Government of Palau

Fiscal Responsibility Framework:

Rational and Description

(including Guidelines for Palau’s Medium-Term Budget Cycle)

January 2021

CURRENCY EQUIVALENTS

Currency unit	—	United States dollar (US$)

ABBREVIATIONS

ADB	—	Asian Development Bank
BPT	—	Business Profits Tax
COFA	—	Compact of Free Association
CSO	—	Community Service Obligations
Compact	—	RoP Compact of Free Association with the United States
CRA	—	Compact Review Agreement
CSPP	—	Civil Service Pension Plan
CTF	—	Compact Trust Fund
DSA	—	Debt Sustainability Analysis
FEIM	—	Facility for Economic and Infrastructure Management
FDIC	—	Federal Deposit Insurance Commission
FIC	—	Financial Institutions Corporation
FRL	—	Fiscal Responsibility Law
FY	—	Fiscal Year (ending on September 30 of the named year)
GDP	—	Gross Domestic Product
GFR	—	General Fund Reserve
GNI	—	Gross National Income
GRT	—	Gross-Receipts Tax
IMF	—	International Monetary Fund
MTFS	—	Medium-Term Fiscal Strategy
MTEF Model	—	Medium-Term Economic and Fiscal Model
OEK	—	Olbiil Era Kelulau (Palau's national congress)
PAYGO	—	Pay As you GO (Pension Fund)
PCRAFI	—	Pacific Catastrophe Risk Assessment and Financing Initiative
PEFA	—	Public Expenditure and Financial Accountability
PFTAC	—	Pacific Financial Technical Assistance Center
PGST	—	Palau Goods and Service Tax
PPEF	—	Pristine Palau Environmental Fee
PPP	—	Private Public Partnership
PPUC	—	Palau Public Utilities Corporation
RoP	—	Republic of Palau
SAFER	—	Safer Rule for Enhanced Reliability
SOE	—	State-Owned Enterprises
TA	—	Technical Assistance

US	—	United States

NOTE

The Republic of Palau government’s fiscal year (FY) ends on September 30.

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1. Introduction

The Government of Palau has benefited from two technical assistance projects separated by a dozen years that together provide support to the government in 2021 to institutionalize substantial changes to fiscal management and to articulate a timely fiscal strategy at the outset of a new administration that builds on prior periods of strong fiscal performance while addressing the massive impact of the COVID-19 global pandemic on the economy and on the fiscal position of Palau.

In 2008 the Government of Palau commissioned a comprehensive planning effort with assistance under the Facility for Economic and Infrastructure Management (FEIM) and the support of the Asian Development Bank (ADB). The project prepared a Medium-Term Development Strategy (MTDS) that addressed development and policy areas in the economic and social sectors. In particular, the FEIM included a special report on a Medium-Term Fiscal Strategy (MTFS). The MTFS proposed a series of recommendations and policy options for consideration by the government of Palau.

Many of those recommendations were subsequently integrated with modest modifications in a November 2018 report entitled "Medium-Term Fiscal Strategy for Sustainable Economic Development," prepared under ADB TA-8581 REG: Strengthening Public Sector Management in the North Pacific. The 2018 report reflected the substantial changes in the prevailing fiscal and economic circumstances as compared to the period prior to 2008. Importantly, the government of Palau committed itself to proposing legislatively mandated reforms to institutionalize "best practice" in fiscal management.

The evolution of the Government's fiscal management institutions and procedures has been affected by the persistently volatile performance of Palau's economy. While the Government has maintained fiscal balance and even surplus through the period from FY2011 through FY2019, the impact of the COVID-19 global pandemic has ended that streak and put an exclamation point on the Government's stated desire to improve and institutionalize our fiscal management approach.

Three key issues or circumstances that have influenced the Government's continued fiscal caution coupled with our desire to leverage the technical assistance received from the ADB to improve and institutionalize our fiscal management approach are briefly described below:

- ***The Compact Review Agreement (CRA)***: The Palau Compact of Free Association with the US calls for reviews at the 15th, 30th and 40th anniversaries of the Compact. With the initial 15 years of the Compact having been from FY1995-2009, those reviews were thus scheduled to occur in FY2010, FY2025 and 2035 during the fifty-year period of the Compact. As a result of the 15th year review an agreement in which the US extended funding and program support through FY2024 was reached. Known as the CRA, the agreement provided further economic assistance to Palau, including additional support to the Compact Trust Fund (CTF), continued direct grant assistance, resources for infrastructure development, and infrastructure maintenance. Importantly support through federal programs and services was extended as well. A prominent feature of the CRA was the recognition that the design of the original Compact was overly optimistic in the potential of the CTF to reach a level sufficient to provide for Palau's future needs. The extension of the economic assistance through a further 15 years was thus intended to enable Palau to achieve its fiscal and economic development objectives. As it turned out, the agreement signed in 2010 did not get implemented until 2018 with the authorization of the CRA by the US Congress followed by appropriation of funding to make Palau (nearly) whole for the CRA. With funds released only at the end of FY2018, Palau had operated under the insecure provision of stop-gap funding for each of the years from FY2010 through FY2018. Funding during the period was provided at about 87 percent of the CRA agreement level and provided no funding for infrastructure. The threat of annual funding cuts, despite never having eventuated, did result in the Government having a cautious fiscal stance.

