. **The Tourism Action Plan aims to promote sustainable tourism.** The plan has been under discussion for several years. The Palau Visitors Authority is currently the sole agent for marketing tourism. There is no administrative organization within the government to propose or implement tourism policies nor is there any regulatory framework. The proposed action plan includes the establishment of an administrative structure and organization, potentially under the Ministry of Commerce and Trade, that oversees visitor management, licensing standards/quality, information and data capture, product capture, community awareness, labor training, policy and legislation.

21. **Palau appears well-suited for targeting the high-end market.** Comparison of daily expenditure per tourist shows that Palau is one of the most expensive destinations amongst island economies. Though the number of hotel rooms per population is relatively high compared to the regional average, local industry experts say that the number of rooms for high-end tourists is not sufficient to handle the expected growth of the tourism market. It is estimated that the hotel occupancy rate of these high-end hotels during the peak season has been over 95 percent.

22. **Greater reliance on foreign investment will be needed to increase supply capacity in the high-end tourism market.** Foreign investment regulations remain restrictive and land access is still limited despite progress in land titling. As most investments involve the purchase and development of land, the progress in land reform must be encouraged to attract foreign capital inflows necessary to sustain growth. To benefit from employment opportunities by foreign investors, more human resources development and training of Palauan workers would help improve tourist-related services and increase local employment.

#### **D. Conclusion**

23. **The tourism industry appears to be relatively competitive and continues to be a strong engine of economic growth for Palau.** Despite a small appreciation in the real effective exchange rate in line with the movement of US dollar, the growth of the sector has remained robust due to strong competitiveness indicators, construction of new hotels, and the introduction of new airline routes. This has led to a sustained increase in tourist arrivals since 2003. Tourism receipts as a share of GDP account for 45 percent and the accommodation capacity is the highest within the Pacific region. It appears to be highly profitable as indicated in tourist expenditure per capita.

24. **Although the tourism industry has performed relatively well so far,** there are risks of environmental degradation from over-exploitation of natural resources and over-dependence on one industry as a source of income. In the near future, there will be greater need to increase supply capacity for the higher-end market. To attract foreign investment necessary to develop tourism, foreign investment regulations and limited land access should be relaxed. The establishment of institutional and regulatory framework is also needed to develop effective policies for eco-friendly tourism. At the same time, Palau would benefit from diversifying its production base beyond tourism in the long run to reduce risks and volatility.

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Table 1. Determinants of Tourism Expenditure in SIEs: OLS and IV Regression Results

	Ordinary Least Squares				Instrumental Variables			
GDP_i	0.87 (71.89)***	0.719 (28.42)***	0.795 (47.18)***	0.62 (22.51)***	0.618 (22.51)***	0.792 (47.18)***	0.716 (28.42)***	0.868 (71.89)***
GDP_i	-0.029 -0.4	0.015 -0.22	0.008 -0.12	0.061 -0.93	0.061 -0.93	0.008 -0.12	0.015 -0.22	-0.02 -0.4
Distance	-0.042 -1.29	-0.037 -1.19	-0.046 -1.47	-0.041 -1.39	-0.041 -1.39	-0.046 -1.47	-0.037 -1.19	-0.04 -1.29
Price	-0.198 (15.85)***	-0.189 (15.69)***	-0.239 (17.45)***	-0.233 (18.03)***	-0.233 (18.03)***	-0.239 (17.45)***	-0.189 (15.69)***	-0.19 (15.85)***
GDP_i p.c.	1.031 (23.69)***	0.949 (21.91)***	1.104 (25.38)***	1.022 (24.17)***	1.642 (33.82)***	1.899 (50.22)***	1.667 (32.66)***	1.901 (48.39)***
Colonial	-0.133 -1.07	-0.102 -0.86	-0.129 -1.08	-0.095 -0.85	-0.095 -0.85	-0.129 -1.08	-0.102 -0.86	-0.13 -1.07
Language	-0.152 (3.71)***	-0.165 (4.23)***	-0.151 (3.84)***	-0.166 (4.47)***	-0.166 (4.47)***	-0.151 (3.84)***	-0.165 (4.23)***	-0.15 (3.71)***
Roads			0.419 (6.21)***	0.466 (7.29)***	0.466 (7.29)***	0.419 (6.21)***		
Rooms		0.196 (6.75)***		0.215 (7.77)***	0.215 (7.77)***		0.196 (6.75)***	
Host dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Source dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	488	488	488	488	488	488	488	488
Adj R-sq.	0.967	0.97	0.969	0.973	0.973	0.969	0.97	0.967

Source: Fund staff estimates.

Absolute value of t statistics in parentheses.

\*\*\* significant at 1%.



### Data Sources and Definitions

The analysis is based on a panel of 13 host countries and 11 source countries or regions between 1991 and 2003. Hence, the data set consists of 143 country pairs ( $=13 \times 11$ ) and the number of observations in a full sample is 1859 ( $=143 \times 13$ ). Due to missing observations mainly in Roads and Rooms, the regression analysis is based on a smaller number of observations. Data on tourism are compiled from the World Tourism Organization's Compendium of Tourism Statistics and Yearbook of Tourism in various years. For Pacific Island countries, data on tourism are drawn from most recent IMF Staff Reports. Data on real GDP, population, exchange rate, and CPI are from the IMF's International Financial Statistics. Colonial ties and common language dummies are constructed from the CIA's World Factbook. Other variables such as infrastructure, pollution, and human capital are drawn from the World Bank's World Development Indicators. The list of countries and variable definitions covered in the data are as follows:

**Host country (i):** Bahamas, Barbados, Dominica, Fiji, Jamaica, Maldives, Marshall, Islands, Mauritius, Micronesia, Palau, Seychelles, Tonga, and Vanuatu

**Source country/region (j):** Africa, Australia, China, East, Asia/Pacific, Europe, Japan, Korea, New Zealand, Philippines, Taiwan POC, and United States/North America

**Tourex** Log of tourist expenditure in the host country by the source country residents, computed as ((number of tourists from country j/total number of tourists) total tourist expenditure) in US\$ billion. Source: World Tourism Organization Compendium, IMF Staff Reports

**Distance** Log of distance between the capitals cities of the host and source countries. For East Asia/Pacific, Tokyo was used to calculate distance. For United States/North America, Washington, DC was used to calculate distance. Source: Internet

**GDP<sub>i</sub>** Log of real GDP of Host country, deflated by CPI. Source: WEO

**GDP<sub>j</sub>** Log of real GDP of Source country, deflated by CPI, Source: WEO

**GDP<sub>i p.c.</sub>** Log of real GDP per capita of Host country, computed as real GDP/population. Source: WEO

**Roads** Log of the percentage of paved roads, Source: World Development Indicators

**Rooms** Log of the number of overnight stays in hotels and similar establishments ( $\times 1000$ ) , Source: World Tourism Organization Compendium

