



REPUBLIC OF PALAU

SELECTED ISSUES

May 2014

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SELECTED ISSUES

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April 7, 2014

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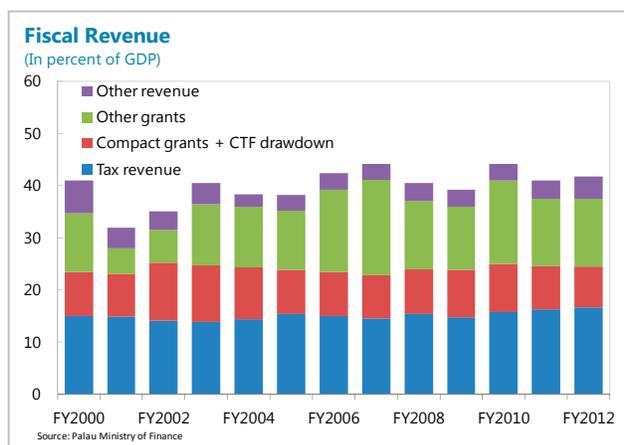
ACHIEVING LONG-TERM FISCAL SUSTAINABILITY IN PALAU¹

This paper describes Palau's fiscal challenges and policy options to achieve long-term fiscal sustainability. Palau relies heavily on Compact grants, and without continued fiscal consolidation over the medium term, the fiscal position will become unsustainable after these grants expire in FY2024. This fiscal sustainability analysis uses an intertemporal budget constraint model to show that reducing the current deficit excluding grants by about 8 percentage points (ppt) of GDP during FY2014–19 would ensure Palau's long-term fiscal sustainability.² This fiscal adjustment requires comprehensive revenue and expenditure reforms as well as improvements in public finance management.

A. Fiscal Challenges

1. This section summarizes Palau's main fiscal challenges in light of the expiration of Compact grants in FY2024. It shows that the decline in Compact grant assistance will imply growing reliance on government domestic revenue and deposits and on withdrawals from the Compact Trust Fund (CTF) to finance government expenditure. Meanwhile, domestic revenue is volatile and low compared to other Pacific Island Countries (PICs), and fiscal expense (current spending), particularly the wage bill, is high. In view of these challenges, continued fiscal consolidation is critical to achieve fiscal self sufficiency by the time Compact grants expire.

2. Palau relies heavily on external grants, particularly Compact grants to finance fiscal expenditure. On-budget grants averaged 21 percent of GDP and represented 52¾ percent of total fiscal revenues during fiscal years FY2000–12. Compact grants were renewed in FY2010, but are scheduled to end in FY2024.³ The renewed agreement is pending ratification by the U.S. congress. In the meantime, Palau has been receiving advances for direct economic assistance. Once the agreement is approved, the United States will provide additional grants for infrastructure projects and debt reduction, and also contribute to the CTF over 9–10 years (Box 1). Total assistance under the agreement, including the advances, will amount to US\$229 million (98½ percent of FY2012 GDP) by FY2024.⁴



¹ Prepared by Rodolfo Dall'Orto (SEC).

² The current balance excluding grants is defined as revenue less grants and expense.

³ U.S. and Palau Governments (2010) and GAO (2012).

⁴ The Compact also establishes a basis for U.S. agencies to provide discretionary federal programs related to health, education, and infrastructure. GAO (2012) estimates that assistance under federal programs will total approximately US\$ 211.7 million through FY2024.

Box 1. Palau: The Compact of Free Association¹

The Compact of Free Association was ratified in 1994. Under the agreement, the United States gave Palau grant assistance until FY2009 and will continue to provide defense protection in exchange for the right to maintain U.S. military facilities on one-third of the territory, if needed, for 50 years. Total assistance under the Compact agreement in FY1994–09 was about US\$580 million.²

In September 2010, the United States and Palau signed an agreement that would provide for additional assistance to Palau. Decreasing assistance, totaling approximately US\$229 million through FY2024, includes the following:

- direct economic assistance (US\$122 million) for Palau government operations;
- infrastructure project grants (US\$40 million) to build mutually agreed projects;
- establishment of an infrastructure maintenance fund (US\$27 million) for maintaining the Compact Road, Palau’s primary airport, and certain other major U.S. funded projects;
- establishment of a fiscal consolidation fund (US\$10 million) to assist Palau in debt reduction; and
- contributions to the Compact Trust Fund (US\$30 million).

Currently, the agreement is pending ratification by the U.S. congress, but the U.S. Department of Interior has been advancing about US\$13 million annually for direct economic assistance. The revised disbursement schedule shows that the grants could be frontloaded, with large disbursements expected in FY2014 if the agreement is ratified.

¹ GAO (2012).

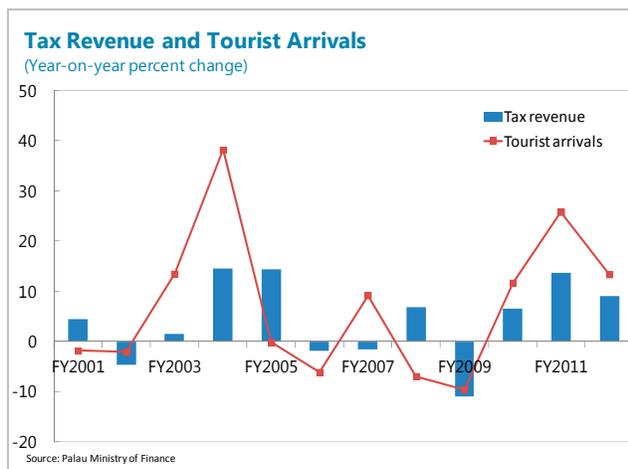
² The Compact also establishes a basis for U.S. agencies to provide discretionary federal programs related to health, education, and infrastructure.

3. Once Compact grants expire in FY2024, fiscal expenditure will have to be financed mainly by government domestic revenue and deposits and withdrawals from the CTF.⁵ Moreover, because some projects that are financed by Compact capital grants will be one-time in nature, the government will need to maintain an adequate level of capital expenditure in order to sustain long-term growth. The annual CTF withdrawals will be capped at US\$15 million during FY2024–44, and without substantial build up of government assets, the current level of government domestic deposits (at 5 percent of GDP) will not suffice Palau’s remaining fiscal financing needs. Therefore, fiscal adjustment to build government deposits through increasing domestic revenue and/or reducing spending over the medium term is needed.

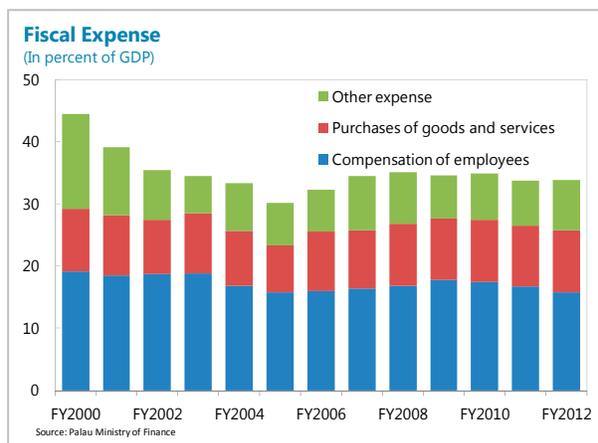
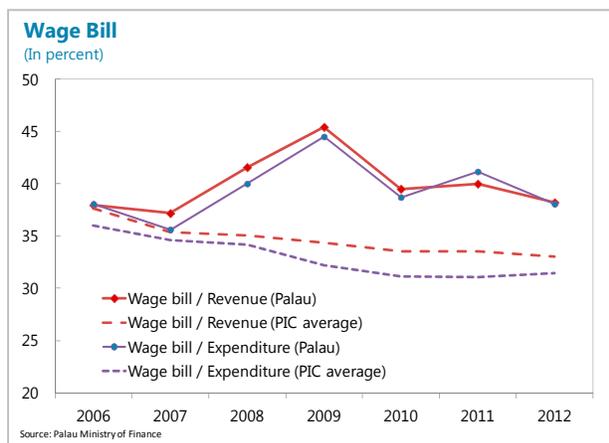
⁵ Under the original Compact agreement, US\$70 million were provided to establish the CTF (US\$66 million in FY1995 and US\$4 million in FY1997). Once the renewed agreement enters into force, the United States will contribute additional US\$30.25 million to the CTF over 9–10 years. The purpose of the trust fund is to provide a steady stream of income that would replace Compact grants after FY2024. Once the new agreement enters into force, Palau will be allowed to gradually increase its current annual withdrawals of US\$5 million to US\$13 million in FY2023, and to withdraw US\$15 million from FY2024 through FY2044.

4. In the meantime, Palau is facing challenges in terms of revenue collection:

- **Volatility:** Although Palau’s tax-to-GDP ratio is close to the mid-range of selected small island states, this is largely due to greater departure-tax collections (Table 1). Continued and increased reliance on tourism-related taxes is contributing to revenue volatility and vulnerability to external shocks.
- **Low collection:** Income tax and goods and services tax as percent of GDP are among the lowest in the region, which suggest potential areas for Palau to raise revenue over the medium term (Table 1).⁶ Recent IMF and Pacific Financial Technical Assistance Centre (PFTAC) technical assistance (TA) has found that the current tax framework has a number of weaknesses, including double taxation of exports, effective tax rates that differ significantly between firms with similar profits, and gaps in the tax base that distort activity and lead to unfair outcomes.