- ***Acceleration of the 30th Anniversary Compact Review***: The US opened the door to an early Review of the Palau Compact in 2019. The timing of the initiative was influenced by US policy concerns expressed in its Indo-Pacific Strategy as well as a desire to have negotiations with all three Freely Associated States (FAS) including the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI). The express goal of the US was to have a mutually agreed Compact funding extension with each FAS in place by the end of December 2020. In the end, the parties negotiated but did not reach concluding agreements in any of the three nations. A new Administration in the US is likely to have similarly high priority concerns with respect to Indo-Pacific Strategy; however, it is now an open question as to if and when negotiations may be restarted. Once again, and despite some optimism, our status argues for continuation of the Government's cautious fiscal stance.
- ***The COVID-19 Global Pandemic***: Palau remains COVID-19 case-free as of this writing; however, Palau's economy and fiscal position has been negatively impacted to an extraordinary degree by the necessary closing of our borders and the resulting crushing impact on the tourism sector and related activities. The impact has been described in ADB-supported economic analysis and in conjunction with emergency borrowing to offset the cyclical shock to the Palauan economy. Looking forward, the impact of expanded borrowing levels is to further focus the Government's attention on fiscal management. Recovery will surely demand continuation of the Government's cautious fiscal stance.
- ***ADB support through the RISES (Recovery through Improved Systems and Expenditure Support) Program Loan for Fiscal Responsibility***: With the onset of

the COVID-19 global pandemic and collapse of the Palau tourism industry there emerged a large fiscal gap and need for mitigation to finance the fiscal deficit. Initial loans totaling $35 million from the ADB supported the economy during FY2020, but further financing will be required during FY2021 and, perhaps, beyond. A $55 million borrowing facility was arranged with the ADB under the RISES program in the form of a Policy-Based Loan (PBL). The program includes a series of reforms to improve both public financial management and the environment for private sector development. The focus of the RISES program was to establish a fiscal responsibility framework that would support stability during economic recovery and over the long run. The design of the program drew heavily on earlier Public Financial Management (PFM) reforms and a fiscal strategy that the Government has been focusing upon more recently.

2. The Fiscal Responsibility Framework

The Government of Palau instituted a review of best practice in terms of fiscal management by reviewing lessons learned in developed and developing countries; however, our efforts to create a new "Fiscal Responsibility Framework" have been most strongly influenced by our Pacific neighbors who have undertaken such reforms. The approach taken is thus substantially refined to meet Palau's unique needs and to build upon—rather than replace—many of the elements of our prevailing fiscal management process.

1. Observations of International Best Practice: Fiscal Responsibility Frameworks

Many countries have successfully enacted a fiscal responsibility framework whose primary objective is to entrench sound fiscal policies in legislation and regulations. As indicated in a recent IMF primer, the primary function of fiscal responsibility frameworks, is to avoid deficits and procyclical biases by constraining the government's use of fiscal discretion[1]. During periods of economic growth and fiscal buoyancy governments tend to excessively expand operating expenditures. During periods of economic decline and fiscal distress governments tend to restrict capital outlays and increase debt to maintain operating expenditures. Both tendencies are contrary to sound fiscal management through the entire economic cycle. The World Bank[2] in an earlier work expressed fiscal responsibility as:

> *The first main provision involves setting fiscal objectives in a two-step process by requiring adherence to "Principles of Responsible Fiscal Management" and mandating preparation of an annual Budget Policy Statement by government. The "Principles of Responsible Fiscal Management" mandate that debt, spending and taxation be maintained at "prudent" levels. Any deviation from the principles requires explanation by the Minister of Finance as well as an explanation as to how and when government will return to the principles. The Budget Policy Statement requirement obligates government to make an annual statement of fiscal intentions for the next three years and their long-term fiscal objectives, as well as the consistency of fiscal intentions and objectives with the "Principles of Responsible Fiscal Management."*

In Pacific Island nations, fiscal responsibility acts have included the following ***four principles***:

- Managing debt at prudent levels, and operating expenses within operating revenues over the medium-term;
- Maintaining levels of net worth to provide a buffer against factors that may adversely impact net worth in the future;
- Managing fiscal risks prudently; and

1 IMF Fiscal Affairs Department, 2017, *How to Notes: Fiscal Policy: How to Select Fiscal Rules; A Primer*, 2017, Washington D.C.

2 World Bank, *Public Expenditure Management Handbook*, Washington, DC, 1998.

- Pursuing policies that are consistent with a reasonable level and stability of tax rates for future years.

Importantly, should a government wish to temporarily depart from the principles of fiscal responsibility, the laws in these Pacific Island nations require the government to specify the reason for departure, the approach intended to restore the principles and the time over which restoration is anticipated. In addition to defining the principles of fiscal management, fiscal responsibility frameworks usually entail a series of ***budget and reporting requirements—in effect these are the elements of the annual budget cycle***:

- The budget call,
- An annual budget statement, presented at the time of budget delivery,
- An economic and fiscal update, including economic and fiscal forecasts, statement of tax policy changes, on which the budget was formulated, and
- A half-yearly economic and fiscal update.