**Colonial** Dummy = 1 if there is/was a colonial tie, = 0 otherwise, Source: CIA World Factbook

**Language** Dummy = 1 if the official or second language is common, = 0 otherwise, Source: CIA World Factbook

**Price** Log of CPI-based real exchange rate of the host country vis-à-vis the source country, Source: WEO

Table 1. Republic of Palau: Gross Domestic Product, 1998–2005 1/

	1998	1999	2000	2001	2002	2003	2004	2005 Est.
(In thousands of U.S. dollars, unless otherwise noted)								
Agriculture	1,398	1,358	1,372	1,399	1,427	1,470	1,544	1,606
Fisheries	2,038	3,148	3,274	3,372	2,529	2,630	2,788	2,928
Mining and quarrying	176	218	229	240	240	243	243	249
Manufacturing	1,702	1,609	1,690	1,774	1,774	532	540	547
Electricity, gas, and water	2360	3,393	3,563	3,741	3,741	3,928	4,242	4,582
Construction	10,389	8,249	12,621	14,261	15,402	16,018	18,421	22,105
Trade	24,837	23,165	23,860	24,337	21,903	22,998	26,218	28,840
Hotels and restaurants	12,370	11,938	12,057	12,419	10,929	11,694	13,565	15,328
Transport and communication	9,191	9,846	10,338	10,855	10,095	10,600	11,660	12,476
Finance and insurance	5,706	4,297	4,511	4,647	4,368	4,499	4,769	4,960
Real estate and business services	6,555	4,611	4,842	5,036	4,985	5,185	5,600	5,935
Public administration	28,462	29,374	30,255	30,860	31,169	31,792	32,428	33,077
Other services	9,907	9,691	9,982	10,381	9,550	9,837	10,132	10,588
Subtotal	115,091	110,897	118,593	123,323	118,114	121,428	132,150	143,220
Less: Imputed bank service charge	2,640	2,384	2,540	2,666	2,681	2,600	2,820	2,890
Plus: Import duties	4,869	4,972	3,810	3,999	4,022	3,900	4,229	4,335
Nominal Gross domestic product (calendar year)	117,320	113,485	119,863	124,656	119,455	122,728	133,560	144,665
Nominal Gross domestic product (fiscal year)	116,293	114,444	118,269	123,458	120,755	121,909	130,852	141,889
CPI (percent change, end-of-period, fiscal year)	1.6	2.2	3.0	-0.4	-1.1	-0.1	6.8	2.3
GDP deflator (percent change; period average (calendar year)) US	1.6	2.4	3.6	2.6	1.6	2.1	2.6	2.8
GDP deflator (percent change; period average (fiscal year)) US 2/	1.6	1.7	3.4	3.0	1.4	2.3	2.3	2.8
Real GDP growth (percent change; calendar year)	2.0	-5.5	2.0	1.4	-5.7	0.6	6.1	5.4
(Percent change)								
Agriculture	6.5	-2.8	1.0	2.0	2.0	3.0	5.0	4.0
Fisheries	-0.9	54.5	4.0	3.0	-25.0	4.0	6.0	5.0
Mining and quarrying	27.7	23.6	5.0	5.0	0.0	1.3	0.0	2.1
Manufacturing	21.3	-5.5	5.0	5.0	0.0	-70.0	1.4	1.4
Electricity, gas, and water	-707.6	43.8	5.0	5.0	0.0	5.0	8.0	8.0
Construction	17.6	-20.6	53.0	13.0	8.0	4.0	15.0	20.0
Trade	3.9	-6.7	3.0	2.0	-10.0	5.0	14.0	10.0
Hotels and restaurants	-11.6	-3.5	1.0	3.0	-12.0	7.0	16.0	13.0
Transport and communication	5.2	7.1	5.0	5.0	-7.0	5.0	10.0	7.0
Finance and insurance	-13.2	-24.7	5.0	3.0	-6.0	3.0	6.0	4.0
Real estate and business services	4.1	-29.7	5.0	4.0	-1.0	4.0	8.0	6.0
Public administration	-3.2	3.2	3.0	2.0	1.0	2.0	2.0	2.0
Other services	7.6	-2.2	3.0	4.0	-8.0	3.0	3.0	4.5
Subtotal	3.2	-3.6	6.9	4.0	-4.2	4.2	8.8	7.9
Less: Imputed bank service charge	25.6	-9.7	6.5	5.0	0.6	-3.0	8.4	2.5
Plus: Import duties	26.7	2.1	-23.4	5.0	0.6	-3.0	8.4	2.5
Gross domestic product	3.9	-1.6	4.7	4.0	-4.2	2.7	8.8	8.3

Sources: Data provided by the Palauan authorities; and Fund staff estimates.

1/ Data for 1998–1999 have been compiled from source data. Estimates for 2000–2005 have been derived from partial source data.

2/ Uses the U.S. CPI.

Table 2. Republic of Palau: Employed Persons by Industry, 1990, 1995, and 1999–2003

	1990 Census	1995 Census	1999 Social Security	2000 Census	2001 Social Security	2002 Social Security	2003 Social Security
Agriculture, fisheries, and mining	446	724	287	215	183	287	261
Construction	861	1,087	946	1,112	1,815	2,285	2,678
Manufacturing	93	78	26	345	-	-	6
Transport, storage, communication, and other public utilities	477	435	766	765	607	573	526
Wholesale, retail, restaurants, and hotels	800	1,448	2,495	2,619	2,364	2,291	2,639
Finance, insurance, and real estate	119	122	119	116	126	150	169
Services 1/	687	1,573	1,147	1,246	1,917	2,049	2,595
Public administration	2,116	2,292	3,048	3,203	4,087	3,997	4,374
Total employed population	5,599	7,759	8,834	9,621	11,099	11,632	13,248

Sources: Office of Planning and Statistics, *1994 & 1999 Statistical Yearbook*; *1995 and 2000 Census of Population and Housing*, and Social Security Office.

1/ Includes business, repair, personal, community, and entertainment and recreation, health, education, and social services.

Table 3. Republic of Palau: Selected Social Indicators, 1995 and 2001–2005 1/

	1995	2001	2002	2003	2004	2005
GDP per capita (U.S. dollars)	5,529	6,352	5,980	6,045	6,480	6,925
Area (sq. miles)						
Land	188	188	188	188	188	188
Sea	237,850	237,850	237,850	237,850	237,850	237,850
Demographic indicators						
Total population	17,225	19,626	19,976	20,304	20,610	20,891
Population growth (percent per annum)						
1986–90	2.4	...	...	...	...	...
1990–95	2.6	...	...	...	...	...
1995–00	2.0	...	...	...	...	...
2001–05	1.8	...	...	...	...	...
Age-dependency ratio (dependents to working-age population)	51	...	...	...	...	...
Labor force	8,368	...	...	...	...	...
Employed 2/	7,780	11,099	11,632	13,248	...	...
Agriculture, fisheries, and mining	724	183	287	261	...	...
Construction	1,089	1,815	2,285	2,678	...	...
Manufacturing	78	...	...	...	...	...
Transport, storage, communication, and other public utilities	436	607	573	526	...	...
Wholesale, retail, restaurants, and hotels	1,455	2,364	2,291	2,639	...	...
Finance, insurance, and real estate	124	126	150	169	...	...
Other business, personal, community, and social services	1,120	1,917	2,049	2,595	...	...
Public administration	2,879	4,087	3,997	4,374	...	...
Unemployed	588	...	...	...	...	...
Age structure (in percent)						
0–14	28	...	...	...	...	...
15–64	66	...	...	...	...	...
65 and over	6	...	...	...	...	...
Public education						
Percent graduating						
Primary	97.0	118.0	119.0	...	...	...
Secondary	65.0	99.0	82.0	...	...	...
College student/teacher ratio	11.0	10.9	11.6	12.1	...	...
Health						
Crude birth rate (per 1,000)	13.4	15.3	13.0	13.7	14.0	13.0
Crude death rate (per 1,000)	7.0	7.0	6.7	6.7	7.0	7.0
Infant mortality (per 1,000)	20.0	16.7	23.2	16.7	16.0	16.0
Life expectancy at birth, female (years)	72.6	...	...	75.4	75.7	...
Life expectancy at birth, male (years)	65.7	...	...	67.5	67.8	...
Life expectancy at birth, total (years)	70.8	...	...	71.3	71.6	...
Hospital beds (per 1,000)	61.0	...	...	65.0	65.0	...

Sources: 1995 and 2000 Census of Population and Housing; Data provided by the Office of Planning and Statistics; Social Security Office and World Bank, *World Development Indicators*.

1/ Figures for 2001–2005 are estimates based on partial data.

2/ Composition of employment figures for 2001–2003 are based on figures from social security records.

