

POLICIES FOR SUSTAINABLE GROWTH REVISITED

A PRIVATE SECTOR ASSESSMENT
FOR PALAU

DISCUSSION DRAFT

About the Pacific Private Sector Development Initiative

The Pacific Private Sector Development Initiative (PSDI) is a regional technical assistance facility cofinanced by the Asian Development Bank (ADB), the Government of Australia, and the Government of New Zealand.

Since 2006, PSDI has been working with ADB's 14 Pacific developing member countries to improve the enabling environment for business and support inclusive, private sector-led economic growth. Its expert team provides support services in policy and program development, advocacy, legislative and administrative reform, and capacity building.

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ABBREVIATIONS

ADB	Asian Development Bank
BOA	Director of the Bureau of Agriculture
EAG	Economic Advisory Group
FIB	Foreign Investment Board
FIC	Financial Institutions Commission
GDP	gross domestic product
NDBP	National Development Bank of Palau
PNCC	Palau National Communications Corporation
PPUC	Palau Public Utilities Corporation
PSA	private sector assessment
PWSC	Palau Water and Sewer Corporation
SOE	state-owned enterprise
UCC	Uniform Commercial Code

EXECUTIVE SUMMARY AND RECOMMENDATIONS

Palau has registered 2 years of substantial economic growth and per capita income has risen to slightly in excess of \$16,000, the second highest in the Pacific region. Yet the strong performance of the economy masks some pressing issues, particularly with respect to the tourism industry, but also in terms of policy implementation, state-owned enterprise (SOE) efficiency, access to finance, and the business law framework. Additional issues are also of importance in ensuring that Palau's recent growth continues and is sustainable without compromising its pristine environment.

Agriculture has the potential to reduce Palau's dependence on food imports, which have been growing rapidly as tourism has expanded. However, a number of steps need to be taken to encourage agriculture, including implementing a land use planning policy to ensure that infrastructure is not overwhelmed.

Reform of several of Palau's laws governing business activity is needed. In particular, the companies act does not contribute to business formation and fails to assist in the development of a viable tourism industry. Reforming the companies act and installing a modern electronic companies registry, which can also be used for business licensing, will promote private sector development and provide positive synergies for the evolution of an improved tourism policy.

Palau should also consider enacting an American-based limited liability companies act as the "LLC" entity type promotes formalization of small, locally-owned businesses. In addition, bankruptcy legislation is needed.

The financial system is not intermediating effectively between savers and lenders—the international banks are sending a large percentage of their excess reserves outside the country. Part of the motivation for doing so is that local lending is risky, but the banks are also not financing local business activity. An interest rate ceiling on lending to businesses is a major contributor to their failing to lend because they cannot charge interest rates that reflect the riskiness of lending. However, the National Development Bank of Palau is a potential lender, particularly to agriculture. Currently its systems are outdated and it has a liquidity shortage. Improving its operating efficiency and tapping into savings will provide Palau businesses with an additional source of financing.

Suggested Reform Priorities

Table 1 identifies key reform priorities the government should focus on to continue improving the business climate and drive sustainable economic growth.

Table 1: Reform Priorities

Area	Priority Recommendations
Tourism	<ul style="list-style-type: none"> Place a moratorium on new construction of tourist-related facilities, and any further increases in the number of tourists arriving on package tours, pending the development of a national tourism policy.
Land	<ul style="list-style-type: none"> Add a provision to laws governing land leases that provides for a notice period of 90 days during which clan members can dispute a clan lease. Develop an effective and binding land use policy that applies to both the national government and to the states.
Financial system	<ul style="list-style-type: none"> Abolish the usury ceiling on lending to businesses by commercial banks. Strengthen the systems of the National Development Bank of Palau and analyze in detail the best way to improve its liquidity
Agriculture	<ul style="list-style-type: none"> Develop a National Agricultural Policy.
Business Law and Regulation	<ul style="list-style-type: none"> Pass a new Companies Act and install an electronic registry. Foreign and domestic companies should be subject to the same Companies Act. Thoroughly review the draft foreign investment bill, ensure that foreign and domestic companies are subject to the same Companies Act and remove provisions that require commencement of operations of foreign companies within a year of approval.
The Economic Empowerment of Women	<ul style="list-style-type: none"> Develop legislation to protect women from sexual harassment in the workplace. Through the Chamber of Commerce, provide business training specifically designed for women entrepreneurs. Provide training on the secured transactions framework to assist women in obtaining finance
Tax Policy	<ul style="list-style-type: none"> The Gross Receipts Tax, which has severe distortive effects on the way that resources are allocated in Palau needs to be replaced. A value added tax would be a significant improvement and might increase tax revenue. Tax collection will be enhanced once the new Companies Act is passed and an electronic registry installed.
State-owned enterprises	<ul style="list-style-type: none"> Ensure that state-owned enterprises operate on commercial principles. Promote the introduction of competition in the telecom sector

Key Recommendations

Table 2 contains the full list of challenges and recommendations contained in the report. Ideally, both government and the private sector should jointly review these recommendations in an effort to establish priorities and develop more detailed actions..