2. Modified for Palau: Seven Fiscal Responsibility Principles

For Palau, the above-described international "best practice" has been modified to fit Palau's unique needs. The government of Palau has proposed that a fiscal responsibility framework be enacted in law. Specifically, the "Fiscal Responsibility and External Debt Management Act" establishes—in section 105—seven principles of responsible fiscal management as follows:

1. Manage operating expenditures over the medium-term within operating revenues and in relation to the rate of growth of the economy;
2. Manage net capital and financial assets, including the COFA Trust Fund, to achieve rising real national net worth over time;
3. Manage debt prudently;
4. Manage the revenue regime to best fit the structure of the economy, to provide for an equitable allocation of tax burdens, and to allow for predictability over time;
5. Manage reserves and insurance coverage to offset cyclical volatility, the costs of natural disasters, and the impact of climate change;
6. Manage the non-primary government public sector prudently including ensuring State Owned Enterprises and Public Financial Institutions are managed to deliver services on an effective and financially sustainable basis; and
7. Manage fiscal risks and contingent liabilities prudently.

3. Adopted for Palau: Departure From & Return to Fiscal Responsibility

In Palau, the identification of the need for departure from any specific fiscal responsibility principle and a requirement to declare the method and expected time period before returning to adherence with that principle has been identified as a critical characteristic of the framework. Depending on the nature and timing of the departure this would either require a statement by the Minister of Finance at the time of the events precipitating departure or during the normal budget cycle.

Again, the above-described observations of international "best practice" have been modified to fit Palau's unique needs with respect to the elements of its fiscal management and budget process. Specifically, the "Fiscal Responsibility and External Debt Management Act" further establishes one periodic element and six annual elements of a revised fiscal management and budget cycle.

4. Modified for Palau: One Periodic Element and Six Annual Elements of the new Budget Cycle

(1) Section 106: Preparation of a Guiding Fiscal Strategy on a Periodic Basis:

The President shall present to the Olbiil Era Kelulau (and publish for public awareness) at the outset of each new administration's 4-year term, or more often as circumstances may dictate, a **Fiscal Strategy** indicating Palau's fiscal goals and policies clearly demonstrating adherence to the principles of fiscal responsibility as set forth in Section 105. The Fiscal Strategy, until amended or replaced, shall guide the annual operation of fiscal policy through the elements of the Palau budget cycle as indicated in Sections 107 through 112 below.

(2) Section 107: Medium-Term Economic and Fiscal Model.

The Minister shall ensure that the Ministry creates and maintains a Medium-Term Economic and Fiscal Model (MTEF Model). The **MTEF Model** shall be a quantitative economic and fiscal framework of the Palauan economy based on Palau's audited fiscal results and published economic results looking backward and capable of producing forward-looking economic and fiscal projections over the medium-term to support the preparation of a fiscally sustainable budget. A key result from the MTEF Model shall be the issuance of an **annual fiscal envelope** to inform the aggregate expenditure limit across all government, but which allows for policy preferences and priorities to be expressed by the President at the level of each branch, ministry, and agency. The MTEF Model results, including the underlying assumptions and the annual fiscal envelope establishing the annual aggregate expenditure limit shall be used to inform the annual budget call.

(3) Section 108: Annual Economic and Fiscal Update.

The Minister shall issue an annual economic and fiscal update, including economic and fiscal forecasts based on current policies. When relevant, the update shall also include the potential impact of each economic and fiscal policy change under consideration by the government. The update shall also include a **Statement of Fiscal Responsibility** attested to by the Minister and reporting on Palau's current and planned adherence to the Principles of Fiscal Responsibility and on such other matters as may be specified by regulation.

(4) Section 109: State of the Republic Address.

The President shall deliver an annual report to the Olbiil Era Kelulau, referred to as the "**State of the Republic Address**" pursuant to Section 13 of Article VIII of the Palau Constitution, which, among other topics, shall address recent economic and fiscal performance. The address shall also include forward-looking statements outlining expected economic and fiscal outcomes over the medium term. If, at the time of the address, the Republic is not in adherence with the principles of fiscal responsibility set forth in Section 105, the President shall address such nonadherence and describe the government's commitments in terms of actions and timeline to return to adherence.

(5) Section 110: Annual Budget Call.

The President shall issue to all branches, ministries, and agencies of government the **Annual Budget Call**. The annual budget call shall take notice of the fiscal envelope establishing the aggregate expenditure limit across all government. The Annual Budget Call shall also take notice of and shall be informed by the Performance Review as set forth in § 373 of Chapter 3 of Title 40.

(6) Section 111: Annual Budget Statement.

The President shall submit to the Olbiil Era Kelulau, along with the **Annual Budget transmission**, an **Annual Budget Statement** that:

a. describes any economic and fiscal policy changes that are assumed in the formulation of the annual budget;
b. describes the key assumptions, including MTEF Model results that established the fiscal envelope, under which the budget was formulated;
c. includes a statement of tax policy and quantitative assessment of any changes that have resulted in material change to the tax revenue forecasts for the fiscal year; and
d. includes a comprehensive clarification of the policy preferences and priorities of the President for the attached budget.

(7) Section 112: Half-Year Economic and Fiscal Update.

The Minister shall issue a half-yearly Economic and Fiscal Update which, at a minimum, will provide an update of key fiscal tables to inform of late-year budget adjustments, if any, and which may also update economic and fiscal forecasts based on the latest information available at the time the Half-Year Update is issued.