Table 4. Republic of Palau: Consumer Price Index: Quarterly and Annual Average, June 2000–June 2005

(December 2004=100)

	All Groups	Food and beverage	Alcohol, tobacco, and betelnut	Clothing and footwear	Housing	Household operations	Transportation	Health, personal care, education, and services	Leisure and entertainment
2000 Average	94.7	92.5	79.0	113.3	106.5	102.0	92.0	92.0	97.5
Jun.	93.6	91.1	79.8	112.5	105.5	100.5	91.5	90.2	95.8
Sept.	95.4	94.1	78.7	114.2	106.3	102.5	91.8	92.8	98.4
Dec.	95.0	92.1	78.6	113.4	107.8	103.1	92.8	93.0	98.3
2001 Average	95.1	93.1	78.6	115.3	111.3	100.1	92.9	93.3	98.0
Mar.	95.6	93.8	77.2	115.4	112.3	101.3	93.4	93.0	99.4
Jun.	95.5	93.8	79.1	115.2	112.7	100.7	92.7	92.7	97.8
Sept.	95.0	92.4	79.8	115.5	111.9	100.3	92.6	93.9	97.3
Dec.	94.2	92.5	78.2	115.0	108.3	98.0	92.9	93.4	97.4
2002 Average	93.9	91.9	76.0	110.0	105.9	100.1	92.1	94.7	98.4
Mar.	94.2	93.4	77.4	114.9	108.9	97.6	92.1	93.1	97.1
Jun.	94.1	93.0	77.6	110.6	108.9	97.5	92.5	94.0	98.1
Sept.	94.0	91.1	76.7	108.6	102.8	102.7	92.1	95.8	99.6
Dec.	93.1	90.1	72.3	106.0	103.2	102.5	91.9	95.9	99.0
2003 Average	94.7	92.6	78.0	106.1	102.5	102.0	93.3	98.5	98.5
Mar.	93.4	90.0	70.9	104.8	102.3	104.0	93.4	96.1	98.7
Jun.	93.7	92.2	70.0	105.9	102.0	101.8	93.2	97.7	98.2
Sept.	93.9	92.0	71.7	107.1	103.0	101.5	92.8	100.5	97.9
Dec.	97.9	95.9	99.5	106.7	102.5	100.9	93.6	99.7	99.3
2004 Average	99.4	99.2	99.4	102.2	100.6	100.3	97.6	99.6	100.1
Mar.	98.4	97.0	99.7	104.4	100.6	100.7	95.1	99.6	100.3
Jun.	99.0	98.4	98.7	104.4	100.0	100.6	97.0	99.5	100.0
Sept.	100.3	101.4	99.1	100.0	102.0	100.1	98.4	99.5	100.0
Dec.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
2005 Average	101.8	98.7	103.2	100.5	99.0	103.5	103.4	102.2	100.7
Mar.	101.1	99.8	102.6	100.0	100.0	101.2	102.8	100.0	100.7
Jun.	102.4	97.5	103.9	101.0	98.0	105.7	104.1	104.5	100.8
Sept.									
Dec.									

Source: Bureau of Budget and Planning.

Table 5. Republic of Palau: Balance of Payments, 2000/01–2004/05

(In thousands of U.S. dollars)

	2000/01	2001/02	2002/03	2003/04	2004/05 Est.
Trade balance	-83,302	-76,367	-79,833	-101,398	-91,765
Exports, f.o.b.	16,567	20,345	8,411	5,882	13,414
Imports, f.o.b.	-99,869	-96,712	-88,244	-107,280	-105,179
Services account	47,889	46,005	68,239	87,698	86,539
Receipts	59,537	58,339	76,911	98,680	98,858
Travel	58,531	57,354	75,612	96,940	97,220
Other	1,006	986	1,300	1,739	1,638
Payments	-11,648	-12,334	-8,672	-10,982	-12,319
Transportation	-10,682	-11,129	-7,697	-9,457	-10,790
Passenger's Service	-1,032	-1,302	-1,095	-1,761	-1,766
Freight and insurance	-9,650	-9,827	-6,602	-7,696	-9,024
Travel	-966	-1,205	-975	-1,525	-1,529
Income	5,985	5,450	4,458	6,019	4,169
Investment income	5,163	4,854	3,911	5,605	3,733
Income and interest payment	-700	-712	-704	-687	-665
Current transfers	19,993	13,954	16,740	20,235	16,151
Private	-1,420	-7,250	-4,750	-4,154	-6,891
Inflows	5,686	7,494	4,123	3,022	1,124
Outflows	-7,106	-14,743	-8,873	-7,177	-8,015
Official	21,413	21,204	21,490	24,389	23,042
Business licenses and fees	1,380	1,148	1,062	1,077	1,634
Grants	20,334	20,561	20,966	23,383	21,650
Other	-301	-505	-538	-71	-242
Current account (includes official grants)	-9,435	-10,957	9,604	12,554	15,094
Current account (excludes official grants)	-29,769	-31,518	-11,362	-10,829	-6,556
Capital and financial account	14,036	10,848	18,996	25,043	34,359
Public Sector	1,064	1,888	12,672	11,527	15,634
Capital grants	1,064	1,888	13,243	12,670	15,277
Gross borrowing	0	0	0	0	1,500
Loan repayments	0	0	-571	-1,143	-1,143
Private sector	12,972	8,960	6,324	13,516	18,725
Foreign direct investment	12,972	8,960	6,324	13,516	18,725
Other private inflows 1/	-29,688	-34,078	-32,039	-47,806	-54,692
Overall balance	-25,087	-34,187	-3,439	-10,209	-5,239
Memorandum items:					
Current account/GDP (in percent)					
Including official grants	-7.6	-9.1	7.9	9.6	10.6
Excluding official grants	-24.1	-26.1	-9.3	-8.3	-4.6
Service receipts/GDP	48.2	48.3	63.1	75.4	69.7

Sources: Data provided by the Ministry of Finance, Palau Visitors Authority, Banks, and Fund staff estimates.

1/ Includes change in net foreign assets of commercial banks and errors and omissions.

Table 6. Republic of Palau: Imports by Product Category, 1994–2004 1/

(In thousands of U.S. dollars; f.o.b.)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 2/
Food and live animals	6,647	9,164	9,317	10,987	8,462	10,446	14,650	14,534	14,381	9,952	15,486
Beverages and tobacco	3,816	5,002	5,428	6,165	5,530	5,588	8,702	7,954	7,004	7,406	6,314
Crude materials, inedible, except fuels	33	187	118	199	172	821	1,858	1,840	1,464	834	1,889
Mineral fuels, lubricant, and related minerals	19,882	15,057	20,886	8,341	14,761	11,036	20,093	9,930	12,430	9,123	32,563
Animal and vegetable oils, fats, and waxes	112	234	204	268	235	188	248	247	246	209	367
Chemicals and related products	1,147	2,306	1,949	2,818	2,396	5,165	7,187	7,134	4,860	3,619	7,487
Manufactured goods	3,546	4,765	4,930	5,713	5,090	14,490	25,223	18,203	23,647	10,651	11,872
Machinery and transport equipment	5,936	13,246	23,846	17,599	18,045	18,977	32,350	23,179	21,902	13,539	52,122
Miscellaneous manufactured articles	7,100	12,567	12,758	17,148	11,037	11,127	16,816	12,744	9,921	5,935	9,896
Commodities and transactions not classified elsewhere	363	191	199	51	147	...	...	...	17	35	...
Total	48,582	62,719	79,636	69,289	65,875	77,838	127,127	95,765	95,874	61,303	137,996

Source: Data provided by the Customs Office, Ministry of Administration.

1/ On a calendar-year basis.

2/ Data for the last three quarters of the year.

Table 7. Republic of Palau: Imports by Country or Territory of Origin, 1996–2004 1/

(In thousands of U.S. dollars; f.o.b.)

	1996	1997	1998 2/	1999 3/	2000	2001	2002	2003	2004 4/
United States	27,010	27,872	...	28,690	41,552	37,611	40,356	28,457	37,496
Singapore	23,412	9,047	...	11,948	12,195	7,343	7,439	5,675	28,328
Guam	12,473	12,223	...	8,381	17,033	13,379	11,558	8,480	10,657
Japan	9,051	9,348	...	11,949	21,996	9,814	9,364	5,390	38,346
Taiwan Province of China	2,391	3,465	...	5,370	8,751	5,091	5,439	3,171	5,746
Australia	1,463	994	...	1,094	2,005	1,047	1,440	1,268	1,351
Hong Kong SAR	1,070	1,245	...	634	4,434	3,484	3,457	539	883
The Philippines	1,053	1,221	...	2,297	4,215	2,617	4,083	2,913	6,277
Korea 5/	570	517	...	2,021	6,852	6,155	8,523	2,376	4,885
Saipan	440	690	...	-	-	-	559	282	420
New Zealand	238	590	...	49	141	38	559	122	149
Federated States of Micronesia	189	-	...	79	118	389	69	231	13
People's Republic of China	42	1,685	...	892	824	2,546	864	476	727
Malaysia	37	...	...	576	648	90	122	111	314
Indonesia	9	...	...	786	2,850	367	389	553	252
Thailand	...	...	...	1,296	177	151	202	136	261
Other	188	391	...	1,776	3,336	5,643	1,450	1,124	1,889
Total	79,636	69,289	...	77,838	127,127	95,765	95,874	61,303	137,994

Source: Data provided by the Customs Office, Ministry of Administration.

1/ On a calendar-year basis.

2/ Data not available.