Table 2: Key Recommendations

Challenges	Recommendations
Tourism	<ul style="list-style-type: none"> • Develop a National Tourism Policy without delay. • Place a moratorium on new tourism building projects. • Use market mechanisms to auction landing rights. • Use peak load pricing to spread tourist visits to popular sites over the day. • Assess the impact of the new departure tax and investigate the feasibility of a daily head tax. • Improve coordination of tourism policies between the national and state governments. • Improve and enforce licensing requirements. Sharply increase penalties for infractions of tourism licensing and regulations.
Land	<ul style="list-style-type: none"> • Introduce a 90-day window for any objection to be filed by clan members to leases signed on behalf of the clan. • Make more government land available for leasing. • Ensure that the structure of leases does not penalize future generations. • Develop a land use planning system.
Financial system	<ul style="list-style-type: none"> • Abolish the usury ceiling on foreign owned lenders on lending to business. • The FIC should consider downgrading unsecured loans when assessing the financial soundness of the commercial banks. If commercial banks secure all loans above a \$5000 threshold, the quality of their portfolios will be higher and they will become more familiar with the secured transactions framework. • Undertake analysis to ascertain if the the National Development Bank should borrow from the commercial banks using the secured transactions framework through loans secured by its portfolio or prepare to accept deposits. • Undertake capacity building for the Development Bank of Palau to improve its systems for granting and monitoring loans. • Establish a credit bureau that is also linked to the US credit bureaus.

continued

Agriculture	<ul style="list-style-type: none"> • Develop a national agricultural policy. • Implement the policy through a joint venture between the Bureau of Agriculture and the Growers Association. • Establish a permanent market for the sale of organic produce. • The quarantine rules raise costs, increase Palau’s vulnerability to supply disruption and should be abolished.
Business Law and Regulation	<ul style="list-style-type: none"> • Redraft the Companies Bill and pass it into law; establish an electronic registry; use this framework to deal with the issue of “fronts”. • Develop a modern business licensing system and integrate it with the electronic Companies Registry. • Once passed, seek assistance with bankruptcy legislation. • Amend the foreign draft foreign investment legislation so that domestic and foreign companies are subject to the same company law and place foreign companies under the jurisdiction of the Registrar of Companies. Integrate foreign companies into the electronic registries. • Remove the requirement that foreign companies commence operation within 12 months of approval.
The Economic Empowerment of Women	<ul style="list-style-type: none"> • Develop legislation to protect women from sexual harassment in the workplace. • Through the Chamber of Commerce, provide business training specifically designed for women entrepreneurs. • Provide training on the secured transactions framework to assist women in obtaining finance.
Tax Policy	<ul style="list-style-type: none"> • Reform the goods and services tax by replacing it with a value added tax.
State Owned Enterprises Policy	<ul style="list-style-type: none"> • Insist that SOEs operate under strict commercial principles. • Explore opportunities for contracting out services that are currently supplied by government and government owned entities. • Vigorously pursue finding additional telecom service providers.

1 OVERVIEW

In 2014 and 2015, Palau's economy expanded strongly, with real gross domestic product (GDP) rising by 5.3% and 8.2% respectively.¹ Per capita GDP also rose, and at the end of fiscal 2015, was in excess of \$16000—the highest among Asian Development Bank (ADB) developing member countries in the Pacific region. Yet this strong performance masks some urgent issues that could threaten the sustainability of the economy and compromise long term prosperity. Palau's economy rests upon a foundation of tourism and the high growth of the last 2 years is primarily due to the explosive growth in the number of visitors. Yet, the expansion has placed significant strain on the carrying capacity of Palau's pristine natural sites and is threatening to overwhelm its infrastructure.