5. On the expenditure side, a comparatively high wage bill in terms of GDP raises funding needs. About half of fiscal expense goes to the wage bill, and the wage bill-to-expenditure ratio is high compared to other Pacific island countries (PIC). Moreover, during FY2000–12, the ratio of wage bill to revenue was high at 43¾ percent of total revenue and 92½ percent of total revenue excluding grants (domestic revenue). This could become unsustainable once Compact assistance expires and would reduce fiscal space to maintain an adequate level of capital expenditure.



⁶ A good comparator country is the Cook Islands, a very small tourist-dependent island state where value-added tax (VAT) has operated since the early 1990s. Reflecting the importance of tourism, the Cook Islands collect a comparable amount of departure taxes. Nevertheless, its income tax and goods and services tax performance shows potential areas for Palau to raise revenue over the medium term.

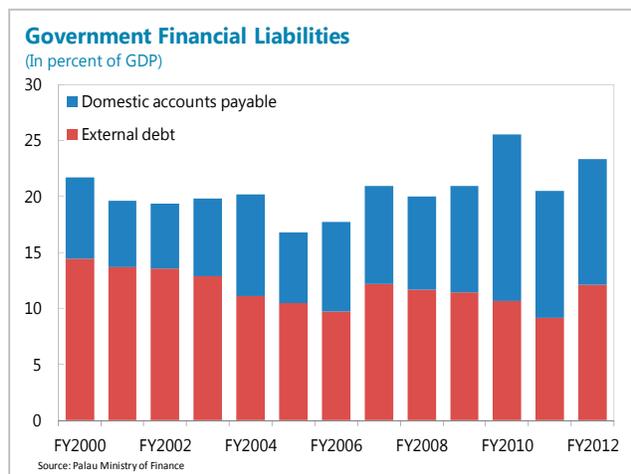
Table 1. Palau: Tax Revenue in Pacific Islands Countries

Country	Tax Revenue	Income Taxes	Domestic Goods and Services Taxes	International Trade Taxes	Other
(in percent of GDP)					
Nauru (FY2012)	6.5	0.0	0.0	6.0	0.5
F. S. Micronesia (FY2011)	12.0	2.4	2.9	3.2	0.0
Vanuatu (2011)	16.5	0.0	12.0	3.8	0.7
Marshall Islands (2008)	17.1	11.1	0.0	5.7	0.4
Palau (FY2012)	17.4	3.2	6.9	4.2	3.0
Tonga (2011)	17.5	5.0	10.7	1.8	0.0
Kiribati (2008)	20.3	7.9	0.1	12.4	0.0
Samoa (2012)	21.0	5.0	14.0	2.0	0.0
Papua New Guinea (2012)	24.6	16.8	4.5	2.6	0.8
Cook Islands (2012)	25.1	10.0	10.0	3.2	1.7
Fiji (2011)	27.5	9.1	10.2	6.1	2.2
Solomon Islands (2011)	30.1	10.1	11.3	8.6	0.0
Average	19.9	6.9	6.9	5.0	0.6

Source: Country authorities and Fund staff estimates.

6. Low fiscal buffers and weaknesses in budget planning and execution have led to the buildup of domestic accounts payable. For example, budget execution is based on appropriations rather than cash availability, resulting in the drawdown of government domestic deposits and/or the accumulation of accounts payable when revenue collection is lower than budgeted. These accounts payables (mostly in the form of trade credits and late payment to suppliers) doubled from about 7 percent of GDP in average during FY2000–08 to 15 percent in FY2010 as a result of the economic slump brought, among other factors, by the global financial crisis. The government is making efforts to clear domestic accounts payable; however, they remained high at 11 percent of GDP in FY2013.

7. Large loans from development partners to improve infrastructure could pose challenges in terms of debt management. In FY2012, the Asian Development Bank (AsDB) granted Palau a US\$16 million loan (7 percent of FY2012 GDP) to improve water and sewer services. In FY2014, the AsDB approved an additional US\$28.8 million loan (12½ percent of FY2012 GDP) to help the country make critical investments in sanitation, water, and power,



and prioritize maintenance.⁷ The increase in public external debt could pose challenges in terms of debt management and calls for continued fiscal consolidation as well as strong governance of these projects.

8. In view of these challenges, continued fiscal consolidation is critical to build fiscal buffers and ensure long-term fiscal sustainability. Furthermore, given the absence of monetary and exchange rate policies in Palau, building adequate fiscal buffers is also crucial to react to any downside risks and sustain external stability. This reinforces the need for comprehensive revenue and expenditure reforms to support the fiscal adjustment.

B. Achieving Long-Term Fiscal Sustainability

9. This section assesses Palau’s long-term fiscal sustainability and derives the conditions to ensure fiscal self-sufficiency when the Compact grants expire in FY2024. The analysis is based on an intertemporal budget constraint model that has been used in previous Article IV consultations, but is updated to incorporate the latest macroeconomic developments and projections.⁸

Framework and Assumptions

10. The analytical framework is based on the government’s intertemporal budget constraint.⁹ This framework requires that the government’s net worth plus the net present value (NPV) of future revenue streams equals the NPV of future expenditure streams. This is expressed in the following equation:

$$W + G + R = C + K$$

where the government’s net worth (W) and the NPVs of grants (G) and domestic revenue (R) are balanced against the NPVs of fiscal expense (C) and net acquisition of non-financial assets (K).

11. The current balance excluding grants (R-C) is set as the policy variable to balance the budget constraint. The government’s initial net worth (W), grants (G), and capital spending (K) are exogenous. The government’s initial net worth (W) is inherited and comprises the CTF and government domestic deposits, less domestic accounts payable and government external debt. Grants (G) are to a large extent determined by development partners. Capital spending (K) should be maintained at a level that supports growth. In contrast to these three variables, domestic revenue (R) and fiscal expense or current spending (C) can be influenced by policy makers, leaving the current deficit excluding grants (R-C) as the policy variable to satisfy the above equation.

12. The government’s initial net worth is estimated at 60½ percent of GDP at end FY2013. The CTF is estimated at 77 percent of GDP, government domestic deposits at 5 percent of GDP,

⁷ The AsDB disbursed US\$9.8 million in FY2012, and is expected to disburse US\$35 million throughout FY2014–22 under these infrastructure loans. Palau is also negotiating potential loans with the AsDB and the World Bank to develop a fiber optic project that would reduce the cost and increase the availability of information and communications technology services needed to support social and economic development.

⁸ This section uses the framework found in Lueth (2008) and updated in *Appendix I: Palau—Long-Term Fiscal Sustainability* of IMF (2012).

⁹ See Appendix 1 for more information on the intertemporal budget constraint framework.

domestic accounts payable at 11 percent of GDP, and government external debt at 10½ percent of GDP.

13. The following assumptions are made:

- Nominal GDP growth: 4 percent (real GDP growth: 2 percent).
- CTF nominal rate of return: 6 percent (real rate of return: 4 percent). The average annual return was 5¾ percent during FY2000–12 and 8 percent since the trust fund’s inception in 1995.
- U.S. Compact grants: US\$146.2 million over FY2014–24 (total direct assistance of US\$229 million minus the advances of US\$52.5 million received during FY2010–13 and US\$30.25 million in contributions to the CTF, which are not part of the government’s budget).
- Annual drawdown from the CTF: gradual increase from US\$5 million to US\$13 million during FY2014–23, US\$15 million during FY2024–44, and 1¾ percent of GDP thereafter.
- Other U.S. grants: US\$170 million over FY2014–24,¹⁰ and 4½ percent of GDP thereafter.
- Other country grants: 4½ percent of GDP.
- Acquisition of non-financial assets: ranges between 6¾–9¾ percent of GDP in FY2014–25, and 9 percent of GDP thereafter.

Findings

14. The results show that reducing the current deficit excluding grants (R-C) by 7¾-8½ ppt of GDP would ensure Palau’s fiscal sustainability. This adjustment should take place between FY2014 and FY2023, and it would increase the government’s net worth to a level that will generate sufficient income to finance a sustainable deficit over the long term. However, there is a trade-off between the speed of adjustment and the level of net worth that can be achieved: the longer the adjustment period, the lower the net worth that can be achieved (hence, the lower the sustainable deficit that can be financed).

15. A gradual reduction of the current deficit excluding grants by 8.1 ppt of GDP during FY2014–19 is recommended. Three

possible adjustment scenarios (immediate, gradual, minimum) are presented for illustration. The total reduction in the current deficit excluding grants is too large to be

Scenarios of Adjustment in Current Fiscal Balance Excluding Grants (R-C)			
	Immediate FY2014	Gradual FY2014-19	Minimum FY2014-23
Years of adjustment	1	6	10
Total reduction in R-C (ppt of GDP)	7.7	8.1	8.4
Annual reduction in R-C (ppt of GDP)	7.70	1.35	0.84
Sustainable R-C (percent of GDP)	4.6	4.2	3.9
Sustainable overall deficit by FY2043 (percent of GDP)	2.6	2.3	2.0
Sustainable net worth (W) by FY2043 (percent of GDP)	139.3	120.1	104.2
Source: Fund staff estimates			

implemented by an immediate adjustment in one year. On the other hand, the minimum adjustment that spreads the adjustment until FY2023, just before the Compact grants expire, would be highly sensitive to risks of slippages and adverse shocks like typhoon Bopha in early FY2013, which prevented

¹⁰ GAO (2012).