3/ Data for last three quarters.

4/ Data year to date ending September.

5/ Includes North and South Korea.



Table 8. Republic of Palau: Tourism and Business Arrivals, and Travel/Work Abroad by Residents, 1998/99–2004/05 1/

	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Tourism							
Visitor arrivals by purpose							
Tourist	45,184	44,034	46,684	44,721	57,465	79,180	80,656
Business	3,722	3,323	3,047	3,436	3,269	4,271	4,348
Employment	3,911	5,076	5,590	4,590	4,392	5,233	5,374
Resident	739	9,730	10,311	335	430	642	534
Other	2,387	4,004	156	11,703	9,949	12,132	10,795
Total tourism and business arrivals	48,906	47,357	49,731	48,157	60,734	83,451	85,004
Total arrivals	55,943	66,167	65,788	64,785	75,505	101,458	101,707
Total arrivals by country of residency							
Taiwan Province of China	12,754	14,390	14,077	13,708	26,813	43,452	39,297
Japan	22,651	21,140	23,505	22,831	21,620	24,384	26,033
United States	11,807	8,072	9,652	10,098	9,449	10,296	10,250
Korea	610	592	451	439	466	2,953	5,062
Australia and New Zealand	550	402	391	395	547	1,241	1,050
The Philippines	2,863	3,819	4,162	3,666	3,409	3,938	3,575
Other 2/	4,708	17,752	13,550	13,648	13,201	15,195	16,440
Total arrivals by country of residency	55,943	66,167	65,788	64,785	75,505	101,459	101,707

Source: Data provided by the Palau Visitors Authority.

1/ On a calendar-year basis from 1993 to 1997, and on a fiscal-year basis from 1998.

2/ Other includes fishermen, crews, students, transits, and dependents.

Table 9. Republic of Palau: National Government Debt and Debt Service, 1996/97–2004/05

(In thousands of U.S. dollars)

	1996/97	1997/98	1998/99	1999/2000	2000/2001	2001/02	2002/03	2003/04 Prov.	2004/05 Prov.
Gross External Debt	9,100	5,500	1,433	20,000	20,000	20,000	19,429	33,786	32,143
ICBC Debt Service									
ICBC Capitol Relocation	...	...	...	20,000	20,000	20,000	19,429	18,286	17,143
ICBC PIA Upgrade	...	...	...	...	...	...	...	15,000	15,000
BOH FPA Support	...	...	...	...	...	...	...	500	0
Debt Service									
Principal	3,400	3,600	4,067	1,433	0	0	571	1,143	1,143
Interest	0	0	0	0	700	712	704	687	665

Sources: Independent Auditor's Report on Financial Statements; and data provided by the Ministry of Finance.

Table 10. Republic of Palau: National Government Budgetary Operations, 1998/99–2004/05

(In thousands of U.S. dollars)

	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04 Prov.	2004/05 Prelim.
Total revenue and grants	53,836	60,855	53,162	51,224	65,866	71,069	76,053
Domestic revenue	25,847	29,076	31,764	28,775	31,657	35,016	39,126
Tax revenue	18,925	22,879	24,097	22,042	22,706	26,131	29,838
Nontax revenue	4,545	4,341	5,781	4,519	5,713	7,321	5,955
Fishing rights income	137	39	110	83	101	106	158
Interest income	97	313	1,442	257	315	2,097	127
from domestic banks	69	253	1,271	202	268	18	29
from foreign banks	28	60	171	55	47	2,079	98
Fees and charges	1,717	1,212	1,413	1,265	2,778	2,855	3,164
Licenses and fees	...	1,480	1,684	1,973	1,915	2,025	1,982
Other	2,594	1,297	1,132	941	604	238	524
Local Trust Funds	2,377	1,856	1,886	2,214	3,238	1,564	1,333
Capital revenue	...	...	...	...	...	...	2,000
Grants	27,989	31,779	21,398	22,449	34,209	36,053	36,927
Total expenditure	72,069	84,493	79,756	80,068	76,305	80,794	76,947
Current expenditure	64,080	71,992	64,395	59,030	60,960	60,767	63,972
Wages and salaries	28,380	27,927	28,480	29,056	30,118	28,965	31,808
Other purchases of goods and services	27,255	29,763	26,200	21,783	22,570	23,804	22,996
Interest payments	-	0	700	712	712	687	665
Investment fees	393	350	185	81	62	54	40
Subsidies and transfers	8,052	13,952	8,830	7,398	7,498	7,257	8,463
Public enterprises	...	3,149	2,837	1,662	1,669	1,549	1,587
State block grants	1,337	1,874	2,123	3,266	3,484	3,268	4,491
Other	6,715	8,929	3,870	2,470	2,345	2,440	2,385
Payment of arrears	...	...	...	...	...	...	...
Capital expenditure	7,989	12,501	15,361	21,038	15,345	20,027	12,975
Errors and omissions							
Accounts payable/receivables	(2,373)	5,502	1,507	-5,343	7,571	659	-4,702
Current balance	-38,233	-42,916	-32,631	-30,255	-29,303	-25,751	-26,846
Overall balance (excluding grants)	-48,595	-49,915	-46,485	-56,636	-37,077	-45,119	-42,523
Overall balance (including grants)	-20,606	-18,136	-25,087	-34,187	-2,868	-9,066	-5,596
Financing	20,606	18,136	25,087	34,187	2,868	9,066	5,596
Net long-term borrowing	-4,067	-1,434	0	0	-571	-1,143	357
New borrowing 1/	0	20,000	0	0	0	0	1,500
Principal repayments	4,067	1,434	0	0	571	1,143	1,143
Withdrawals from non-trust fund assets	24,673	-430	25,087	29,187	-1,561	5,209	239
Withdrawals from Trust Fund	...	...	...	5,000	5,000	5,000	5,000

Sources: Audit Report, and DILOG 134-P Financial Report, Ministry of Finance.

1/ A new loan of \$15.5 million was contracted in 2003/04 but is only partially drawn.

Table 11. Republic of Palau: National Government Budgetary Operations, 1998/99–2004/05

(In percent of GDP)

	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04 Prov.	2004/05 Prelim.
Total revenue and grants	47.0	51.5	43.1	42.4	54.0	54.3	53.6
Domestic revenue	22.6	24.6	25.7	23.8	26.0	26.8	27.6
Tax revenue	16.5	19.3	19.5	18.3	18.6	20.0	21.0
Salaries and wages	4.5	4.6	4.8	4.9	5.2	5.0	4.9
Import tax	4.3	5.4	5.5	4.5	4.7	6.0	6.2
Gross revenue tax	4.9	5.2	5.6	6.1	5.8	5.8	6.4
Other	2.8	4.0	3.7	2.7	2.9	3.2	3.5
Nontax revenue	4.0	3.7	4.7	3.7	4.7	5.6	4.2
Fishing rights income	0.1	0.0	0.1	0.1	0.1	0.1	0.1
Interest income	0.1	0.3	1.2	0.2	0.3	1.6	0.1
from domestic banks	0.1	0.2	1.0	0.2	0.2	0.0	0.0
from foreign banks	0.0	0.1	0.1	0.0	0.0	1.6	0.1
Fees and charges	1.5	1.0	1.1	1.0	2.3	2.2	2.2
Licenses and fees			1.4	1.6	1.6	1.5	1.4
Other	2.3	1.1	0.9	0.8	0.5	0.2	0.4
Local Trust Funds	...	...					
Capital revenue	2.1	1.6	1.5	1.8	2.7	1.2	0.9
Grants	24.5	26.9	17.3	18.6	28.1	27.6	26.0
Current	11.9	16.9	16.5	17.0	17.2	17.9	15.3
Capital	5.8	10.0	0.9	1.6	10.9	9.7	10.8
Total expenditure	63.0	71.4	64.6	66.3	62.6	61.7	54.2
Current expenditure	56.0	60.9	52.2	48.9	50.0	46.4	45.1
Wages and salaries	24.8	23.6	23.1	24.1	24.7	22.1	22.4
Other purchases of good and serv.	23.8	25.2	21.2	18.0	18.5	18.2	16.2
Interest payments	0.0	0.0	0.6	0.6	0.6	0.5	0.5
Investment fees	0.3	0.3	0.1	0.1	0.1	0.0	0.0
Subsidies and transfers		11.8	7.2	6.1	6.2	5.5	6.0
Public enterprises	1.2	2.7	2.3	1.4	1.4	1.2	1.1
State block grants	5.9	1.6	1.7	2.7	2.9	2.5	3.2
Other		7.5	3.1	2.0	1.9	1.9	1.7
Capital expenditure	7.0	10.6	12.4	17.4	12.6	15.3	9.1
Current balance	-33.4	-36.3	-26.4	-25.1	-24.0	-19.7	-18.9
Overall balance (excluding grants)	-42.5	-42.2	-37.7	-46.9	-30.4	-34.5	-30.0
Overall balance (including grants)	-18.0	-15.3	-20.3	-28.3	-2.4	-6.9	-3.9
Memorandum item:							
GDP (fiscal year; in thousands of US dollars)	114,444	118,269	123,458	120,755	121,909	130,852	141,889

Sources: Audit Report, and DILOG 134-P Financial Report, Ministry of Finance.