OUTLINE OF THE PRIVATE SECTOR ASSESSMENT

This PSA focuses on key issues identified at two Economic Symposia held in Palau on November 2014 and November 2015, as well as some other topics that analysis revealed as being important to the long term development of the Palau economy.

The PSA commences with a brief overview of methodology of private sector assessments. A section on the political economy factors that influence policy making follows. There is then a discussion of the structure of the economy and how it has evolved since 2001, including an analysis of key recommendations of the PSA completed in 2007 and the progress made with respect to the proposals that it contained. A discussion of the

four issues raised at the Symposia follows, namely tourism, finance, agriculture, and land.

In addition to these four topics, the analysis of the business environment in Palau identified several additional factors that are constraints to private sector development. These are issues related to the economic empowerment of women, land issues, the commercial legal framework, tax policy and the impact of state-owned enterprises on the economy. The discussion is framed by how potential reforms relate to current political economy issues that need to be addressed.

THE METHODOLOGY OF THE PRIVATE SECTOR ASSESSMENT

The PSAs analyze the key constraints in the business environment that inhibit investment and entrepreneurship. They take into account ongoing or planned reforms. They assess progress to date with reforms already implemented and suggest priorities for further reforms. They reflect the views of the private sector, government, and development partners, regarding their perceptions of key constraints and priority areas.

Some of the factors that the PSA identifies are:

- The public goods necessary to support business activity.
- The rationale and limits of public initiatives, particularly with regard to market failure, information asymmetry, and market imperfections.

¹ Palau's fiscal year runs from October 1 to September 30.

- The role of the state in removing barriers to private sector activity.
- A reform agenda based on the priorities identified in the analysis.

PSAs discuss in detail many, or all of the following issues:

Policy, legal, and regulatory environment.

The legal framework for doing business, including commercial law, business formation, business licensing, and the contracting environment. To what extent reform measures have contributed to improving the legal and regulatory environment that supports the growth of the private sector.

Public sector institutions. To what extent do public institutions support the growth of the private sector. This includes public institutions that (potentially) regulate, assist or inhibit the growth of the private sector and/or purchase or supply goods and services from (or to) private suppliers.

State-owned enterprises. The characteristics and efficiency of SOEs; whether they are a drain on the budget and the potential for public private partnerships; contracting out and privatization. Furthermore, the analysis takes into account the extent to which SOEs impact the efficiency of the private sector. In most countries in the region, SOEs are monopoly providers, are often inefficient, and frequently impact negatively the competitiveness of the private sector. They often also crowd out private sector providers of similar services, especially when SOEs are also in business in competition with the private sector and receive government subsidies or other assistance that distorts the competitive framework (see competition, below).

Trade and investment. The openness of the economy, the level of trade and investment with other countries, as well as barriers to trade; investment promotion policies, regulations, and procedures, including restrictions and processes surrounding foreign investment.

Communications. Including internet connectivity; the cost and availability of mobile phone services; and air and sea transport and costs.

Financial sector. The structure of the financial sector and how it intermediates between savers and investors. The cost of borrowing and the structure of interest rates, and the regulatory and legal framework of the financial sector. The collateral framework for borrowing and the way that financial institutions incorporate secured transactions reform into their lending policies.

Infrastructure. The adequacy of infrastructure and transport services available to the private sector. The level of integration and concentration; the degree to which public ownership and/or monopoly practices are impeding development; and the extent to which effective regulations and institutions are present.

Labor market. The structure of the labor market; the flexibility and ability of the workforce to accommodate change and legislation governing employment; the availability of skills and education, and the presence of social safety nets, if any; employment creation; and migration and short-term labor programs

Land. The degree to which the restricted access to customary land for economic use represents an impediment for the private sector, distinguishing between the impact on small, medium and large

enterprises. Examine the land leasing system and the impact it has on private sector development.

Gender. The ways in which customary and social practices impact on how men and women participate in the private sector. Evaluate the existing legal and regulatory impediments to women’s participation and make recommendations to ease such impediments.

Competition. The effectiveness of competition policy, including laws and regulations governing monopolistic behavior. The robustness and capabilities of the regulatory regime. The extent to which SOEs fall under the umbrella of competition policy and how effectively they are regulated.

The macroeconomic environment. Inflation and its impact if any on businesses; the real exchange rate; and the structure of taxation.

Specific factors. Issues such barriers to tourism; resource extraction such as resource booms or busts; agriculture and other specific important sectors of the economy; and remittances and their importance.ng to overwhelm its infrastructure.