Diagrammatic presentation of the Fiscal Responsibility Framework

5. Public Financial Management (PFM)

1. ***Medium-Term Budget Framework***: As part of the original Facility for Economic and Infrastructure Management (FEIM), Palau initiated an effort to develop a Medium-Term Budget Framework (MTBF). The Fiscal Responsibility Framework outlined in this framework is integrated generally with a medium-term approach to budgeting and the Annual Budget transmitted to the Olbiil Era Kelulau is, in fact, a medium-term budget.

2. **Public Expenditure and Financial Accountability**: Palau has undergone a PEFA self-assessment and has made progress with implementation. Palau will undertake a full external assessment and establish a roadmap for future reforms.

6. Future Compact relations

Under the Compact, Palau benefits from a series of US federal programs and services. The status of these benefits is unclear after the expiration of the Compact Review Agreement in FY2024. In the context of the (early) negotiations prior to the 30th anniversary of the Compact, Palau has requested that such programs continue indefinitely or for the twenty-year period the US has indicated it will cover under the 30th Anniversary Review. Palau's fiscal strategy will need to account for the current uncertainty and at least address the level of risk to the economy and fiscal stance posed by the potential cessation of the US federal programs and services.

3. Rationale and Discussion for Each of the Seven Fiscal Responsibility Principles

1. *Manage operating expenditures over the medium-term within operating revenues and in relation to the rate of growth of the economy*

- ***Fiscal Rules***: Many countries, particularly developed nations, have adopted strict and specific fiscal rules, that govern the level of permissible deficit over the medium-term, expenditure targeting over the full economic cycle or even revenue targets. Given the difficulty in defining such permanent, legislated targets in Palau and given the substantial economic volatility to which Palau is subject, **the Government does not propose to specify strict fiscal rules** in our fiscal responsibility framework. Neither does the Government propose to establish fiscal rules or even targets by law. Instead, the principles will remain broadly stated in law, while the Government will utilize the Fiscal Strategy and the annual elements of the budget cycle to state specific "rules" under which it intends to operate fiscal policy. Such rules would, in effect, operationalize their attention to, and compliance with, the legislated fiscal responsibility principles without the rigidity that might arise from an over-specified legislative framework that would be inconsistent with the economic and fiscal volatility Palau has faced and will likely continue to face.
- ***Current expenditures should be financed out of domestic revenues in the long-term***: A major feature of the earlier fiscal strategy of the FEIM was the objective that current expenditures should be financed out of domestic revenues. The FEIM considered grant aid from the US as about to terminate and from other sources as unsustainable in the long-term. Accordingly, it was recommended that Palau should move towards self-sufficiency. Current grants excluding represent 11 percent of total revenues or 5 percent of GDP. Elimination of these grants, which are generally considered to be sustainable over the long-term, and replacement with domestic revenue would place significant stress on the budget and economy. It is thus proposed that this objective be adopted as a long-term objective. It is thus anticipated that the first principle would, over time, evolve such that the government would manage recurrent revenues within "domestic revenues." To do so now would imply replacement of US-funded federal programs and services and use of Taiwan resources entirely for capital expenditures. The glide path to this modified principle could very well be long. This also implies development of a responsive tax regime that can sustain higher rates of tax without distortion. It further suggests that grant

aid should only be utilized for projects that do not have a permanent call on the budget.

2. *Manage net capital and financial assets, including the COFA Trust Fund, to achieve rising real national net worth over time*

1. ***Capital Assets***: Palau has until recently adopted a policy of financing capital expenditures through concessional loans or through capital grants. However, both capital grants and expenditures have shown a significant decline in relation of GDP. For a nation that is now graduating from developing country status, new ways of financing investment and infrastructure will be required.
   - ***Infrastructure Reserve Fund***: A major and as yet untapped source of funds would be through generation of savings through the budget. In effect government would save a proportion of the revenues from taxation and fees for investment in infrastructure. This would display responsibility, commitment, and self-reliance in the nation's development. Policy would entail establishment of a target level of infrastructure over the medium-term. This would involve the establishment of an infrastructure reserve fund dedicated to infrastructure projects. When grant, loan and other financing sources were not available or sufficiently supportive, projects would be implemented utilizing funds drawn from the reserve fund. The fund would be established through setting aside a given proportion of domestic revenues in a similar manner to the Cyclical Reserve Fund and Climate Resilience Fund discussed below.
   - ***Grant funded investment***: Palau's traditional bilateral partners (Japan and Taiwan) have provided a valuable source of funds to finance infrastructure projects. While there is no anticipated change in these relationships, overtime it can be expected that these resources will fund a declining proportion of economy-wide investment needs.
   - ***Concessional loan finance***: Both multilaterals (ADB) and bilaterals (Taiwan) have provided significant resources to fund Palau's infrastructure and development needs. More recently both AIFFP (Australia Infrastructure Financing Facility for the Pacific) and JBIC (Japanese Bank for International Cooperation) are lending to Palau. The World Bank is also an important source of finance that has a large pool of institutional knowledge that Palau has not tapped into. All sources have significant pools of resources to fund investment and will play a continuing role in Palau's financing needs. However, these sources will not provide a source of funds for all types of investment for projects that Palau may wish to develop.
   - ***Private Public Partnerships (PPP)***: Palau is currently entering into two PPPs relationships: the airport renovation project, and a Power Purchase

Agreement for the supply and storage of electricity. The PPP Knowledge Lab defines a PPP as a "long-term contract between a private party and a government entity, for providing a public asset or service, in which the private party bears significant risk and management responsibility, and remuneration is linked to performance.".[3] Private-sector technology and innovation help provide better public services through improved operational efficiency. The public sector provides incentives for the private sector to deliver projects on time and within budget. However, while PPPs can provide a valuable means to support the development of public infrastructure, they have also been controversial, often with unforeseen risks and unspecified contingent liabilities. In order to establish a suitable framework for the evaluation and regulation of PPPs Palau has requested TA from the ADB, which is part of the RISES program.