Table 12. Republic of Palau: Revenue, 2000/01–2004/05

(In thousands of U.S. dollars)

	2000/01	2001/02	2002/03	2003/04	2004/05 Est.
Domestic revenue	31,763	28,775	31,658	35,015	39,126
Tax revenue	24,096	22,041	22,707	26,130	29,838
Fish export tax	526	413	379	384	882
General import tax	6,142	4,626	5,269	6,887	7,960
Fuel excise tax	618	828	424	998	900
Road use tax	480	472	455	475	511
Salary and wage tax	5,959	5,901	6,326	6,508	6,978
Business gross revenue	6,856	7,380	7,120	7,536	9,072
Hotel occupancy tax	1,071	950	1,026	1,223	1,498
Traveler's head tax	1,117	1,156	1,310	1,732	1,749
Delin. taxes, penalties & interest	1,181	249	346	338	221
All other taxes	146	66	50	49	68
Nontax revenue	5,781	4,520	5,713	7,321	7,955
Fishing rights income	110	83	101	106	158
Interest income	1,442	257	315	2,097	127
Fees and charges	1,413	1,265	2,778	2,855	3,164
Airport fees and rentals	0	0	1,186	1,397	1,497
Water utility charges	692	622	652	616	664
Postal service	447	398	411	435	453
Court and fines and fees	273	245	318	189	332
Seaport fees	0	0	113	133	141
Other	0	0	98	86	77
Licenses and Permits	1,684	1,973	1,915	2,025	1,982
Foreign labor permits	829	1,082	1,302	1,406	1,086
Business licenses	179	166	157	162	169
Banking fees	0	0	0	0	27
Foreign investment permits and fees	411	414	168	140	234
Corporate filing fees	24	32	31	35	34
Other licenses and permits	241	279	257	282	432
Other	1,132	941	604	238	2,524
Indirect cost recoveries	191		66		
Serv Mart sales	0	0	62	61	38
Belau Mariculture Dem.	21	22	16	21	...
Other	920	920	460	156	2,486
Trust funds	1,886	2,214	3,238	1,564	1,333

Source: Ministry of Finance.

Table 13. Republic of Palau: Tax Structure Legislation History, 1994–2004

	1994 (RPPL 4-10)	1996 (RPPL 4-40)	1998 (RPPL 5-7)	2000 (RPPL 5-41)	2002 (RPPL 5-41)	2003 (RPPL 6-26)	2004 (RPPL 6-35)	2004 (RPPL 6-37)
Inclusion and authority to define "commercial purposes"	...	x						
Allowable deduction of salaries and wages paid from GRT for non-citizen	100%	50%				0%		
Tax refund for wages less than \$2,000 annual	Yes					No		
Fish Export Tax - any species of tuna or billfish in any form per kilogram	...	\$0.125		\$0.25				
Travelers Head Tax								
Citizens [effective @ 11/21/95 & @ 11/01/97]	\$5.00	\$10.00	\$20.00					
Non-citizens [effective @ 11/21/95 & @ 11/01/97]	\$10.00	\$15.00	\$20.00					
Palauans and spouses				\$10.00				
Exemptions:								
Children less than 3 years	...	x						
Masters, pilots and crew members	...	x						
Palauan students	...	...	...	x				
Medical referral patients and escort					x			
Import Tax [effective @ 01/01/98]								
Cigarettes, per 20 cigarettes		\$0.18		\$0.50				\$2.00
exemption 1 carton (10 packs containing 20 cigarettes)							x	
Tobacco products, other than cigarettes, ad valorem	60%	75%	150%		100%	150%		
Beer, per oz.		\$0.02	\$0.03		\$0.015	\$0.03		
Liquor, per oz.		\$0.13	\$0.30					
Wine, per oz.		\$0.10	\$0.20		\$0.10	\$0.20		
Wine cooler, per oz.	...	\$0.05			\$0.03	\$0.05		
All other alcohol not fruit based						\$0.30		
Vehicles, ad valorem plus \$250 per vehicle	3%		5%					
Perfume and cosmetics		25% ad valorem						
Carbonated soft drinks, per 12 fluid ounce		\$0.10						
Liquid fuel, per gallon		\$0.05						
Bottled water, except distilled water							25% ad valorem	
Elimination of Exemption of small businesses with gross revenues less than \$2,000	...	...	...	x				
Road Use Tax [effective @01/01/98]								
Motor vehicles weighing 0–2,000 lbs.	\$10.00		\$50.00					
Motor vehicles weighing 2,000–4,000 lbs.	\$25.00		\$75.00					
Motor vehicles weighing over 4,000 lbs.	\$35.00		\$150.00					

Table 13. Republic of Palau: Tax Structure Legislation History, 1994–2004 (cont'd)

	1994 (RPPL 4-10)	1996 (RPPL 4-40)	1998 (RPPL 5-7)	1998 (RPPL 5-8)	2000 (RPPL 5-41)	2002 (RPPL 5-41)	2003 (RPPL 6-26)	2004 (RPPL 6-35)	2004 (RPPL 6-37)
Definitions									
Director - BRCT instead of BNT	...	...	...	x					
Bureau - BRCT instead of BNT	...	...	...	x					
Business...	...	...	...	x					
Motor vehicles...	...	...	...	x					
Powers and duties of the Director to enter in binding agreements for the									
liquidation of tax liability	...	...	...	x					
BRCT prohibited employment				x					
Fees for employment of non-resident workers [effective @ 11/01/97]									
Non-resident worker fee [after effective date of Act]	\$75.00			\$150.00					
Non-resident worker annual fee	...	...	...	\$100.00					
Non-resident worker dependent fee	...	...	...	\$500.00					
Licenses Required; Fees [effective @ 01/01/98]									
Taxicab operator	...	...	...	\$150.00					
Massage parlor	\$50.00			\$500.00					
Fees for Division of Labor									
Change status to employment	\$1,000.00			\$500.00					
Temporary permit	\$500.00			\$500.00					
Extension of permit	\$100.00			\$125.00					
Re-issue permit	\$50.00			\$75.00					
Transfer employment	\$125.00			\$150.00					
Change of employment status	\$100.00			\$125.00					
Citation	...	...	...	\$75.00					
Change of occupation	...	...	...	\$100.00					
Application fee	\$5.00			\$5.00					

Source: Ministry of Finance.