POLITICAL ECONOMY, GOVERNANCE, AND THE PRIVATE SECTOR ASSESSMENT

Political economy and governance issues are of central importance in translating PSA recommendations into meaningful policy implementation. An issue that many Palauans raised in the course of discussions is that even with well-designed policies, without the capacity to implement and enforce them, reforms will have

little impact. Many of the issues identified in this report can be dealt with by appropriately designed policies but they require comprehensive and effective implementation. This includes proper training and ongoing support, and also leveraging technology where appropriate to automate certain governmental functions. Nevertheless, institutions are emerging that should over time improve governance.

The Economic Advisory Group (EAG). A positive development is the establishment of an Economic Advisory Group (EAG).² Its mandate is to implement the Government’s Medium Term Development Strategy. Each year it prioritizes actions for the upcoming 12 months. The fact that such a forum exists, and that there is dialogue between government and the private sector is a strongly positive aspect of policy making in the country.

The EAG has been instrumental in developing policy statements to guide the process of development, which has culminated in the following statement of objectives signed by the President of the Republic of Palau:

Investment policy objectives promote proactive development of long term growth investments that create local jobs and add local value-added to the economy. The required investment system should be simple to operate and provide transparent support and incentives Palau can afford to provide. Improved regulatory process at lower costs will continue to be prioritized and the environmental protection will always remain criteria for investment proposal selection. Data collection and analysis as well as professional economic advice will be needed to achieve Investment

² The Economic Advisory Group (EAG) is jointly chaired by the Minister of Finance and the Chamber of Commerce. Its members consist of the Chairmen of the Ways and Means Committees in each house of the OEK; Directors of Finance, Infrastructure and Tourism; members of the Chamber of Commerce; other Directors of government departments who attend on an as-needed basis

Policy Objectives. Other policies will be reviewed to better support this policy – namely labor, land, taxation, education/training and physical planning. Alignment of future public infrastructure with private investment throughout the Republic will also be necessary. The Office of the President is the lead agency for this policy with coordination provided by the Ministry of Finance. The Foreign Investment Board, National Development Bank, Bureau of Tourism, and Palau Visitors Authority monitoring efforts should reflect the Investment Policy. The Ministry of Natural Resources, Environment, and Tourism and Ministry of Health will monitor environmental and social impacts and provide feedback to the Office of the President and Ministry of Finance. Given the rapid growth in investment interest in Palau, this particular policy has significant importance to the government and people of Palau. The Economic Advisory Group has been used to provide much of the technical and professional support for initiatives such as tourism policy development. Their efforts would not be possible without the partnership of the Private Sector and collaboration amongst agencies which I will continue to foster and support.

As a general statement of objectives, the policy statement is coherent and well crafted. Combined with policy statements on agriculture, state owned enterprises, and labor, it represents a good first step towards improving governance and implementing policies for sustainable development. Nevertheless, successful implementation of policies will require not only coordination but also concrete measures leading towards execution that in the past have been difficult to achieve. The EAG has a central role to play in this process. Furthermore, the general statements subsume many details that are of critical importance if Palau is to achieve its potential. These issues are analyzed in more detail in the sections that follow.

OTHER POLITICAL ECONOMY ISSUES

An additional governance issue arises from differences in implementation, and even goals of the national and state governments. At times, these appear to be at odds, which undermines attempts to present a coherent and unifying set of policy measures. For example, the imposition of user charges on scenic attractions located within a particular state provides an independent source of revenue for the state imposing the charges, but may be viewed by other states as conferring an unfair advantage on the one blessed with the natural resource. This is particularly the case for Koror state, which is earning substantial revenue from the visitor charges to the Rock Islands. At this point, there is little coordination between the state and national governments on the fiscal division of revenues and the relative responsibilities of the national and state governments.

There is also little coordination regarding land use policies. States are granting land leases for tourism development which are not consistent with a national land use planning framework. Palau's Medium Term Development Strategy calls for a Forum in terms of which the national and state governments can coordinate their policies, but so far this has yet to be implemented.

Palau is the most prosperous of the ADB's developing member countries in the region. It is also one of the smaller countries in the Pacific, with a population that is less than 20,000 of which a significant portion is made up of migrant workers who are temporary residents. In the 2014 and 2015 fiscal years, real GDP growth has been strong, at 5.3% and 8.2% respectively. Over the same period, per capita income continued to increase and at the end of the 2015 fiscal year, stood at over \$16,000.³

³ Republic of Palau, 2016, Economic Statistics, Economic Monitoring and Analysis Program.