Palau from continuing on the needed adjustment path. Therefore, gradually reducing the current balance excluding grants by 8.1 ppt of GDP during FY2014–19 (1.35 ppt annually on average) is more appropriate. This gradual approach will leave the government with extra years in case the necessary consolidation is not achieved as planned, which is important in light of Palau’s high vulnerability to external shocks. Since the fiscal adjustment in FY2014 is projected to be 1½ ppt of GDP, the adjustment in FY2015–19 should be about 1¼ ppt a year on average.

16. This will bring down the current fiscal deficit excluding grants to 4¼ percent of GDP by FY2019 and, in the process, allow for the buildup of deposits. By keeping the current deficit excluding grants at this level into the long run, the overall balance will continue in surplus until FY2025, allowing the government to build up deposits during this period. Beyond FY2025, and as a result of the expiration of the Compact grants, the overall balance will switch into a deficit, which will gradually increase until reaching a sustainable level of 2¼ percent of GDP in FY2043. This deficit will be financed by drawing from the deposits (and their returns) accumulated during the surplus years. The government’s net worth will reach about 105½ percent of GDP in FY2024 and will continue to increase until reaching a sustainable level of about 120 percent of GDP in the long run, which will also offer an adequate fiscal buffer to address future shocks. The path of medium-term fiscal consolidation and long-term fiscal sustainability is illustrated in Figure 1.

17. The above result is fairly robust to different parameter assumptions. Lower rates of return and lower valuations of the government’s initial net worth (for example, to reflect new external debt and/or to include public enterprise debt) increase the required annual fiscal adjustment. Higher real GDP growth rates and inflation also increase the needed adjustment. Overall, however, reasonable variations in these parameters have fairly small impacts on the estimated annual fiscal adjustment of 1.35.

Sensitivity Analysis under Gradual Adjustment														
		Real GDP Growth (in percent)					Real GDP Growth (in percent)					Real GDP Growth (in percent)		
		1	2	3			1	2	3			1	2	3
Real Rate of Return (in percent)	2	1.50	1.70	1.80	Inflation (in percent)	1	1.00	1.16	1.35	Govt Initial Net Worth (percent GDP)	0	1.43	1.54	1.67
	3	1.33	1.54	1.75		2	1.16	1.35	1.57		15	1.34	1.48	1.64
	4	1.16	1.35	1.58		3	1.35	1.57	1.77		30	1.29	1.45	1.62
	5	0.99	1.15	1.37		4	1.58	1.77	1.85		60	1.16	1.35	1.57

Source: Fund staff estimates

C. Policy Implications

18. The analysis above shows that Palau could secure long-term fiscal sustainability by pursuing fiscal consolidation over the medium term. The adjustment can be brought about through lower fiscal expense (C) or higher taxes (R) or a combination of both. To the extent that domestic revenue (R) can be raised from its current level throughout the adjustment period, fiscal expense (C) cuts will be smaller. In this context, policies that raise domestic revenue and/or cut fiscal expense would help secure Palau’s long-term fiscal sustainability. In the process, anchoring fiscal policies based on this adjustment path would also isolate the budget from the volatility of tourism revenue and build adequate fiscal buffers to address future shocks.

19. A comprehensive revenue reform, tailored to Palau’s specific characteristics, can address weaknesses and inefficiencies in the tax system and increase fiscal revenue. Implementing a modernized tax system with enhanced revenue-raising capacity requires strong political commitment and involves extensive technical process. Clearly communicating all aspects of such a reform package to engage stakeholders is also critical. As recommended by recent TA by Fiscal Affairs Department (FAD) and PFTAC (Box 2), the priorities should include: replacing the gross revenue tax (GRT) and existing import taxes with a single rate VAT with no exceptions except for exports, moving to c.i.f. (cost, insurance, and freight) valuation for imports, raising the net income tax (NIT) for financial institutions, and expanding it to all taxpayers registered for VAT. The wage and salary tax rate for low income households could be reduced to offset a potential adverse impact of price increases due to VAT adoption. These reforms should increase revenue-raising capacity and address loopholes, double taxation of exports, and other inefficiencies of the current tax framework. In addition, improving revenue administration capacity would be necessary to support such a major reform. If such a reform is not feasible in the short run, removing import tax exemptions; moving to c.i.f. valuation; applying an excise, equivalent to import taxes, on local production of excisable goods; and increasing the NIT rate for financial institutions could be implemented as intermediate actions.

20. Reforms to contain fiscal expense play a critical role. The wage bill-to-revenue ratio is high, especially when compared to other Pacific Island Countries. Containing the wage bill growth below the inflation rate remains the top priority and would help reduce overall fiscal expense in terms of GDP and open up space for maintaining adequate levels of capital spending. In this context, undertaking a well-planned civil service reform, enforcing mandatory retirement, and retraining civil servants could go a long way in improving the effectiveness and efficiency of public service delivery.

21. The above-mentioned reforms would contribute evenly to closing the financing gap. Tax reforms measures, as recommended by the TA, and improvements in nontax administration could raise domestic revenue by 4 ppt of GDP during FY2014–19. Containing the growth of the wage bill below the inflation rate, complemented with civil service reforms, could reduce current spending by 4 ppt of GDP during FY2014–19 while providing adequate resources for capital spending. These combined revenue and expenditure reforms would help achieve long-term fiscal sustainability.

Impact of Fiscal Reforms, FY2014–19 (ppt. of GDP)	
Measures	Gradual Adjustment
Revenue	
Tax reforms, including Value Added Tax and Net Income Tax	3.5
Improvement in nontax administration	0.5
Expense	
Civil service reforms	4.0
Total	8.0
Source: Fund staff estimates.	

22. Continued fiscal consolidation over the medium term will need to be supported by sustained improvements in public finance management. The recently established budget reserve fund will serve as the basis to manage government deposits that are expected to increase substantially over the medium term. In this context, accountable, transparent, and prudent management of this fund would help safeguard government’s assets. Given the disbursements of new infrastructure loans, sound management of public debt and strong governance of infrastructure projects would help ensure debt sustainability and minimize fiscal risks. Grant disbursements under the Compact’s fiscal consolidation fund should help reduce domestic account payables. However, the authorities should strengthen budget execution and planning to prevent their buildup in the future. Finally, the adoption of a medium-term budget framework is needed to formulate multiyear fiscal policies and strengthen fiscal discipline and transparency.

Box 2. Palau: Comprehensive Tax Reform—Technical Assistance Recommendations

A technical assistance mission by Fiscal Affairs Department (FAD) and the Pacific Financial Technical Assistance Centre (PFTAC) visited Palau in July/August 2013 to review the government's tax reform plans and advise on tax policy options, tax administration prerequisites, and the legislation necessary to give effect to the recommended reforms. The recommended tax measures are as follows:

- Move to c.i.f. valuation for imports.
- Replace the gross revenue tax (GRT) and import taxes with a value-added tax (VAT) having the following features:
 - A single rate of VAT in the range of 10 to 15 percent would apply.
 - Exemptions are kept to a minimum, and exports are zero-rated.¹
 - All government institutions and public enterprises would be subject to VAT.
 - Businesses with 'turnover' (sales) of more than US\$300,000 would be required to register for VAT. Other businesses with turnover' exceeding US\$100,000 can register if they meet record keeping requirements.²
- Reduce wage and salary tax rates for low income households to improve the overall fairness of the system and offset any cost increases from higher consumption taxes.
- Increase the rate of net income tax (NIT) for financial institutions to around 20 percent.³
- Expand the NIT to all taxpayers registered for VAT:
 - A rate of around 20 percent is suggested.⁴
 - Retain the current GRT arrangements for international airlines until the impact of VAT and NIT is fully understood.⁵
 - Introduce a simple, low rate turnover tax to apply to smaller businesses.⁶
 - Exempt micro businesses with a turnover of less than US\$40,000 from turnover tax, subject to payment of a business license.

¹ Experience from other countries strongly suggests that exemptions and/or reduced VAT rates for basic goods and services should only be considered if targeted expenditure is not feasible. Further, to the extent that foodstuffs are consumed by tourists, the benefits of exemptions and reduced rates effectively flow to non-residents. Instead, a reduction in the wage and salary tax rates for low income residents to improve the overall fairness of the system is preferred.

² Current GRT data suggest that a threshold of US\$300,000 would limit the VAT to the 110 largest businesses, which account for around 90 percent of all sales.

³ Major banks pay tax rates of 35 percent of profit in their home country (mainly the United States), thus effectively transferring the tax to the U.S. Treasury. A higher tax rate would likely be used to offset U.S. tax, and would not significantly impact banks' incentives to do business in Palau.