Table 14. Republic of Palau: National Government Expenditure, 1990/91–2004/05

(In thousands of U.S. dollars; by Budget Category)

	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/2001	2001/2002	2002/2003	2003/2004 Prov.	2004/2005 Est.
Office of the President	701	754	1,013	1,221	1,251	985	1,408	1,645	1,879	1,942	1,690	1,971	1,225	1,166	1,159
Office of the Vice-President	231	290	330	346	390	410	437	507	442	450	402	560	453	529	380
Ministries															
State	806	1,022	1,116	1,234	1,627	1,846	1,731	1,859	2,244	2,440	2,409	2,135	2,329	2,186	2,180
Administration	2,513	2,652	2,752	1,578	1,618	2,204	1,953	1,911	2,587	2,661	2,479	2,889	3,781	3,362	3,134
Health	...	...	...	5,833	7,608	8,030	9,704	9,147	9,536	10,193	10,391	10,053	10,604	12,527	11,874
Education	...	...	...	9,741	11,204	8,844	9,173	8,833	9,710	9,055	9,431	8,730	8,517	9,138	11,122
Community & Cultural Affairs	...	...	...	920	1,010	726	654	815	748	785	768	808	1,175	1,348	952
Social Services	11,441	13,303	15,055	...	...	...	...	...	...	...	...	...	...	...	...
Justice	1,334	1,592	1,565	2,030	2,308	2,458	2,973	2,970	3,870	4,366	3,538	3,579	3,510	3,589	4,208
Resources & Development	...	...	...	8,274	4,736	3,931	4,830	5,534	7,719	9,161	7,657	6,766	6,463	6,557	7,094
Commerce & Trade	...	...	...	407	810	914	1,559	1,753	1,386	1,475	1,503	1,290	1,518	1,603	1,368
Natural Resources	8,998	6,608	9,597	...	...	...	...	...	...	...	...	...	...	...	...
Boards, Comm & Authorities	385	487	465	598	1,208	835	791	454	335	564	526	443	428	587	589
Office of the Public Auditor	151	229	344	378	391	527	608	566	779	689	667	684	380		
Office of the Special Prosecutor	0	173	175	156	136	188	117	62	213	227	225	281	235	1,412	1,124
Olbiil Era Kelulau (Congress)	2,162	2,665	2,597	3,227	3,470	3,261	3,651	3,384	3,394	3,606	3,312	3,368	3,372	3,396	3,433
Grants to State Governments	1,874	2,123	3,266	3,484	3,268	1,747	4,682	4,612	4,514	4,850	4,453	4,453	4,463	4,573	4,491
Judiciary	1,148	1,294	1,390	1,464	1,618	1,793	1,915	2,045	2,206	2,259	2,268	2,342	2,124	2,255	2,170
Other 1/	1,525	6,213	2,748	4,056	4,260	7,018	6,890	5,204	4,074	5,191	5,269	3,834	5,658	1,863	4,057
Capital expenditures	11,074	10,663	3,792	3,012	8,529	17,003	18,290	9,856	7,988	12,501	15,361	21,038	15,345	20,027	12,975
Interest payments	0	0	14	...	...	...	...	...	...	...	700	712	712	687	665
Operating transfers 2/	230	246	357	2,422	9,809	12,429	5,176	3,460	8,052	12,078	6,707	4,132	4,014	3,989	3,972
Public enterprises	181	196	207	266	5,543	7,889	3,036	1,000	1,337	3,149	2,837	1,662	1,669	1,549	1,587
Other 3/	49	2,879	150	2,158	4,266	4,540	2,140	2,460	6,715	8,929	3,870	2,470	2,345	2,440	2,385
Total	44,343	50,314	46,576	50,381	65,251	75,148	76,542	64,617	71,678	84,493	79,756	80,068	76,306	80,794	76,947

Sources: Reports on the Audit of Financial Statements and data provided by the Bureau of Program, Budget, and Management, MOF.

1/ Other expenditures includes other programs from general fund expenditures, special revenue fund expenditures, and CIP management fees.

2/ Includes subsidies and other transfers for current operations.

3/ Other major public entities receiving transfers are: Palau Community College Board of Trustees, COM Board of Regents, and Civil Service Pension Plan.



Table 15. Republic of Palau: Operating Accounts of the State Governments, 1996/97–1998/99

(In thousands of U.S. dollars; end of the period)

	1996/97 1/	1997/98 2/	1998/99 3/
Revenues			
National government grant	3,092	1,346	1,546
Fishing right fees	373	166	112
Interest income	73	12	96
Other	273	12	133
Total revenues	3,811	1,535	1,791
Expenditures			
Salaries and wages	1,312	455	552
Capital expenditure	2,005	645	778
Other	1,320	880	596
Total expenditures	4,637	1,980	1,926
Net collection (deficit)	-826	-445	-135
Account receivables/loan repayment	-15		
Fund balance (beginning of year)	1,368	526	82
Fund balance (end of year)	526	82	-53

Source: Data provided by the Office of the Public Auditor. No reporting after 1998/99.

1/ A total of (2) states operations are not yet included in FY 1997.

2/ A total of (11) states operations are not yet included in FY 1998.

3/ A total of (12) states operations and the Fund balances are not yet included in FY 1999.

Table 16. Republic of Palau: Financial Holdings of the Central Government, 1994/95–2004/05

(In thousands of U.S. dollars; end of period)

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04 Prov.	2004/05 Prov.
Foreign assets 1/											
Deposits with foreign banks	96,173	83,953	76,086	64,241	64,628	45,313	39,785	10,805	10,874	7,324	7,541
Change in FB assets		-12,220	-7,867	-11,845	387	-19,315	-5,528	-28,980	69	-3,550	217
Change due to:											
Deposits	60,230	23,938	22,410	21,221	13,652	13,714	37,313	16,006	13,928	14,071	12,533
Interest income	4,522	4,472	308	74	28	60	171	55	48	2,079	188
Investment Gains/Losses	4,084	3,281	13,679	4,772	9,857	10,247	(8,928)	(768)	1,094	(1,675)	261
Investment Fees	(450)	(552)	(477)	(419)	(393)	(350)	(185)	(81)	(62)	(54)	(40)
Withdrawals	(38,449)	(43,359)	(43,787)	(37,493)	(22,757)	(42,987)	(33,900)	(44,192)	(14,938)	(17,971)	(12,725)
Total change	29,937	(12,220)	(7,867)	(11,845)	387	(19,316)	(5,529)	(28,980)	70	(3,550)	217
Grant deposited/withdrawn from Bank of Guam							23,328	(23,329)			
Domestic assets 2/											
Deposits with domestic banks	622	2,300	4,715	17,580	2,377	32,369	3,882	2,907	5,493	2,159	1,964
Change in DB assets		1,678	2,415	12,865	-15,203	29,992	-28,487	-975	2,586	-3,334	-195
Fiduciary funds 3/	70,779	77,176	105,536	122,362	141,139	161,833	135,039	124,496	136,295	141,613	152,509
Total financial holdings	167,574	163,429	186,337	204,183	208,144	239,515	178,706	138,208	152,662	151,096	162,014

Sources: Data provided by the Office of the President and Ministry of Finance.

1/ Deposits with all foreign banks, including those in the United States.

2/ Deposits with local banks.

3/ Refer only to Compact Section 211(f) Trust Fund, excluding the Civil Service Pension Trust and Social Security Retirement Fund.

Table 17. Republic of Palau: Financial Position of the Compact  
Section 211(f) Trust Fund. 1994/95–2004/05

(In thousands of U.S. dollars; end of the period)

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04 1/ Prov.	2004/05 1/ Prov.
Total receipts	71,034	6,961	28,862	17,600	19,621	21,472	(25,810)	(4,695)	19,518	11,312	16,780
Compact grants	66,000		4,000								
Investment Gains and											
Interest Income	5,034	6,961	24,862	17,600	19,621	21,472	(25,810)	(4,695)	19,518	11,312	16,780
Investment gains (losses)	5,034	...	14,917	10,559	11,368						
Investment interest income	...	6,961	9,944	7,040	7,579						
Total expenditures	255	564	502	773	845	778	984	5,848	7,719	5,995	5,883
Investment Fees	255	564	502	773	845	778	984	848	2,719	995	883
Withdrawals	...	...	...	...	...	...	...	5,000	5,000	5,000	5,000
Overall balance	70,779	6,397	28,360	16,826	18,776	20,694	(26,794)	(10,543)	11,799	5,317	10,897
Fund balance at year end	70,779	77,176	105,536	122,362	141,139	161,833	135,039	124,496	136,295	141,612	152,510

Sources: Independent Auditor's Report on Financial Statement; and data provided by the Office of the President and Ministry of Administration.

1/ Unaudited figures for FY 2004 and FY2005.