In spite of the strong economic performance, a number of pressing problems face Palau, which will require strategic policy decisions that will impact both the economy and society. The most urgent of these is the explosion in the number of tourists arriving in Palau, which has grown from 56,000 in 2000 to approximately 170,000 in the year ending December, 2015. At the same time there has been

a large change in the nationality of tourists. This expansion has taken place without the development of either a tourism policy or land use planning and has led to concerns that the natural beauty of Palau's World Heritage sites is in danger of being overwhelmed by the increased tourist numbers and ultimately degraded.

Table 3: Output by Activity

	2011	2012
Agriculture and forestry	1.5	1.21
Fishing	2.5	1.83
Mining and quarrying	0.9	0.39
Manufacturing	3.1	0.96
Electricity and gas	2.4	1.64
Water supply and sewerage	0.7	0.42
Construction	12.0	4.30
Wholesale and retail trade	13.9	13.38
Transportation and storage	5.2	6.43
Accommodation and food services	6.4	14.84
Information and communication	3.6	3.17
Financial Intermediation	4.3	2.42
Real estate activities	4.0	5.77
Professional, scientific and technical	2.0	1.67
Administration and support	2.0	1.48
Public Administration	16.6	13.72
Education	5.3	3.92
Human health and social work	3.4	2.91
Arts, entertainment and recreation	0.7	5.66
Other service activities	0.8	1.25
Private Households With Employees	1.0	1.36
less intermediate FISIM	-1.5	-0.62
GDP at basic prices	90.9	88.13
Taxes on products	9.5	12.02
less subsidies	-0.4	-0.14
GDP at purchasers prices	100.0	100.00

2 THE STRUCTURE AND PERFORMANCE OF THE ECONOMY

THE STRUCTURE OF THE PALAU ECONOMY BY SECTOR

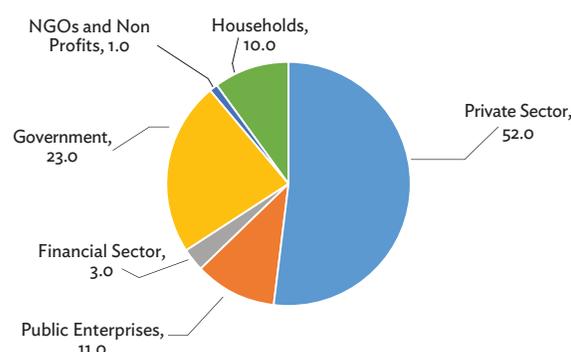
The Palau economy is dominated by tourism and the public sector. The breakdown by sector is shown in Table 3, which also shows the composition of output in 2001. The sectorial breakdown does not specifically identify tourism, which is subsumed under accommodation and food service, art, entertainment and recreation, and transportation. This suggests that tourism accounted for close to 25% of total output. Its importance in the economy has grown, because the same output classifications in 2001 accounted for about half the 2015 output. Other major changes in sectorial composition was the sharp decline in the importance of construction, which is the result of significant infrastructure projects have been underway in the earlier period. Other notable changes were a decline in public administration output from 16.6% of the total to 13.7%.

However, this does not include public enterprises. Another feature was the 2.5 percentage point increase in revenue from taxes on products, indicating a positive tax elasticity associated with the growth of the economy.

The private sector of Palau's economy accounts for approximately half of total output. An additional 10% is produced by households, with the majority of the remained being attributable to government and to SOEs. Agriculture and fishing account for approximately 3% of total output.

While sectorial breakdown does not clearly delineate the specific contribution of tourism to

Figure 1: Output by Sector (%)



the economy, accommodation and food services, wholesale and retail activities and recreation services—all of which are major components of tourist activities—account for the substantial majority of private sector output. In turn, this suggests that the economy is almost totally dependent on tourism.

Over the 2001 to 2014 period, the proportion of accommodation and food services in total output nearly doubled, while that of recreation services increased eightfold. The most substantial decline was registered by construction, from 12.1% of total output in 2001, to 3.3% in 2014, reflecting the substantial fall of public works.

Interviews with both the private sector and public officials revealed that the construction slowdown will reverse over the next 3 years. A significant number of private homes are under construction, new tourist facilities are being built and large sewer,

and water projects, currently being planned, will commence in 2016 and last until at least 2018.