- ***Domestic financial market development***. Palau has considerable resources in the domestic commercial banking system and one of the lowest loans to deposit ratios in the world. Given Palau's favorable fiscal performance, accessing this market through issuance of domestic bonds offers the potential of a further financing mechanism. However, before development of a domestic bond market, such instruments would need to be compliant with FDIC regulations, and establishment of a credit rating with one of the international agencies would also be a pre-requisite. Careful planning will be undertaken to ensure that Palau achieves the highest ranking possible. Adoption of the fiscal responsibility framework such as outlined here together with resolving issues such as the threatened collapse of the Civil Service Pension Plan would provide further confidence to potential investors. However, clearly funds raised through private markets would come with higher interest rates, which the government recognizes will require a strict and cautious project evaluation process.
- ***Asset Management Board***: For all these alternative forms of financing government will consider appointment of a Palau asset management board or authority, whose function is to manage and regulate government investments and infrastructure developments. The Board would have oversight of appraisal of projects for economic and financial viability and monitoring of performance against targets and contracts.
- ***Infrastructure Development Plan***: Lastly, as part of the FEIM an infrastructure development plan was established in 2008. Twelve years on circumstances have changed. There has been significant tourist development and the government intends to develop Babeldaob, a largely undeveloped region, as a focus for new projects. Reflecting these needs Palau with ADB support is currently updating the infrastructure development plan

[3] See PPP Knowledge Lab at https://pppknowledgelab.org

that sets the priorities and details infrastructure needs. This is also part of the RISES program.

2. ***COFA trust fund and establishing a perpetual fund***: The COFA trust fund was designed as a sinking fund to provide an annual yield of $15 million through the end of the 50-year Compact period. The CTF has performed well and is currently estimated to deliver the $15 million specified in the Compact but with a 7 percent probability of collapse prior to the end of this period. It has been the desire of Palau to transform the CTF into a perpetual fund capable of yielding a perpetual stream of inflation-adjusted benefits indefinitely. This will be the government's request in the early negotiations with the US for extension of Compact funding support after FY2024.

3. Manage debt prudently

Palau's external debt until the advent of the COVID-19 global pandemic has been professionally managed without threat of debt stress. However, there exists no formal debt management policy or framework. In many countries a debt management framework is adopted in law, which specifies formal procedures for evaluating proposals and analyzing a countries debt profile. Given the current unavoidable needs of Palau to incur significant external debt to finance government during the COVID-19 global pandemic and during the recovery period Palau is enacting into law an external debt management framework. The framework will require the Minister to establish a debt management unit in the Ministry of Finance with the following responsibilities:

- Provide technical discussion on every proposed borrowing, in particular, assessment of the various risks involved, terms and conditions of borrowing, and debt-servicing strategy;
- Assist the Minister to develop and maintain a debt management policy for adoption by the President and OEK;
- Develop and utilize a project appraisal and approval framework for the assessment of loan financed project and activity proposals and to provide subsequent advice to the Minister;
- Undertake a periodic Debt Sustainability Analysis (DSA) to support the debt management component of the annual economic and fiscal update required under the Fiscal Responsibility Law; and
- Undertake an annual risk assessment on the loan portfolio in its entirety and render its opinion or advice thereon to the Minister.

4. *Manage the revenue regime to best fit the structure of the economy, to provide for an equitable allocation of tax burdens, and to allow for predictability over time*

Tax reform is perhaps the most important fiscal policy change confronting the Government. The revenue base consisting of the traditional taxes on wages, gross receipts and imports has declined in real terms. Fiscal balance has been maintained in part by discretionary increases in taxes on tobacco, tourists, windfall gains from fishing royalties, and economic growth. While economic growth will clearly enhance revenue potential, the other options relied upon in the past will fail to provide a sustainable, buoyant alternative to addressing potential fiscal imbalances in the future.

Palau has an outdated tax regime inherited from Trust Territory days that has many weaknesses, including an inefficient and outmoded tax structure, distortionary taxes, and outdated institutional administration. The major traditional taxes suffer from many structural weaknesses. The gross receipts tax is levied on output and cascades with each transaction and is thus distortionary. It is intended as a proxy income tax, but the incidence is equivalent to that of a sales tax. The wage tax is levied on all employees and has proved buoyant, but requires reform to eliminate distortions. Import taxes, the remaining major category, are inelastic with respect to GDP. The tax system is inequitable in that taxes are levied on labor, but capital is effectively untaxed: there is no profits tax. Government has committed to major reform to create a modern and efficient tax regime suited to the structure of Palau's tourism-led economy.