⁴ The suggested rate is among the lowest rates observed in other small island states in the region. Replacing existing GRT and import taxes (excluding alcohol and tobacco) by a VAT rate of 10 percent and a NIT rate of 20 percent would yield a revenue-neutral reform, based on experience in other small island states in the region.

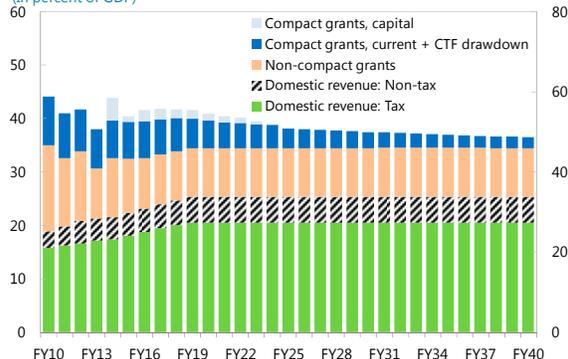
⁵ It appears that the simple NIT rules may not be robust enough to provide guidance on income and expense allocation for cross-border services in a manner which would replace lost GRT revenue.

⁶ Because retailers have lower margins than service providers such as professionals, a single turnover tax rate may be unfair. Alignment with the NIT may require two tax rates; one for trading enterprises and a higher one for services.

Figure 1. Palau: Long-Term Fiscal Sustainability, FY2010–40

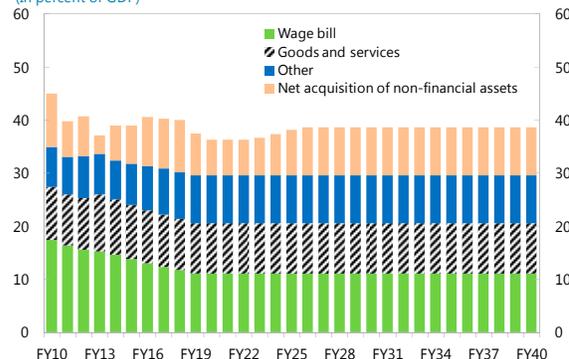
Fiscal Revenue

(In percent of GDP)



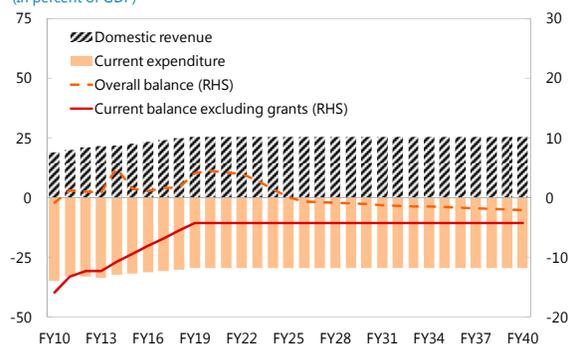
Fiscal Expenditure

(In percent of GDP)



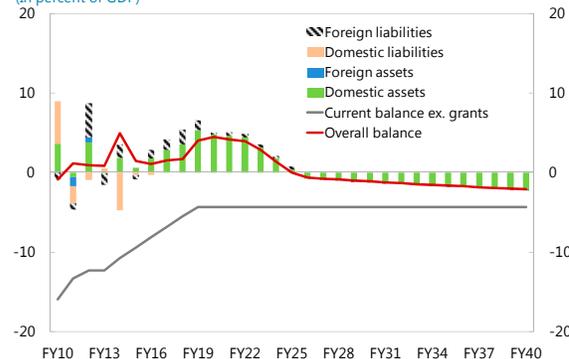
Fiscal Balance

(In percent of GDP)



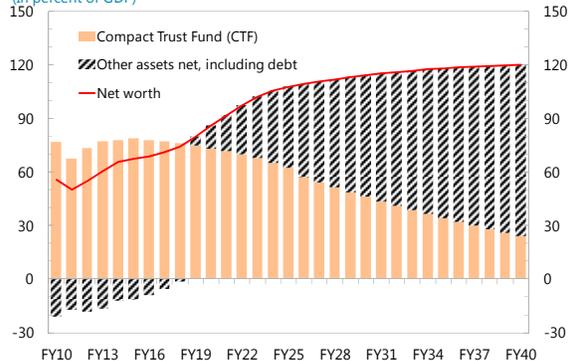
Deficit Financing

(In percent of GDP)



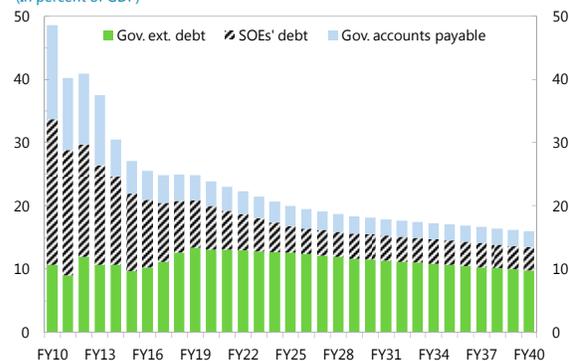
Government's Net Worth

(In percent of GDP)



Public Debt

(In percent of GDP)



Source: Country authorities and Fund staff estimates and projections.

Appendix 1. Palau: The Intertemporal Budget Constraint¹

The analytical framework used for the analysis is based on the government's intertemporal budget constraint, which states that all present and future government expenditures (wages, goods and services, investment, etc.) must be covered either by the government's net wealth or by present and future fiscal revenues (taxes, grants, etc.). All expenditures and revenues are discounted to a base-year in order to make payments, which occur at different points in time comparable. In Palau's case, this can be expressed as follows:

$$W_{2013} + \sum_{t=2014}^{\infty} (1+r)^{2013-t} G_t + \sum_{t=2014}^{\infty} (1+r)^{2013-t} R_t = \sum_{t=2014}^{\infty} (1+r)^{2013-t} C_t + \sum_{t=2014}^{\infty} (1+r)^{2013-t} K_t$$

where W is the government's net worth, r is the nominal interest rate (assumed to be constant and equal for savings and debt), G is grant revenue, R is domestic revenue, C is fiscal expense, and K is net acquisition of non-financial assets.

The intertemporal budget constraint of the government can be viewed as a financing constraint: fiscal policies that change one of its components will induce a change in at least one other component.

The intertemporal budget constraint can also be stated in terms of current and future generations' net tax burdens. Specifically, the government's net debt must equal the sum of discounted net taxes paid by members of living or future generations. In the long term, all government spending must be balanced by the tax payments made by either current or future generations. If present generations do not want to leave the burden of fiscal adjustment solely to their descendants, present as well as future taxes might be increased.

¹ This appendix draws on the analyses found in Engel and Valdés (2000); Barnett and Ossowski (2002), Jägers and Raffelhüschen (1999), and Kotlikoff and Raffelhüschen (1999).

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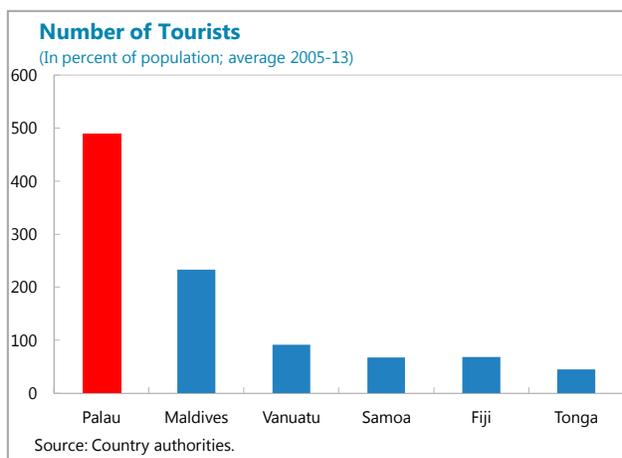
PROMOTING TOURISM AND GROWTH IN PALAU¹

This paper discusses the role of tourism in Palau and identifies policy priorities to further promote this sector and sustain growth. Tourism has played an important role in Palau’s economy in generating growth, supporting the balance of payment, and providing fiscal revenue, but the country’s heavy reliance on tourism has also contributed to economic volatility and vulnerability. Therefore, promoting diversification, both within and outside the tourism industry, is critical to strengthen economic resilience and sustain growth.

A. The Patterns of Tourism

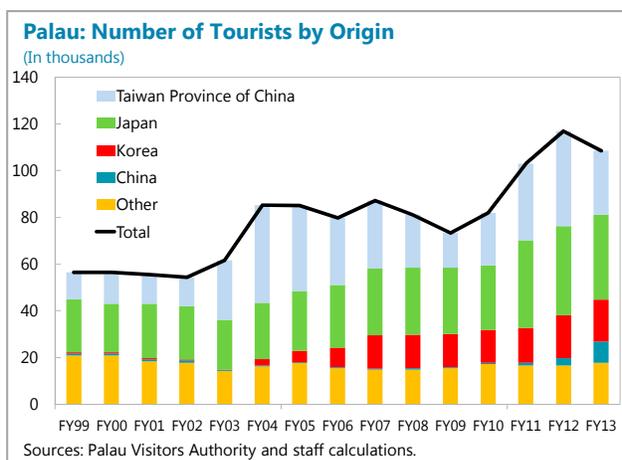
1. This section describes developments of tourism in Palau, provides some stylized facts, and identifies key factors driving Palau’s tourism performance.