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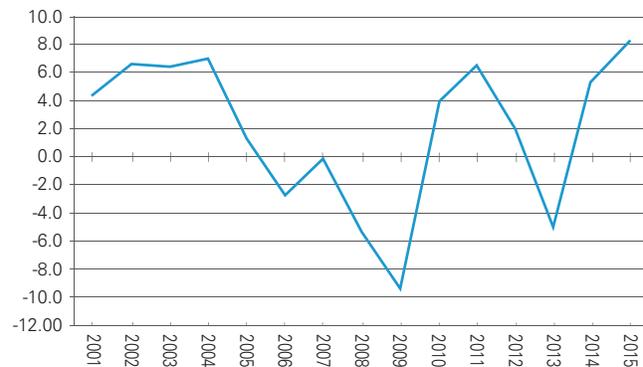
While sectorial breakdown does not clearly delineate the specific contribution of tourism to the economy, accommodation and food services, wholesale and retail activities and recreation services—all of which are major components of tourist activities—account for the substantial majority of private sector output. In turn, this suggests that the economy is almost totally dependent on tourism.

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THE GROWTH OF PALAU'S ECONOMY

Figure 2: The Real Growth Rate of Palau's Economy



Over the period 2001 to 2015⁴, the annual average real growth rate of Palau's economy was 1.23%. Furthermore, there was a high degree of variance in the growth rates, with real GDP falling by some 15% in the years FY2008 and FY2009, as the economy was severely buffeted by the world financial crisis and recessions over that period.

More recently, over the 2010 to 2015 period, growth has been robust (Figure 2), apart from a small decline in 2013. However, this still left the output of the economy lower than it was in 2005, when real GDP reached \$194 million.

Private sector output has fluctuated substantially more than the output of the economy as a whole (Figure 3). In 2003, when real GDP declined by 6%, private sector output fell by more than double that amount. Similarly, in 2008 and 2009, private sector output fell sharply, declining by over 17% in 2009. However, in 2014, private sector output grew at

⁴ In referring to gross domestic product data, years cited are financial years, which run from October 1 to September 30. Thus, 2015 refers to the period October 2014 to September 2015.

nearly double the rate of the economy as a whole. Private sector economic activity appears to be much more closely aligned with fluctuations in the world economy than is overall output. This is unsurprising, since the reliance of the Palau economy on tourism expenditures tracks world economic activity closely. The sharp fall in private sector output in 2008 and 2009, when the world economic slowdown occurred, confirms this relationship

Over the 2001 to 2014 period, per capita GDP rose at an annual rate of 1.2%, as the population of the country declined as a result of out migration and a fall in the number of migrant workers. The population of Palauans remained roughly constant. Developments in per capita GDP illustrates the countercyclical effect of migrant workers—when demand in the Palau economy slackens, the number of migrant workers falls so that per capita GDP does not always reflect developments in the output of the economy overall.

Figure 3: Growth Rate of Private Sector Output (%)

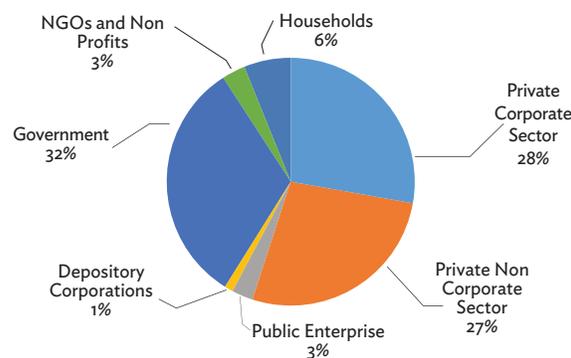


LABOR AND EMPLOYMENT

Government at the national, state, and local level is the largest single employer, although the private corporate sector and the private non-corporate

sector together employ just over half the labor force (figure 4). The extent of unemployment and underemployment is difficult to gauge. Employers interviewed for the private sector assessment maintain that it is hard to hire local workers because Palauans appear to favor public sector employment over working in the private sector. They also indicated that they were having difficulty recruiting foreign workers as a result of the Palau government's ban of workers from Bangladesh. A tightening of restrictions on workers travelling to Palau by the government of the Philippines, causing concern over the possibility of future labor shortages, especially since public infrastructure investment is set to increase in 2016 to 2018.

Figure 4: Employment by Sector in 2015



3 THE 2007 PRIVATE SECTOR ASSESSMENT: RECOMMENDATIONS AND OUTCOMES

This section reviews briefly the recommendations of the previous private sector assessment (PSA) for Palau that was completed in 2007 and which identified a number of key constraints to the future growth of the economy. The PSA suggested measures that would improve the business environment, thereby increasing the long-term growth rate. A summary of key recommendations, together with a brief note on outcomes to date appears below. These issues are discussed at greater length in the sections that follow.