Palau has at various times in the past considered tax reform and asked the IMF to prepare a review of the existing regime and recommend suitable reforms. Missions were fielded in 1998, 2006, in 2013 and again in 2018. As part of the RISES program Palau has committed to reform its tax system consistent with the reforms outlined in the 2018 mission. The main ingredients of the reforms currently under consideration are:

- A Palau Goods and Service Tax (PGST) replaces the existing general import tax on imported goods at the c.i.f. level and applies also to domestic production and distribution of goods and services.
- The hotel-room occupancy tax, will be retained to support the PGST tax base and attainment of Palau's high value tourism objective. Likewise, the Pristine Paradise Environmental Fee (PREF) or departure tax will be retained.
- A Business Profit Tax (BPT) would be introduced for all registered businesses above a defined threshold and replace the Business Gross Receipts Tax.

- Only the largest businesses above a certain threshold ($100,00) would be required to register for the BPT and PGST.
- Some tax would apply to businesses not registered, based on a fixed fee for certain bands of turnover.
- Special rates of import taxes on alcohol and tobacco would remain, and domestic excises would be levied at similar rates on competing industries.

The objective of the tax reform initiative outlined in the RISES program will be an introduction of the reforms on a revenue neutral basis. After reform and selection of the individual components of the regime, it is probable that the PGST will be selected to equilibrate or attain revenue neutrality. The PGST is a very powerful tax in Palau, with a tax base equivalent to close to 100 percent of GDP. Relatively minor adjustments to the PGST rate will provide an efficient means to attain the revenue neutral objective.

5. Manage reserves and insurance coverage to offset cyclical volatility, the costs of natural disasters, and the impact of climate change

Palau has implemented a general fund reserve through which 2 percent of unrestricted local revenues and unreserved general fund balance (essentially accumulated past fiscal surpluses) are set aside for downturns in the economic cycle to finance revenue shortfalls or financing of disasters. However, the existing regime is not optimal. There is no limit on the magnitude of the reserve in relation to needs and under law all accumulated past surpluses are required to be transferred to the reserve leaving no funds available for cash flow needs of the government.

As a result, Palau will be reforming the existing reserve and introducing two new special funds: (i) the cyclical reserve fund, and (ii) the climate resilience fund. The cyclical reserve will be maintained at the same rate of contribution as the earlier fund until 3 months' worth of domestic revenues have been achieved after allowing for cash management needs. Once funds have attained the target, contributions will cease. Withdrawal of funds will be permissible only if annual domestic revenues have fallen more than 5 percent below budget levels.

The climate resilience fund will be earmarked to address climate related events and natural disasters. A smaller rate of contribution of 1 percent of domestic revenues will be set aside into the fund until a target is reached based on the World Bank's Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI). In Palau's case the risk and cost of an annual climate event is about 1.5 percent of GDP. The target for the fund has been set to 10 years of annual climate risk. Withdrawal of funds will be permissible once the President declares a state of national emergency. In addition to the Climate Resilience Reserve, Palau maintains access to the

ADB's Disaster Resilience Program, which under the current replenishment allows Palau to draw up to $20 million of funds in the advent of a qualifying natural disaster. Commitment costs for the ADB's DRP, or any other such insurance facility, may be drawn from the climate resilience fund.

6. Manage the non-primary government public sector prudently including ensuring State Owned Enterprises and Public Financial Institutions are managed to deliver services on an effective and financially sustainable basis

SOE Framework: In August 2014, the President issued a SOE policy statement with the backing of the ADB with the following purpose: "*The Primary Objective of each SOE is to operate as a successful business and, to that end, to recover all of its costs, including the costs of capital*." The policy included several important functions: (i) identification and costing of Community Service Obligations (CSO), (ii) appointment of qualified officials to Boards without publicly elected officials, and (iii) creation of a monitoring unit in the Ministry of Finance. However, the policy statement was not acted upon or follow up in law. A recent assessment of the private sector conducted by the Private Sector Development Initiative an arm of the ADB in 2017 found that the SOE sector remained "*inefficient and constituted a drain on the government's budget*". The SOE policy statement provides a framework for best practice for the conduct of operation of the sector, and it is the intention of government to enact the framework into law.

Reform of PPUC: In the power and water sector the adoption of full cost recovery has not been achieved. While explicit subsidies have been avoided in the *power sector* the implicit level of subsidy has been hidden by the depreciation of the capital base without provision for replacement or maintenance. To rectify the situation Palau has incurred a PBL of $10 million with the ADB to reform the sector and finance capital needs and maintenance costs. One of the conditions has been the adoption of a new tariff designed specifically to achieve full cost recovery. In the *water and wastewater* sector a $28 million loan was incurred to rehabilitate the Koror Airai system, but further funds are required to complete the program. As a result, revenues from the sale of water and wastewater are less than half of operating cost, implying the need for substantial subsidy. Without reform the sector will continue to pose a significant fiscal risk requiring a continuing and increasing level of subsidy.

Reforms to Social Security: The Social Security system in Palau has been professionally managed and although the unfunded liability may be considered large at 66 percent, the ratio of contributions and investment earnings to benefits and administrative costs has generally been within sustainable limits. However, the recent award of three supplemental benefits of $50 per month has raised the level of fiscal risk posed by SS. While the initial supplemental benefit was subsequently accompanied by an increase in the contribution rate from 6 to 7 percent to offset the cost, the remaining two supplemental benefits require significant annual transfers from the general fund. As part of the RISES program an actuarial study has been commissioned to study the financial position of SS and to recommend reforms including governance reforms to ensure financial stability. SS was designed to operate independently without Government support or reliance on transfers and until such time as this objective is re-established, SS will pose significant fiscal risk.