The performance of Palau’s tourism sector fares favorably compared to other Pacific Island Countries (PICs) and also Maldives, which is Palau’s main competitor as a world class diving destination. However, limited hotel capacity constrains tourism growth, heavy reliance on tourists from only a few origin economies contributes to tourism volatility, and flat tourist spending indicates little improvement in profit margin. Moreover, high reliance on food and fuel imports to meet tourists’ consumption makes Palau vulnerable to sharp fluctuations in commodity prices.



2. Palau is one of the world’s major diving destinations and has received a large number of tourists over the past decade.

Its main attractions are its natural beauty, including crystal clear beaches, coral reefs, and wild maritime life, as well as its pleasant and comfortable weather. The number of tourists increased from around 56 thousand in FY2000 (ending in September) to 117 thousand in FY2012, with an intermediate break during the 2008–09 global financial crisis, and before declining again in FY2013. The number of tourist arrivals every year is about five times the total population, more than in its comparator countries.



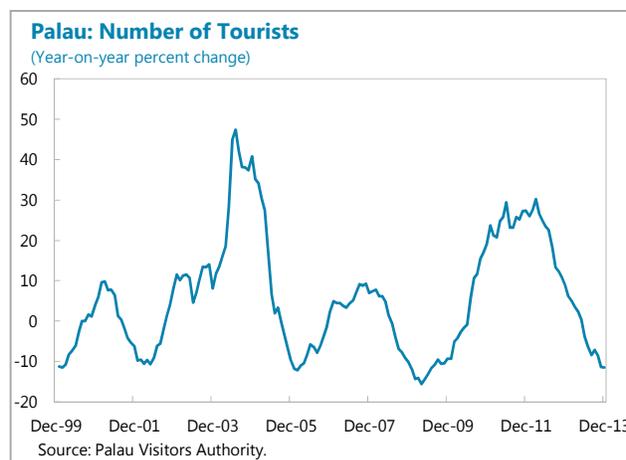
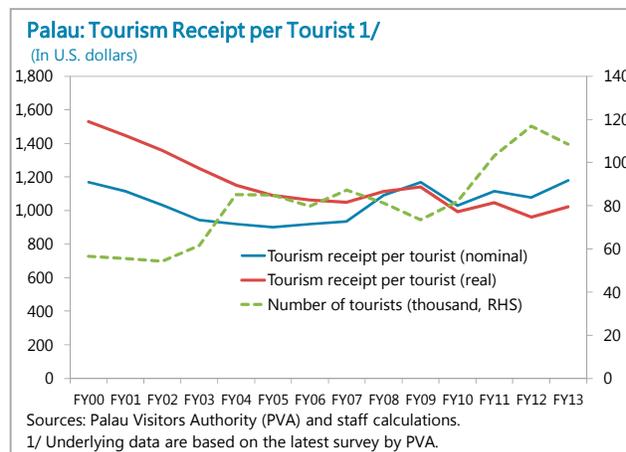
¹ Prepared by Ioana Hussiada (APD).

3. Tourists come mostly from Asia. Taiwan Province of China and Japan are the top origins, with Korea ranking third and picking up fast during the last decade. These three origins account for around 80 percent of the visitors, in contrast with other PICs like Fiji, Samoa, and Vanuatu, which receive tourists primarily from Australia and New Zealand. In the last couple of years the number of visitors from China has also increased rapidly.

4. In contrast to the substantial increase in tourist arrivals, spending per tourist has remained flat at best. Based on the survey of tourism expenditure data compiled by the Palau Visitors Authority (PVA), the amount of spending per tourist is estimated to have remained broadly flat in nominal terms (about US\$1,000–US\$1,200) and even declining in real terms during the past 10 years.

5. Tourism in Palau has been volatile throughout the past decade.²

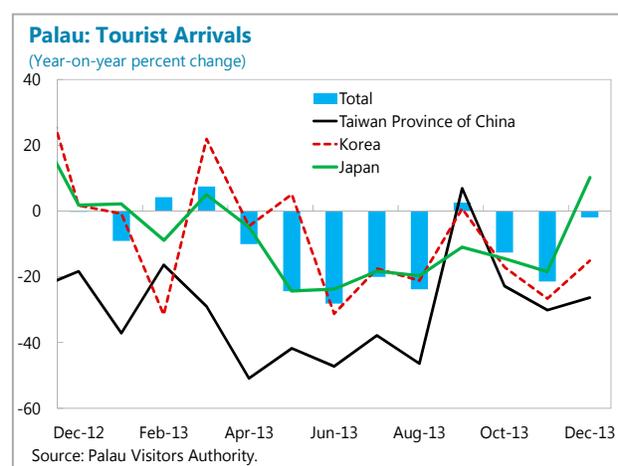
- FY2000–04:** After a slowdown in tourist activity during the Asian crisis in the late 1990s and a dip in tourist arrivals in FY2002 due to 9/11-related events, tourism started growing again. The number of visitors peaked in FY2004, when visitor arrivals increased more than 38 percent from a year earlier, possibly attributed to “The Pacific Arts Festival”, “The South Pacific Mini Games”, and the filming of “Survivor Palau”.³ The number of tourists from Taiwan Province of China more than tripled between FY2001–04 due to a new direct flight and the construction of a new hotel. The rebound in tourism and the construction of a new capital markedly contributed to the high economic growth in FY2004.
- FY2005–08:** Tourism activity remained subdued during FY2005–06, rebounded strongly in FY2007, and then contracted again by nearly 7 percent in FY2008, as the world economy entered the financial crisis and Far Eastern Air Transport (FAT) that had a direct flight to Palau went into bankruptcy. These events and the end of the Compact Road project contributed to a 5½ percent decline in Palau’s real GDP growth in FY2008.



² Graduate School USA (2013).

³ See Box 1. Palau Tourism Sector, Palau 2012 Article IV Consultation, IMF Country Report No. 12/54.

- FY2009–12:** As the global economy remained in recession in 2009, tourist arrivals continued to decline further, by almost 10 percent in FY2009 compared with a year before, followed by a considerable drop in real growth of 10¾ percent. As the world economy began to come slowly out of recession and global demand started picking up again, so did the tourist industry and growth in Palau. In FY2010 and FY2011, visitor arrivals rebounded by 11¾ and 25¾ percent respectively, contributing to 5¾ percent growth in the economy during the FY2011. In FY2012 tourist arrivals continued its upward trend and increased by around 13½ percent heavily contributing to the 5½ percent growth of the economy.
- FY2013:** Tourism declined 7 percent in FY2013 (13¾ percent during the fourth quarter). Tourists from Taiwan Province of China, which accounted for more than a quarter of total visitors, declined 32½ percent in FY2013, mainly due to the increase in tourist attraction fees, the cessation of Palau Airways' direct flights in April 2013, and the reduction in the number of flights of China Airlines and Korean Air from three times to twice a week. Airport renovations also contributed to the decline in flight arrivals. The number of tourists from Japan declined by around 16¼ percent in the last quarter of FY2013, partly due to the depreciation of the yen against the U.S. dollar and the reported shortage in airplanes in Japan following the grounding of Boeing 787 Dreamliner. The resumption of direct flights to Hong Kong SAR in December and the increase in charter flights from Japan should contribute to the rebound of tourism in FY2014 (signs of the latter are already reflected on the December 2013 statistics).



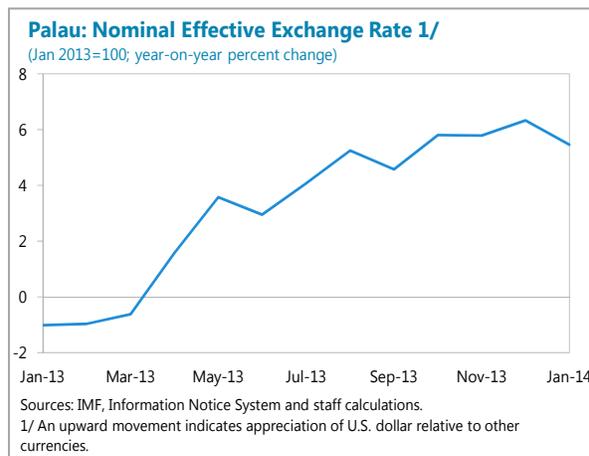
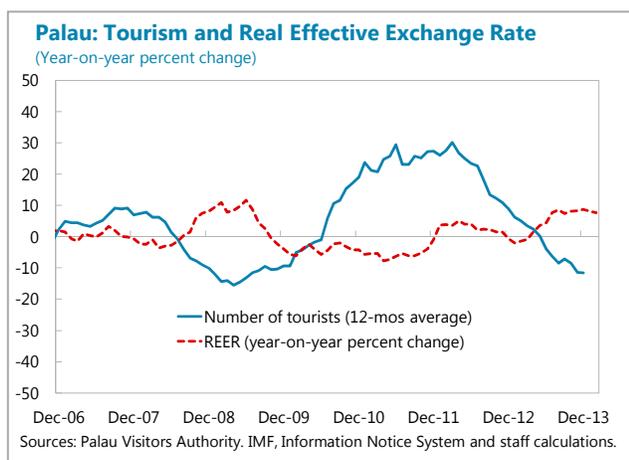
6. These patterns suggest that the performance of Palau's tourism sector depends on the following factors.