The main conclusions of the 2007 PSA regarding barriers to private sector development in Palau were:

- (i) **The role of the state.** There was too much involvement of the state and the economy, with budgetary processes funding employment at the expense of investment in infrastructure. Furthermore, state ownership of utilities added to the problem of underinvestment and weak public administration hampered the implementation of necessary policies.

Outcome. The state remains the largest employer of Palauans. Despite the government expressing interest in contracting out, little progress has been achieved.

- (ii) **The tax system.** An inefficient and inequitable tax system distorted investment by placing very high tax burdens on some firms and almost none on others. Evasion was widespread and many smaller businesses ignored tax rules completely. The cascading effects of the gross receipts tax fell heavily on some businesses, such as wholesalers

and some retailers that harmed poorer Palauans. The PSA recommended that the gross receipts tax be replaced by a value added tax. Political uncertainty and changes in congress has resulted in delays in reforming the tax system, although the government has indicated that it remains committed to this reform.

Outcome. The Gross receipts tax remains in place.

- (iii) **Access to finance.** The PSA noted that the private sector had extreme difficulty obtaining funding for investment. It recommended that a secured transactions framework be introduced.

Outcome: A new secured transactions framework has been installed, although its impact is limited because of a number of factors that inhibit bank lending that are discussed in the Access to Finance chapter.

- (iv) **Regulation of the financial system.** The 2007 PSA noted that regulation of the financial system was weak. In 2007, 12 regulations were awaiting passage through the legislature to implement the Financial Institutions Act, which required a joint resolution through both houses.

Outcome: This is an area where major progress has been made and the Financial Institutions Commission (FIC) has done an excellent job in improving the stability of the financial system. The number of banks in the financial sector has declined from 13 initially licensed by the FIC, to five. However, more restrictive legislation by the US Government is causing difficulties, which

will require new initiatives to address a national payments system.

- (v) **The Business Law Framework:** The PSA observed that the legal system for commercial transactions was outdated with important laws missing—for example, bankruptcy.

Outcome: A number of bills have been drafted to improve the business law framework but they have not been passed.

- (vi) **Foreign Investment:** The PSA concluded that the foreign investment regime was inefficient, raised uncertainty, and encourage low-quality foreign investors. Furthermore, the long list of reserved activities was encouraging “fronts”, in terms of which businesses were nominally owned by Palauans, but in reality were owned and operated by foreigners.

Outcome. So far, little has transpired in this area but the Economic Advisory Group has proposed a new investment policy related to foreign investors.

- (vii) **Foreign workers.** The PSA suggested that the system for bringing in foreign workers needed to be rationalized to promote them being employed and more productive activities. In particular, labor regulations should apply equally to foreign and domestic workers alike.

Outcome: The number of foreign workers has declined as a result of the completion of some large infrastructure projects. However, a potential labor shortage could occur in the event of substantially ramped up infrastructure projects. Different rules for domestic and foreign workers still exist.

- (viii) **Land issues:** the PSA suggested that land rights needed to be clarified and that an efficient framework for long-term leases needed to be developed. Land values had increased substantially as a result of higher demand from foreign investors, which is causing some displacement for Palau residents as a result of unclear land rights.

Outcome: Little progress has been made.

- (ix) **Tourism Policy:** The PSA recommended that an up-market tourism policy should be developed to limit the number of package tours and charter flights. It pointed out that environment protections and land use planning were insufficient to protect the environment, which endangered the natural beauty of Palau that was the prime attraction for tourists.

Outcome: There has been much discussion of an upmarket tourism policy and there has been a moratorium on charter flights landing. Positive developments include the establishment of a Bureau of Tourism, and funding has been increased for developing a tourism policy. Ongoing discussion indicates that there is now a keen awareness of the need for a comprehensive tourism policy. As of April 2016, however, a tourism policy has yet to be implemented.

These outcomes and the lack of progress in a number of areas, indicate that policy formulation and implementation remains a major issue in Palau. Without significant progress in this area, the potential of the country will not be realized.

4 ISSUES FACING THE PALAU PRIVATE SECTOR

The analysis that follows examines in considerable depth four issues that 2014 and 2015 Annual Economic Symposiums and the Economic Advisory Group identified as being of primary importance. However, while undertaking background investigation for this PSA, several other issues were identified as being of significant importance.