Reform of the CSPP: Unlike the Social Security system, the Civil Service Pension Plan has been less financially well-managed and is currently in imminent threat of collapse. With contributions projected to remain stagnant and benefits growing strongly, a recent actuarial evaluation of the system, projected system collapse by FY24. In the FY20 budget a total of $4.4 million was transferred to the CSPP, and a loan of $10 million is under consideration with Taiwan to finance the shortfall in the near term but will only push back the inevitable collapse a few additional years. An actuarial assessment with reform options that provide a lasting and financial sustainable solution to the problem is required. Without reform the CSPP remains the most serious fiscal risk facing Palau with greater potential impact than the COVID-19 global pandemic.

7. Manage fiscal risks and contingent liabilities prudently

Areas that pose significant and special fiscal risk to Palau have been isolated under principle 6 of the fiscal responsibility framework. The following provides a list of areas that will be included in the Annual Economic and Fiscal Update.

i. ***Macro-economic volatility***: The Palau economy is subject to a high degree of economic volatility. In the last 20 years not including the recent COVID-19 global pandemic there have been 9 years of negative growth and 6 years experiencing a greater than 5 percent increase or decrease in GDP. Such volatility has significant impact on tax revenues and provision of public services. Principle 5 of our fiscal responsibility framework provides for the creation of a cyclical reserve fund to mitigate the impact of fiscal risk. An assessment of the impact of economic volatility on tax revenues will be provided in the Annual Economic and Fiscal Update.

ii. ***Financial sector crisis***: The financial sector is comprised of private and public sector entities. Public sector financial institutions pose a special fiscal risk and have been separately identified under principle 6. In the past the banking sector has precipitated at least one period of severe financial crisis but is now well regulated under FDIC provisions (for the US bank branches) and the Financial Institutions Commission (for all banks). An annual assessment of the banking sector concerning financial soundness, capital adequacy, non-preforming loans etc. will be provided by the FIC for inclusion in the annual economic and fiscal update.

iii. ***Change in debt interest rates***: Much of Palau's external debt has been incurred on concessional terms with low interest rates. However, a considerable portion is on variable international rates based on LIBOR plus a percentage. Should the international climate for interest rates change the potential for significant fiscal risk and debt stress exists. Principle 3 of our fiscal responsibility framework provides for the establishment of an external debt management unit. The unit will develop a stress testing methodology for external debt as well as the standard DSA for inclusion in the Annual Economic and Fiscal Update.

iv. ***Demographic changes***: The population of Palau is comprised of Palauans and a significant number of foreign workers primarily from the Philippines and Bangladesh. While the population of Palauans has remained largely static, under the provisions of the Compact, Palauans have the right to live and work in the U.S. Should these conditions change there is potential for significant fiscal impact. Maintaining good relations with Palau's neighbors and monitoring human and worker's rights will provide a safe and secure environment for foreign workers and ensure stability in the supply of foreign labor. The Palau economy is highly dependent on foreign workers on which the tourism economy and SS system depend. While demographic change is generally long-term in nature it requires careful monitoring.

v. ***Natural disasters***: Palau is subject to periodic and significant climate events and natural disasters. In the last 10 years there have been two major Typhoons and one el Nino draught. Under principle 5 of our fiscal responsibility framework Palau has created a climate resilience fund with a target of 3 months of domestic revenues ($19 million) and has subscribed to the ADB Disaster Resilience Program with immediately available loan funding of up to $20 million. Palau is projected to be subject to "significant," albeit periodic, climate events that might require greater funding and additional insurance options will be examined.

vi. ***Government guarantees***: Most loans incurred on behalf of the public entities from institutions like the ADB are incurred by the sovereign government and are thus not guaranteed. However, there remain a small number, but important volume of lending, to the SOE sector such as the RUS loan to the PPNC. These will be disclosed in the Annual Economic and Fiscal Update.

vii. ***Government litigation and lawsuits***: These are generally of an unknown nature and cannot be forecast in advance. However, when such events occur and are known they will be disclosed in the Annual Economic and Fiscal Update.

viii. ***Public private partnerships and/or private financial initiatives***: Private public partnerships are a new form of financing and provision of services in Palau. As part of the RISES program a PPP policy statement is being prepared for adoption in Palau. Part of the initiative may include the establishment of an entity such as the external debt management or SOE monitoring unit. This unit would be responsible for providing an assessment of fiscal risk.

ix. ***Environmental degradation***: Palau devotes special attention to its environment given the special attributes immeasurable value of its natural resources. To preserve its environment Palau has declared a marine sanctuary over much of its EEZ and prohibits commercial fishing in 80 percent of its ocean waters. The nation's tourism industry is, unsurprisingly, highly dependent on the quality of its environment. Degradation of the environment is thus a key area of fiscal risk to be closely monitored.

x. ***Local government and/or developed administrations***: Transfers to state governments have grown strongly with a near-doubling in the last 10 years. This poses a significant fiscal risk. While most state governments have not been strongly impacted by the COVID-19 global pandemic, Koror state faces serious financial issues due to the pandemic. Koror state is particularly dependent on the tourism industry with 75 percent of its revenues from access fees to the rock islands and leases to the tourist industry. As a result, the state has requested financing from the national government. In normal circumstances Koror state does not pose a significant fiscal risk. However, the current events have revealed the weak nature of the state's fiscal management which has proved inadequate to analyze or address the crisis on a timely basis. This indicates that a risk assessment of the state government's needs will be an important element of the Annual Economic and Fiscal Update.

xi. ***State owned enterprises***: The SOE sector is a special area of fiscal risk and has been included under principle 6 of our fiscal responsibility framework. However, a brief annual assessment of performance will be included in the Annual Economic and Fiscal Update.