- Flight routes:** Palau's tourist arrivals depend heavily on the availability of direct flight routes. The experience over the past decade indicates that any changes in direct flights (initiation or cessation) would lead to substantial changes in tourism performance.
- Hotel capacity and infrastructure:** Hotels operate at nearly full capacity (around 1,400 rooms), which constrains tourism growth and raises hotel rates. The development of new hotels has been hampered by infrastructure bottlenecks, although Palau's tourism infrastructure compares favorably with other small island tourist destinations.⁴ In addition, the upcoming water and sanitation projects, faster internet connection, ongoing airport renovation, and the construction of new hotels would improve tourist-related infrastructure.⁵

⁴ Kinoshita (2006).

⁵ Two new hotels are expected to start operation in FY2014.

- **Business climate:** The development of new hotels appears to be hindered by restrictions on foreign investment and complex licensing arrangements to start a business.
- **Exchange rate:** The recent decline in Asian tourists in FY2013 was partly due to the depreciation of Asian currencies against the U.S. dollar (Palau's legal tender), making Palau's tourist attractions more expensive for Asian tourists. In fact, past data show that the number of tourists and Palau's real effective exchange rate (REER) are inversely correlated.⁶



- **Tourist spending:** Spending by tourists contributes to domestic economic activities and fiscal revenue, but the fact that spending per tourist has remained flat over the past decade suggests that the value added to tourism revenue from an individual tourist has not improved.
- **Asia's economic growth:** Economic conditions in Palau's most important tourist origins, such as Taiwan Province of China, Japan, and Korea, would contribute to Palau's tourism performance. For example, tourist arrivals in Palau declined substantially during the Asian crisis in the late 1990s.
- **International food and fuel prices:** Palau relies heavily on imports of food and fuel and inflation is sensitive to their price fluctuation. Higher prices of food and fuel would raise domestic prices, especially since Palau uses the U.S. dollar, making tourism services more expensive and less competitive compared with peers.

B. The Economic Role of Tourism

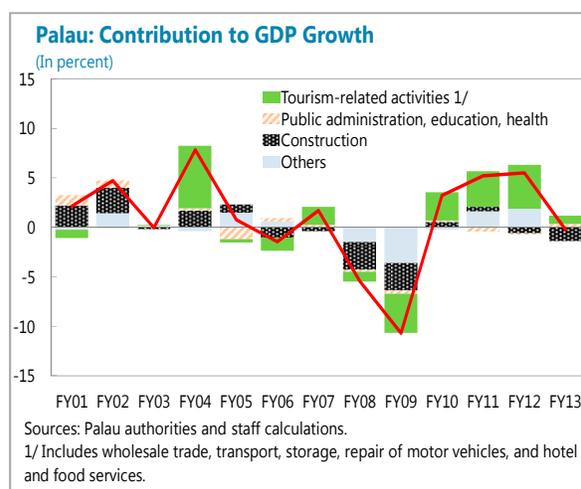
7. This section discusses the role of tourism in Palau's economy and presents a cross-country comparison.⁷ Tourism provides a substantial contribution to GDP growth, current account balance, tax revenue, and employment in Palau. Empirical estimation further supports the importance of tourism on income in Palau and other PICs. By comparison, Palau's reliance on tourism has been

⁶ Real effective exchange rate is the exchange rate of the national currency (U.S. dollar in the case of Palau) relative to exchange rates of the main trading partners, adjusted for the effects of inflation in Palau and in trading partners.

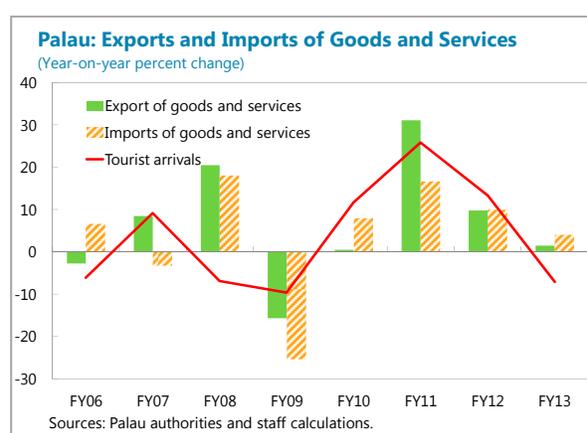
⁷ Other studies on the role of tourism in the economy for example, Hampton et al. (2013), Harrison et al. (2013), Tuifa'asisina et al. (2012), and Pacific Islands Forum Secretariat (2013).

greater than in peer countries. However, its heavy reliance on tourism also poses risks and challenges, including volatile growth performance, high reliance on food and fuel imports to meet tourists' consumption, and dependence on the economic conditions of tourist originating economies.

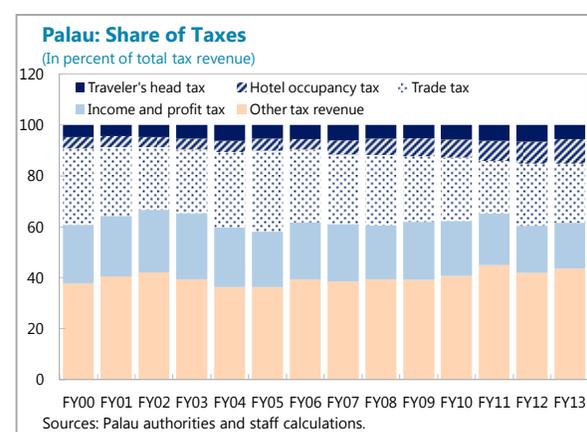
8. Tourism activities have contributed to about three quarters of Palau's economic growth. The remaining ¼ of growth is contributed by non-tourism activities such as construction and public sector spending. Tourism-related industries like hotel, food services, and transport contributed around 4½ percentage points of the 5½ percent growth in real GDP in FY2012, or 3.6 percentage points of the 5.2 percent growth in FY2011. In FY2013 had it not been for the positive contribution of tourism-related activities, despite the decline in tourist arrivals, growth would have been even lower than -0.2 percent.



9. The tourism industry provides large trade openness in terms of exports and imports of goods and services. Exports of travel services (or travel receipts) account for more than 80 percent of exports of goods and services. Imports of goods (mainly food and fuel), which account for nearly half of Palau's total imports of goods and services, are also partly driven by tourism, as the demand for food and fuel depends on the number of tourists. To some extent, this serves as an automatic stabilizer to the current account in the sense that the impact of a slowdown in tourism on the current account would be mitigated by a decline in food and fuel imports (provided that international fuel and food prices do not increase).



10. Fiscal performance also relies on tourist arrivals. There are two main direct taxes related to tourism in Palau, the traveler's head (departure) tax and the hotel occupancy tax. Both were increased recently in an effort to contain the number of tourist arrivals and preserve the environment. The share of these two taxes to total



tax revenue has increased from nearly 9 percent in FY2003 to around 15 percent in FY2013, indicating the importance of tourism to the fiscal sector in Palau.

11. Tourism-related activities provide large employment in Palau. More than 40 percent of total employment in Palau is occupied in tourism-related activities, including a large number of foreign workers, who, by comparison, make up around 50 percent of total employment.⁸

12. Empirical estimation further supports the importance of tourism on income. The analytical work that estimates the impact of tourism on income in Palau and other PICs results in statistically significant coefficients with correct signs for tourist arrivals and spending (Box 1).

13. Cross-country data indicate that Palau's reliance on tourism is higher than comparator countries (Figure 1). Palau's revenues from tourism—in percent of GDP as well as tourism receipts per inbound tourist in U.S. dollars—are higher than peers except Maldives. Palau ranks slightly behind Maldives and Vanuatu in terms of tourism contribution to GDP, but Palau ranks the highest in tourism contribution to exports of goods and services and employment. Meanwhile, Palau falls behind Maldives and Fiji in the number of hotel rooms.

14. Palau's heavy dependence on tourism creates some challenges. Tourism is highly susceptible to global economic and financial conditions, and Palau's narrow economic base that relies mostly on tourism has led to volatile growth over the past two decades. Tourism activities also contribute to large fuel and food imports (30 percent of GDP), which makes the country vulnerable to global commodity price fluctuations. Therefore, large increases in commodity prices could surge inflation, depress domestic demand, weaken fiscal position, and, to a lesser extent, deteriorate the external position. Moreover, appreciation of the U.S. dollar could hurt Palau's competitiveness, especially of the tourism industry, and an economic slowdown in Asian economies could reduce the number of tourists and risk Palau's economic outlook. Natural disasters, including those related to climate change, or environmental accidents (for example, fuel spill from a tanker) could further erode tourism and growth. Against this backdrop, promoting diversification within and outside the tourism industry could reduce the volatility of tourist arrivals, support growth, and increase tourism revenue, which would help Palau build adequate economic buffers to reduce economic risks and vulnerabilities.