Table 18. Republic of Palau: Financial Position of the Social Security Fund, 1989/90–2004/05

(In thousands of U.S. dollars)

	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Revenues	1,532	2,476	3,165	4,268	3,349	5,727	4,930	8,280	6,791	10,276	13,469	-221	5,402	13,137	10,311	16,819
Contributions	1,471	1,592	2,557	2,889	3,383	3,615	4,014	5,310	5,487	5,587	6,362	6,891	8,166	7,882	7,828	8,580
Government	730	740	1,385	1,534	1,853	1,948	2,011	2,681	2,644	2,748	2,780	2,885	3,381	3,545	3,688	4,054
Private	736	848	1,168	1,345	1,517	1,649	1,983	2,599	2,805	2,838	3,403	3,925	4,521	4,320	4,059	4,447
Penalties and interest	5	4	4	10	13	18	20	30	38	1	179	81	264	17	81	79
Investment and other income	61	884	608	1,379	-34	2,112	916	2,970	1,304	4,689	7,107	-7,112	-2,764	5,256	2,482	2,482
Investment with trust company	61	884	608	1,360	-48	2,097	900	2,952	1,288	4,664	7,034	-7,130	-2,787	5,228	2,396	8,140
Other income (local)	...	...	...	19	14	15	16	18	16	25	73	18	23	27	87	99
Expenditures	1,715	1,835	2,011	2,312	2,539	2,625	2,871	3,105	3,354	3,713	4,215	4,721	5,195	5,720	5,848	6,150
Total benefit payout 1/	1,502	1,553	1,752	1,947	2,192	2,304	2,420	2,616	2,780	2,990	3,551	3,968	4,252	4,566	4,950	5,286
Administrative fees 2/	213	282	259	365	347	321	451	489	574	723	664	753	943	1,154	898	864
Net collection (deficit)	-183	641	1,154	1,956	810	3,102	2,059	5,175	3,437	6,563	9,254	-4,942	207	7,417	4,463	10,669
Fund balance (end-year) 3/	4,765	5,556	6,709	8,666	9,477	12,579	14,639	19,817	23,254	29,817	39,071	34,129	34,336	41,866	46,329	56,998

Sources: Annual audit reports; and data provided by the Palauan Social Security Office.

1/ Total benefit payout includes retirements, survivors, disability, and lump sum payments.

2/ Including administrative and investment management expenses and fees.

3/ Capitalized assets of \$77,000 in FY2000.

Table 19. Republic of Palau: Financial Position of the Civil Service Pension Fund, 1990/91, 1994/95–2004/05

(In thousands of U.S. dollars; end of period)

	1990/91	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04 Prov.	2004/05 1/ Prov.
Revenues	2,363	7,221	5,688	7,068	5,108	12,183	14,115	(1,329)	2,951	10,100	6,466	11,414
Contributions												
Government employees	1,975	2,851	3,125	3,285	3,309	3,438	3,596	3,926	4,096	4,214	4,328	4,861
Investment gains (losses)	30	1,827	653	3,305	1,201	3,880	6,288	(7,653)	(2,097)	5,101	1,493	5,734
Investment interest income	112	227	290	346	456	455	554	605	595	566	309	353
Other income	96	86	120	132	142	110	177	268	232	219	336	466
Transfers from national government	150	2,230	1,500	...	...	4,300	3,500	1,525	125	...	...	...
Expenditures	1,077	2,305	2,536	3,025	3,116	3,491	4,597	5,318	5,219	5,548	5,794	6,168
Total benefit payout 2/	956	1,980	2,078	2,545	2,703	3,008	3,819	4,752	4,740	5,069	5,284	5,876
Administrative fees 3/	121	325	458	480	413	483	778	566	479	479	510	292
Net collection (deficit)	1,286	4,916	3,152	4,043	1,992	8,692	9,518	(6,647)	(2,268)	4,552	672	5,246
Fund balance (end-year)	4,233	13,212	16,364	20,407	22,399	31,093	40,614	33,967	31,699	36,251	36,923	42,169

Sources: Independent auditor's report on financial statements; and data provided by the Palau Civil Service Pension Plan Authority.

1/ Unaudited figures for FY 2005.

2/ Including lumpsum benefits, refunds, and disability benefits.

3/ Including investment management expenses and fees.

Table 20. Republic of Palau: Operating Accounts of the Major Public Corporations, 1996/97–2003/04

(In thousands of U.S. dollars; end of period)

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04 unaudited
<b>Palau Utility Corporation</b>								
Operating revenues	6,170	8,055	7,797	9,248	11,528	10,422	11,071	12,553
Operating expenses	9,379	9,761	8,378	11,400	12,263	11,576	12,137	14,725
Gross operating profit (loss)	-3,209	-1,706	-581	-2,152	-735	-1,154	-1,066	-2,172
Non-operating revenues (expenses)	...	...	...	...	...	...	1,038	...
Subsidies from government and foreign grants	2,239	1,566	706	1,990	1,198	552	535	571
Net total profit (loss)	-970	-140	125	-162	463	-602	506	-1,601
<b>Palau Housing Authority</b>								
Operating revenues:	389	270	201	115	209	403	201	258
Operating expenditures	398	258	227	139	120	94	149	133
Change in equity during the year	23	41	-26	-24	89	309	52	125
Fund equity, beginning of year	-268	-245	-245	-231	-255	-166	143	195
Fund equity, end of year	-245	-205	-231	-281	-166	143	195	320
<b>Palau National Communications Corporation</b>								
Operating revenues	5,835	6,390	6,412	6,656	6,059	8,812	8,812	8,629
Operating expenses	4,496	5,632	6,206	5,594	6,166	8,438	8,523	9,760
Other income (expenses)	-1	-1	-1,911	-1,337	-1,496	1,686	1,686	1,579
Change in equity during the year	828	...	-1,705	-275	-1,603	-1,312	-2,267	-2,712
Fund equity, beginning of year	13,111	13,939	13,536	11,831	12,041	10,438	10,783	5,715
Fund equity, end of year	13,939	13,536	11,831	11,556	10,438	9,126	8,516	3,002

Sources: Independent auditor's report on financial statements; and data provided by the Palau Utilities Corporation, Palau Housing Authority; and Palau National Communications Corporation.

Table 21. Republic of Palau: Assets and Liabilities of the National Development Bank of Palau, 1996/97–2004/05

(In thousands of U.S. dollars; end of the period)

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
<b>Assets</b>									
Cash	33	113	919	3,583	3,589	482	1,169	1,800	3,836
Time certificates of deposit	606	1,339	1,413	1,084	1,149	2,219	1,241	896	1,363
Loans	5,728	5,049	4,181	4,007	5,966	8,653	10,315	11,337	13,100
Fixed assets	25	33	16	133	100	109	88	54	60
Investments								5,007	1,000
Other 1/	33	46	210	1,097	95	109	97	278	704
<b>Total assets</b>	<b>6,425</b>	<b>6,580</b>	<b>6,739</b>	<b>9,904</b>	<b>10,899</b>	<b>11,572</b>	<b>12,911</b>	<b>19,373</b>	<b>20,063</b>
<b>Liabilities</b>									
Accounts payable 2/	1	8	10	23	25	32	19	110	104
Bonds payable	0	0	0	0	0	0	0	0	
Loans payable	407	0	0	0	0	0	500	6,000	6,300
Bank capital 3/	6,016	6,572	6,729	9,881	10,874	11,540	12,392	13,262	13,659
<b>Total liabilities</b>	<b>6,424</b>	<b>6,580</b>	<b>6,739</b>	<b>9,904</b>	<b>10,899</b>	<b>11,572</b>	<b>12,911</b>	<b>19,373</b>	<b>20,063</b>

Sources: Independent Auditor's Report on Financial Statement; and data provided by the National Development Bank of Palau (NDBP).

1/ Includes other receivables, inventory, prepaid expenses, and receivable from Republic of Palau.

2/ Includes accrued expenses.

3/ Includes contributed capital and retained earnings.

Table 22. Republic of Palau: Operating Accounts of the National Development Bank of Palau, 1996/97–2004/05

(In thousands of U. S. dollars; end of the period)

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Revenues	872	820	727	2,970	1,068	1,106	1,283	1,374	1,552
Interest	0	0	629	564	737	904	1,137	1,211	1,244
Loan fees	746	770	20	61	84	89	81	100	149
Others	126	50	78	195	247	114	65	63	158
Transfers from national government 1/	0	0	0	2,150	0	0	0	0	0
Contributions from other countries	0	0	0	0	0	0	0	0	0
Net provision for allowance for loan losses					320	15	0	8	-441
Expenditures:	602	256	571	572	395	455	431	512	715
Wages and salaries	136	123	148	158	203	250	224	230	266
Depreciation	16	13	15	35	33	38	45	51	37
Interest	0	5	0	0	0	0	2	83	245
Others	450	115	408	379	159	167	160	148	166
Net income (losses)	270	564	156	2,398	992	666	852	870	397
Fund equity, beginning of year 2/	6,176	6,446	6,572	6,728	9,882	10,874	11,540	12,392	13,262
Fund equity, end of year	6,446	7,010	6,728	9,126	10,874	11,540	12,392	13,262	13,659

Sources: Independent Auditor's Report on Financial Statements; and data provided by the National Development Bank of Palau (NDBP).