4. Outline of the (i) Fiscal Strategy, and (ii) Annual Economic and Fiscal Update

The President has transmitted the Fiscal Responsibility Framework law to the Olbiil Era Kelulau for consideration and presumed adoption at their earliest opportunity. That "Fiscal Responsibility and External Debt Management Act" will drive the Government's fiscal management going forward. This section provides an indicative outline of two of the elements of the presumed new budget cycle. While it is premature to issue these elements in their final 2021-2025 form for the Fiscal Strategy and in the 2021 form for the FY2022 budget year for the Annual Economic and Fiscal Update, the Government can herein indicate its intent in terms of an outline for each document and some of the content to be subsequently specified at the appropriate time in the upcoming budget cycle.

1. Palau's Fiscal Strategy 2021-2025 (February 2021)

This document will guide fiscal management for the stated period unless circumstances require amendments to the strategy sooner than expected. The document is anticipated to have the following four sections, subject to additions to address emerging issues and/or emergencies:

1. **Fiscal Status**—provide charts, tables and analytical narrative to describe recent and projected fiscal performance.
2. **Goals of Fiscal Strategy**
    a. **Encourage economic and financial stability**—defined as long-term fiscal sustainability such that sustainable revenues are sufficient to finance total expenditures without entailing a reduction in net economic and environmental wealth.
    b. **Encourage maximum use of resources**—bring the maximum use of economic resources, including land, capital and labor into efficient production.
    c. **Encourage savings and investment**—increase the level of savings mobilized through intermediation of the financial sector into efficient investment to accelerate the rate of economic growth and development.
    d. **Encourage economic and social equity**—defined as an equitable distribution of resources supporting inclusive economic growth and social service delivery to the population.
    e. **Encourage growth of the private sector**—increase the rate of growth of the private sector through investment in infrastructure and improvement in the regulatory environment.
    f. ***Taxation***: Maintain an equitable tax regime that supports the efficient allocation of resources, economic development, savings and investment.
3. **Outline of Economic and Fiscal Priorities of the Administration**—the Fiscal Strategy will include the major economic, fiscal and infrastructure programs,

plans and policies that the Administration intends to implement during its term of office.

4. **Strategies and Policies to Achieve Fiscal Goals**—the Administration's approach will be articulated in terms of new and continuing efforts with regard to the major items outlined in 3 above and confronting the nation for the achievement of each goal.
5. **Matrix for Monitoring of Measurement Indicators, Benchmarks and Targets**—the goals articulated in section 2 of the Fiscal Strategy will be presented in matrix format to add measurement indicators and timeline commitments for each goal's cluster of strategies and policies.

2. Palau's Annual Economic and Fiscal Update (March 2021)

This document will inform policymakers on an annual basis in the formulation and approval of the annual budget as well as in the annual execution of strategies and policies that have been articulated in the Fiscal Strategy. The document is anticipated to have the following four sections, subject to additions to address emerging issues and/or emergencies:

1. **Economic Update and Forecast**—charts, tables and analytical narrative to describe recent and projected economic performance:
   a. Gross Domestic Product (GDP) and components of GDP
   b. Consumer prices (CPI)
   c. Population and employment
   d. Tourism statistics
   e. Money and credit statistics
2. **Fiscal Update and Forecast**—charts, tables and analytical narrative to describe recent and projected fiscal performance:
   a. Revenues
   b. Expenses
   c. Capital expenditures
   d. Financing, including a statement of borrowing and schedule of principal and interest repayments
   e. Public debt
   f. Overall fiscal deficit and the Government's net position
   g. Statements necessary to fairly estimate national net worth
3. **Monitoring of Fiscal Operations and of Implementation of the Fiscal Strategy**

a. Comparative budgeted and estimated actual figures for the prior and current fiscal year in relation to each variable in the fiscal forecasts
b. Statement of all significant assumptions underlying the fiscal forecasts
c. Statement that shows the sensitivity of the fiscal forecasts to changes in economic conditions
d. Statement that compares prior year fiscal forecasts with actual year-end results
e. Update of the matrix presented in the Fiscal Strategy
f. Narrative discussion of Government's progress in implementing the Fiscal Strategy

4. Fiscal Responsibility Attestation of the Minister

a. Attestation as to Adherence to Fiscal Responsibility Principle #1 (and path to return if applicable)
b. Attestation as to Adherence to Fiscal Responsibility Principle #2 (and path to return if applicable)
c. Attestation as to Adherence to Fiscal Responsibility Principle #3 (and path to return if applicable)
d. Attestation as to Adherence to Fiscal Responsibility Principle #4 (and path to return if applicable)
e. Attestation as to Adherence to Fiscal Responsibility Principle #5 (and path to return if applicable)
f. Attestation as to Adherence to Fiscal Responsibility Principle #6 (and path to return if applicable)
g. Attestation as to Adherence to Fiscal Responsibility Principle #7 (and path to return if applicable)