⁸ The calculation is based on FY2013 employment data from inputs from the Social Security accounts and is approximated by employment in wholesale and retail trade plus transportation and storage plus accommodation and food service activities as a ratio to total employment.

Box 1. Palau: Estimating the Impact of Tourism on Income

This analytical work attempts to estimate the effect of tourism on income in Palau and other PICs that rely heavily on tourism sector. In line with previous studies the model is specified as follows:¹

$$YPCP_{it} = \alpha + \beta_1 GOV_{it} + \beta_2 OPEN_{it} + \beta_3 T_PCP_{it} + \beta_4 T_EXP_{it} + \beta_5 INFL_{it} + \beta_6 INR_{it} + \delta_i + \varepsilon_{it}$$

where: *i* = country, *t* = year (2000-13), δ_i = fixed effect term, and ε_{it} = the error term.

- YPCP = per capita income, nominal GDP in US\$ divided by population
- GOV = government expenditure, current plus capital expenditure in percent of GDP
- OPEN = economic openness, exports plus imports of goods and services in percent of GDP
- T_PCP = tourists per capita, the number of tourists divided by population
- T_EXP= tourist expenditure, tourist spending in US\$ divided by the number of tourists
- INFL = inflation
- INR = infrastructure, proxied by the share of urban population.

The model is estimated using panel least square with fixed effect based on cross-country samples (Palau, Maldives, Fiji, Samoa, Tonga, Vanuatu, and Federated States of Micronesia). All variables are expressed in logs to accommodate large difference in scale and for easier interpretation of the results.

The results show a good fit as all estimated coefficients have the expected sign and the tourism-related variables are statistically significant. The parameter estimate indicates that one percent increase in tourist arrivals, assuming other parameters remain constant, would lead to ½ percent increase in per capita income. Moreover, one percent increase in spending for each tourist contributes to ¼ percent increase in income. These confirm the argument that not only the quantity, but also the quality of tourists matters on growth, and therefore, the efforts to attract higher-income visitors are important to create more value-added in the economy.

Dependent Variable: YPCP	
Regressors	Coefficient
Constant	2.21
GOV	0.04
OPEN	0.12
T_PCP	0.45 ***
T_EXP	0.28 ***
INFL	0.64 *
INR	0.44 **
R-squared	0.998
Adjusted R-squared	0.997
Number of observations	98
The asterisks indicate the p-values:	
* p-value<0.1, ** p-value<0.05,	
*** p-value<0.01	

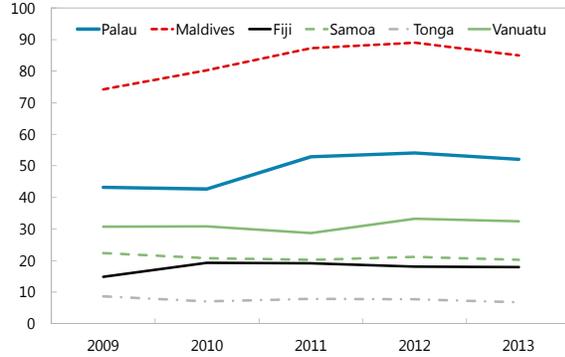
¹ See Thacker at al. (2012).

Figure 1. Palau and Pacific Islands Comparators

Receipts from tourism stand above 50 percent of GDP in Palau, higher than the other countries except Maldives.

Tourism Receipt

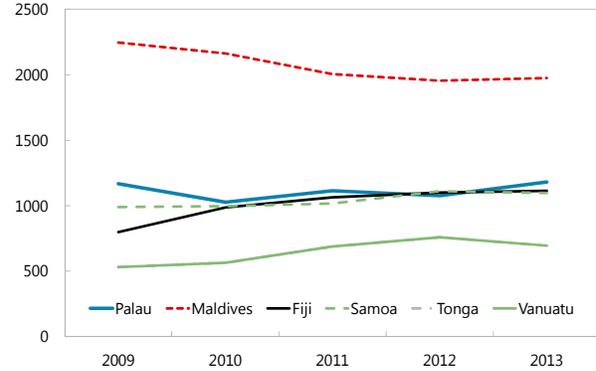
(In percent of GDP)



Palau also ranks second behind Maldives in terms of tourism receipts per visitor.

Tourism Receipt Per Inbound Tourist

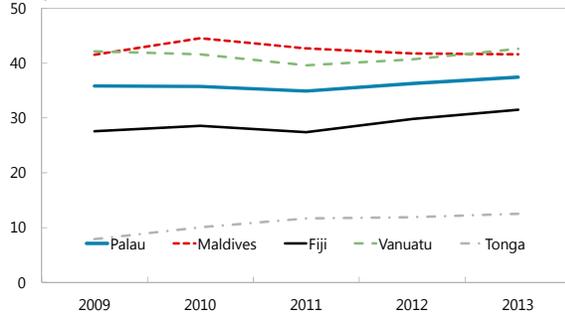
(In U.S dollars)



The contribution of tourism activities to GDP in Palau is slightly lower than in Maldives and Vanuatu.

Travel and Tourism Activities in the Economy

(In percent of GDP)

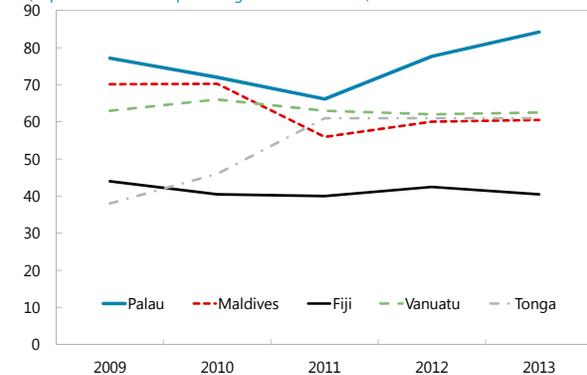


Note: For Palau, it assumes GDP in trade, transport and storage, accommodation and food services, and half of construction and utilities.

Travel exports as a share to total exports of goods and services is the highest in Palau.

Travel Exports

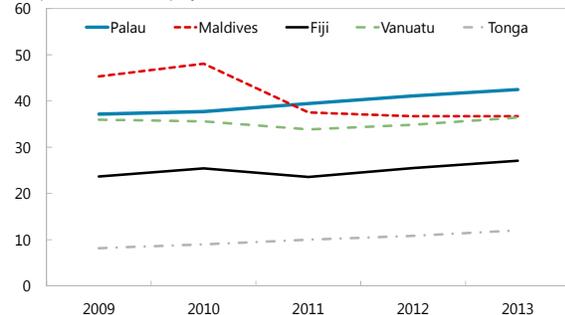
(In percent of total exports of goods and services)



Tourism contribution to employment is comparable between Palau, Vanuatu, and Maldives.

Travel and Tourism Employment

(In percent of total employment)

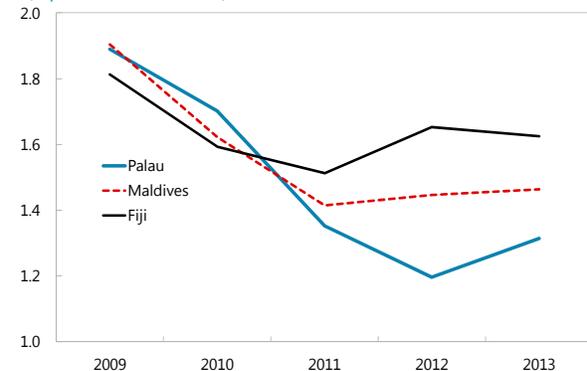


Note: For Palau, it assumes employment in trade, transport and storage, accommodation and food services.

But the number of hotel rooms is limited in Palau compared to peers, constraining tourism growth.

Number of Hotel and Motel Rooms

(In percent of tourist arrivals)



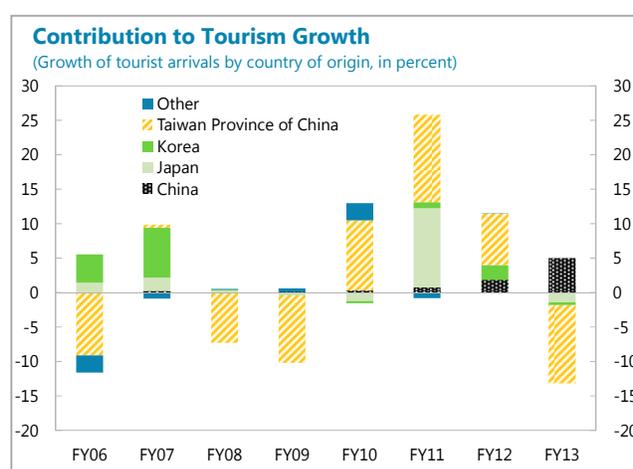
Sources: Country authorities; World Travel and Tourism Council, Country Reports; The *Compendium of Tourism Statistics*, World Tourism Organization; and Fund staff calculations. For Palau some data are from the 2012 Statistical Yearbook.