1/ Capital transfers include amount of \$ 149,916 for Y2K upgrading project and \$2 million for the first time home-owner program from the government.

2/ Adjustment of fund equity for FY 2001 due to a restatement.



Table 23. Republic of Palau: Bank Credit Allocation by the National Development Bank of Palau, 1990–2005

	Agriculture	Fisheries	Tourism	Forestry	Manufacturing	Commerce and Construction	Housing	Total Loans
1990	55,009	191,552	755,995	14,858	86,140	574,674	...	1,678,228
1991	65,905	253,118	917,419	11,565	150,837	882,035	...	2,280,879
1992	56,934	237,764	910,211	4,357	91,543	1,411,854	...	2,712,663
1993	23,377	270,936	867,315	181	1,763	1,640,543	...	2,804,115
1994	47,346	239,374	1,259,143	...	1,739	1,353,788	...	2,901,390
1995	54,586	201,608	1,257,773	...	...	1,789,561	...	3,303,528
1996	65,000	359,000	348,000	...	48,271	2,469,000	...	3,289,271
1997	45,000	164,000	265,000	...	...	1,685,000	...	2,159,000
1998	7,000	16,000	...	...	...	70,000	...	93,000
1999	...	...	...	...	...	...	...	...
2000	15,000	...	...	...	488,651	2,378,217	2,881,868	5,763,736
2001	15,000	16,882	...	...	1,134,984	1,881,138	3,048,004	6,096,008
2002	0	25,449	...	...	0	1,671,583	2,736,012	4,433,044
2003	189,539	76,086	669,825	0	0	3,820,427	6,677,830	11,433,707
2004	180,186	90,938	763,772	0	0	3,804,231	7,603,875	12,443,002
2005	194,092	90,060	1,400,570	0	0	4,900,703	8,483,768	15,069,193

Source: Data provided by the National Development Bank of Palau (NDBP).

Table 24.1. Structure of Interest Rates of the National Development Bank of Palau, 2000–2005

(In percent)

Particulars	May 2000	May 2001	May 2002	May 2003	May 2004	May 2005
Deposit rates						
Checking account (with minimum balance)	...	...	...	...	...	...
Savings account	...	...	...	...	...	...
Time savings account					...	...
30 days	...	...	...	...	...	...
One year	...	...	...	...	...	...
Certificates of deposit					...	...
Six months	...	...	...	...	...	...
One year	...	...	...	...	...	...
Two years	...	...	...	...	...	...
Three years	...	...	...	...	...	...
Lending rates						
Consumer loans	...	...	...	...	...	...
Commercial loans (one year)	10.00-12.00	10.00-12.00	10.00-12.00	10.00-12.00	10.00	11.00
Residential housing loans						
30-year, fixed (Maximum 20 year)	8.00-12.00	8.00-12.00	8.00-12.00	8.00-12.00	8.00-10.00	8.00-10.00
15-year, fixed	12.00	12.00	12.00	12.00	10.00	10.00
Government-directed scheme 1/	8.00	8.00	8.00	8.00	8.00	8.00
Normal loan scheme	12.00	12.00	12.00	12.00	10.00	10.00

Source: Data provided by the National Development Bank of Palau (NDBP).

1/ Under government-directed loan scheme, loan is provided to Palauans who have never owned a house.

Table 24.2. Structure of Interest Rates of Bank of Hawaii-Palau Branch, 2000–2005

(In percent)

	May 2000	May 2001	May 2002	May 2003	May 2004	May 2005
Deposit rates						
Checking account (with minimum balar	...	...	...	...	N/A	0.0 - 0.08
Savings account	2.02	1.75-3.00	.25-2.05	.25-1.00	0.30 - 0.85	0.05 - 1.45
Time savings account						
30 days	2.32 - 2.47	1.40-2.27	1-1.51	0.30	...	...
One year	3.75 - 5.00	1.45-2.25	1.20-1.75	N/A	...	...
Certificates of deposit						
Six months	3.65 - 4.10	1.45-2.26	1.00-1.51	0.45	0.45	0.35 - 1.10
One year	3.75 - 5.00	1.45-2.25	1.20-1.75	0.50	0.5	1.40 - 1.50
Two years	3.95 - 5.25	2.00-2.50	1.90-2.60	1.30	1.5	2.9
Three years	4.00 - 5.75	2.50-3.00	3.00-3.25	2.00	2.5	3.05
Five years	...	...	...	3.00	3	3.15
Lending rates						
Consumer loans	15.00	15.00	10.00-15.00	10.0 - 16.0	10.0 - 16.0	10.0 - 16.5
Commercial loans (one year) 1/	P + 4%	P+1-4%	P+.75-4	P + 0.50 - 4.0	P + 0.50 - 4.0	P + 0.50 - 4.0
Residential housing loans				P + 0.75 - 4.0	P + 0.75 - 4.0	P + 0.75 - 4.0
30-year, fixed	...	...	...	...	...	...
15-year, fixed	...	...	...	...	...	...

Source: Data provided by the Bank of Hawaii, Palau Branch.

1/ Commercial loan rates follow WSJ Prime (P) plus .75–4 percent.

Table 24.3. Structure of Interest Rates of Bank of Guam-Palau Branch, 2000–2005

(In percent)

	May 2000	May 2001	May 2002	May 2003	May 2004	May 2005
Deposit rates						
Checking account (with minimum balar	N/A	N/A	1.25	.25-.50	0.25	0.25
Savings account	2.50-3.00	3.00	1.50	.50-1.00	.50 - .75	0.75
Time savings account						
30 days	4.07-4.38	2.50	0.88	0.88	0.73	0.77
One year	4.60-5.10	2.50	0.88	0.88	0.73	1.34
Certificates of deposit						
Six months	4.35-4.79	3.04	1.16	.56-.67	.77-.89	1.21
One year	4.60-5.10	3.07	1.21	.94-1.00	1.25	1.34
Two years	5.07-5.26	3.40	1.44	1.18-1.36	2.00	1.84
Three years	5.19-5.45	3.40	1.44	1.28-1.36	2.50	2.11
Lending rates						
Consumer loans	15.00–18.00	15.00	15.00	15.00	15.00	15.00
Commercial loans (one year)	9.75–12.50	11.75	7.50–13.50	7.50–13.84	7.50–13.50	8.25
Residential housing loans						
30-year, fixed	N/A	N/A	N/A	N/A	N/A	N/A
15-year, fixed	N/A	N/A	N/A	N/A	N/A	N/A

Source: Data provided by the Bank of Guam, Palau Branch.

Table 24.4. Republic of Palau: Structure of Interest Rates of Pacific Savings Bank, 1997–2004

(In percent)

	<u>May</u> 1997	<u>May</u> 1998	<u>May</u> 1999	<u>May</u> 2000	<u>May</u> 2001	<u>May</u> 2002	<u>May</u> 2003	<u>May</u> 2004
Deposit rates								
Checking account (with minimum balance)	0.0–4.5	5.0	5.0	5.0	5.0	5.0	5.0	4.0
Savings account	2.25–5.0	4.75	4.75	4.75	4.75	4.75	4.75	2.75
Time savings account								
30 days	3.00–5.00	4.75	4.75	4.75	4.75	4.75	4.75	2.75
One year	4.5–6.0	6.0	6.0	6.0	6.0	6.0	6.0	4.0
Certificates of deposit								
Six months	5.0	5.0	5.0	5.0	5.0	5.0	5.0	3.0
One year	6.0	6.0	6.0	6.0	6.0	6.0	6.0	4.0
Two years	7.0	7.5	7.5	7.5	7.5	7.5	7.5	5.5
Three years	8.0	8.0	8.0	8.0	8.0	8.0	8.0	6.0
Lending rates								
Consumer loans	15.0–18.0	15.0–18.0	15.0–18.0	15.0–18.0	15.0–18.0	18.0	18.0	18.0
Commercial loans (one year) 1/	9.5–12.50	...	...	...	...	...	...	...
Residential housing loans								
30-year, fixed	12	...	...	...	...	...	...	...
15-year, fixed	12	...	...	...	...	...	...	...

Source: Data provided by the Pacific Savings Bank.

1/ Commercial loan rates follow the highest New York Prime plus 4%.