C. Promoting Tourism and Private Sector Development to Sustain Growth

15. This section discusses the importance of economic diversification (within and outside the tourism sector) to minimize economic volatility and vulnerabilities derived from the heavy reliance on tourism. As a start, promoting diversification within the tourism industry could reduce the volatility of tourist arrivals and increase tourism revenue. Developing domestic economic activities that support the tourism industry would also create more value added in the economy and contribute to growth. Finally, preserving macroeconomic and financial stability, addressing infrastructure bottlenecks, and improving the business and investment climate are essential to promote private investment and sustain growth.

16. Promoting diversification within the tourism industry could reduce volatility and increase tourism revenue.

- Diversifying tourist attractions:** Efforts to diversify tourist attractions outside diving (for example, eco-tourism, extending aquatic sports, adding golf courses, etc.) could make tourists stay longer and spend more. Supported by efforts to preserve the pristine environment, these could attract higher-income tourists and create more value added in the economy. In this context, promoting ecotourism and terrestrial attractions, particularly in the underdeveloped Big Island, would distribute tourist activities more equitably between land and sea.



- Diversifying tourist origins:** Promoting tourism from new countries would reduce dependence on only a few countries. Various reports indicate that there has been a remarkable boom in Chinese travelers, who are also one of the highest spenders among tourists.⁹ Therefore, promoting tourist arrivals from China and adjusting tourism hospitality and services to accommodate these new visitors could support tourism growth. Moreover, Palau’s relative proximity to robust and dynamic Southeast Asian economies presents a comparative advantage over other PIC tourist destinations. In the same context,

⁹ In fact, the decline in tourist arrivals in FY2013 was less severe because tourists from China contributed to positive (5 percent) growth while those from other markets contributed to negative (-12 percent) growth.

Palau should promote tourism from other potential new sources like Russia and other European countries. Allowing visitors to book accommodations and make arrangements via well developed and fast websites would further facilitate promoting tourism.¹⁰

- **Attracting higher-income tourists:** In order to contain the strain on the environment from the large number of tourists, the Palau authorities are seeking ways to lower the number of low-income tourists in exchange for fewer, but higher-income tourists in order to maintain or even increase tourism revenue.¹¹ In this context, the planned creation of the Bureau of Tourism, whose mandate is to ensure compliance with regulation, maintain set standards in the tourism industry, and safeguard the quality of tourism-related services among providers, is a step in the right direction.

17. Promoting diversification outside the tourism industry, but maintaining tourism as the centerpiece of the economy could further reduce tourism volatility, enhance growth potential, and promote an inclusive model of growth.¹²

- **Developing agriculture, aquaculture, and fishery:** Augmented agricultural production, especially given the enormous bio diversification of the Palauan islands, aquaculture, and fishing could supply hotels and restaurants with locally grown produce, sea food, and fish.¹³ This would reduce food imports and minimize the adverse impact of volatile global commodity prices. In other words, enhancing linkages and synergies between agricultural production and fishery with hospitality would achieve a more sustainable growth. However, preserving Palau's pristine environment remains a top priority, and therefore, environmentally friendly crops, carefully planned agricultural development, and regulated aquaculture and fishing are essential.
- **Moving up the value chain:** Tourist activities incorporate a wide range of goods (for example, foods and beverages, crafts, spa products, massage oils, fragrances, cosmetics) and services (for example, transport, accommodation, leisure, attractions) that are not necessarily produced or purchased in Palau. Anecdotal evidence suggests that tour packages are often purchased overseas resulting in minimal monetary benefit to Palau. The domestic value added would be greater if a larger share of the supply chain of tourism-related operations such as production, distribution, and marketing of products and services were based in Palau. This would raise growth potential, but it requires improvements in the investment and business climate to promote private investment.

¹⁰ According to Hotels.com (2013), the top five items a Chinese tourist seeks in a hotel is free Wi-Fi, a kettle to prepare tea, mandarin speaking hosts and translated travel guides, smoking rooms, hotel websites translated in Chinese language, Chinese breakfast, etc. In terms of booking and reservations, two in five Chinese travelers use websites or mobile apps to book online and plan their trip. By comparison, according to "Tourism Economics" an Oxford Economics Company, half of European travelers use the internet and/or social networking for their travel arrangements.

¹¹ For example, a simple calculation based on PVA data indicates that an increase in tourism from Japan by 6.5 percent would compensate a 10 percent drop in the number of tourists from Taiwan Province of China in order to maintain the same level of tourist spending.

¹² Chen et al. (2014).

¹³ The small share of agriculture and forestry sectors (less than 2 percent of GDP) offers a potential for growth. However, small scale operations, complex land ownership, and limited labor supply pose a challenge.

- **Expanding the service industry:** With the expected improvement of internet service and connectivity, Palau could take up on the call service business and other opportunities. Also, by expanding the number of high-end hotels and spacious resorts, the country could obtain the necessary infrastructure to host conferences and conventions.
- **Improving the education system:** Enhancement of the education system to better match skills of high school and college graduates with employment in the service sector is also needed. These efforts would provide domestic employment opportunities to Palau youth.

18. Preserving macroeconomic and financial stability and fiscal sustainability is essential to support Palau’s efforts to diversify the economy and promote private sector development.

Successful tax and expenditure reforms over the medium term would help achieve fiscal consolidation that is needed to ensure long-term fiscal self-sufficiency and debt sustainability. Given the absence of monetary policy, a prudent fiscal policy would contribute to low inflation and stable external balances. In addition, a sound financial sector would reduce financial risks and facilitate business activities. However, macroeconomic and financial stability would support the efforts to diversify the economy and promote growth if it is complimented by the following structural reforms:

- **Addressing infrastructure bottleneck:** Promoting development of new hotels would improve tourism growth, but this would require development of basic infrastructure such as water and sanitation systems. Although Palau compares favorably to other PICs, further improvement in the road network and its aviation connectivity can benefit other sectors of the economy. In order to expand the services sector, Palau would also need to improve its telecommunications infrastructure. Finally, enhancing medical services would attract more high-income tourists of a wider age range.

- **Improving the business and investment climates:** The Doing Business Indicators show that Palau’s rank improved from 114 to 100 in 2014. However, Palau’s performance is slightly behind Maldives and significantly behind Vanuatu and Fiji, suggesting large scope for improvement. Some regulations in Palau pose hurdles that limit private sector development and the country has

	Palau	Maldives	Vanuatu	Fiji
Starting a Business	129	71	126	141
Dealing with Construction Permits	45	18	50	74
Getting Electricity	78	131	129	81
Registering Property	20	161	110	63
Getting Credit	86	109	55	55
Protecting Investors	178	80	80	52
Paying Taxes	84	115	30	88
Trading Across Borders	96	138	119	111
Enforcing Contracts	141	90	72	63
Resolving Insolvency	96	40	57	50
Overall "Ease of Doing Business"	100	95	74	62

Source: The World Bank.

ample room to strengthen investor protection, contract enforcement, and starting a business.¹⁴ Banks provide limited domestic credits and place most of their assets abroad due to credit risks,

¹⁴ The recent establishment of the Economic Advisory Group comprising representatives from the government, congress, and the private sector would help address these challenges by facilitating better coordination between the private and public sectors.

limited domestic investment opportunities, and inadequate capacity by small businesses to prepare financial plans and statements.¹⁵

19. In summary, by identifying and addressing these tourism-related challenges, Palau could improve growth potential and reduce economic vulnerabilities (Table 1). In this context, Palau could promote the development of new hotels, particularly for high-end tourists, to address the limited hotel capacity and create more value added. Moreover, promoting tourism from, and establishing flights with, new countries could reduce the reliance on only a few originating outbounds. Establishing domestic supply chains oriented towards the tourism industry and increasing the share in the supply of goods and services in tourism-related activities could limit the volatility in growth and fiscal position, and the vulnerability of the external position. Lastly, diversifying tourist attractions could ramp up tourist spending.

Challenges	Policies
Limited hotel capacity has constrained tourism growth and raised hotel rates, which make tourist attractions expensive and undermine competitiveness.	Promote development of new hotels, particularly the high end, by addressing infrastructure bottlenecks and improving investment and business climate to attract new investments in the sector.
Spending per tourist has remained flat in current dollar value.	Diversify tourist attractions to make tourists stay longer and spend more. Attract tourists from wealthier countries.
Heavy reliance on tourists and direct flights from three markets only contribute to tourism volatility.	Promote tourism from, and increase flight connectivity with, new countries to diversify tourist origins.
Heavy reliance on imports of food and fuel contributes to external sector vulnerability.	Develop domestic supply chains to the tourism industry by developing environmentally friendly agricultural produce, aquaculture, and fishing catered to the tourism industry.
Heavy reliance on tourism contributes to growth and fiscal volatility and balance of payment vulnerability.	Diversifying the sources of growth outside tourism sector (for example services), and enhancing the growth potential by increasing the domestic share of tourism-related operations (production, distribution, and marketing).

¹⁵ The establishment of the Small Business Development Center to assist small businesses and new entrepreneurs with setting up financial statements and prepare them for the loan application process required by the banks' regulations is a step in the right direction.

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