ISSUES IDENTIFIED BY THE ECONOMIC ADVISORY GROUP

The Economic Advisory Group identified four areas of importance for the Palau economy. They are

- Tourism
- Land
- Access to finance
- Agriculture.

OTHER CHALLENGERS

While the four issues noted above are undoubtedly significant, the analysis undertaken as part of the private sector assessment revealed additional challenges that face the economy that affect strongly the performance of the economy. These are dealt with in the analysis that follows. The main issues that are also discussed are

- The commercial law framework
 - The Economic Empowerment of Women
 - Tax Policy
 - The efficiency of state owned enterprises.
-

5 TOURISM

Recommendations:

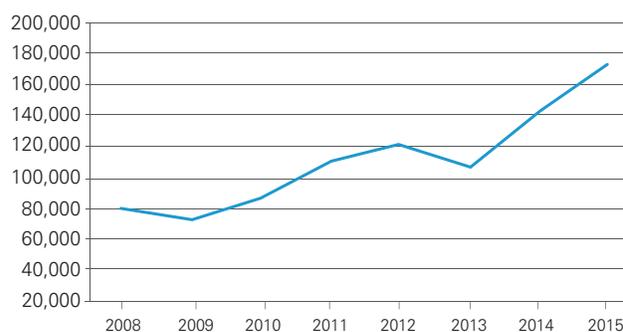
- Develop a National Tourism Policy without delay
- Place a moratorium on new tourism building projects
- Assess the impact of the new departure tax and investigate the feasibility of a daily head tax
- Use market mechanisms to auction landing rights
- Use peak load pricing to spread tourist visits to popular sites over the day
- Improve coordination of tourism policies between the national and state governments
- Improve and enforce licensing requirements. Sharply increase penalties for infractions of tourism licensing and regulations

INTRODUCTION

Palau's attraction as a tourist destination is based on its pristine environment and unique features, which have led to several areas within the country being declared World Heritage Sites. In the past, high-end tourism has resulted in a significant addition to economic activity that accounts for a substantial portion of private sector activity. More recently, however, there has been explosive growth in lower end tourism, particularly from the Peoples Republic of China, that has the potential to threaten the sustainability of Palau's unspoiled environment and in the longer term, the viability of the tourism industry as a whole.

This chapter discusses some policy options to restrain the influx of low-cost tourists. It does not address issues related to the longer-term development and marketing of the tourism sector. This is discussed comprehensively in a recent

Figure 5: Growth in Visitor Arrivals, 2008–2013



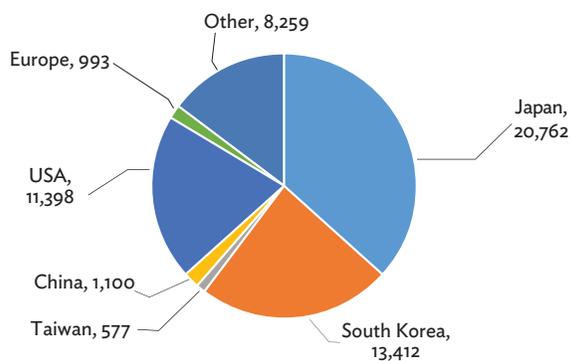
report by a renowned tourism expert.⁵ This chapter focuses on providing some economic and regulatory measures to discourage low value added tourism. It also suggests that a longer-term strategy to encourage high-end tourists that provide benefits to Palau's population as a whole should be developed along the lines of the Jamieson Report.

⁵ See, Walter Jamison, 2015, *An Assessment of Selected Policy Options and Future Capacity Development Needs for Tourism Development in Palau*, mimeo.

THE GROWTH IN TOURISM

The growth in tourism has been explosive. In 2000, 56,500 tourists visited Palau. By 2015 this number had risen to more approximately 170,000.⁶ The bulk of low-end tourists arrive on charter flights, the frequency of which have expanded sharply. A moratorium on the number of charter flights was placed in 2015.⁷ In addition, in March 2016, the departure tax was increased to \$150.

Figure 6: The Composition of Tourists by Nationality, 2000



In addition, the composition of tourism has changed. In 2000 more than 50% of tourists came from Japan or South Korea. By 2015, over 90,000 tourists came from China (Figures 6 and 7). Since Chinese tourists tend to spend far less per night than do many other nationalities, the per capita spending in Palau has declined, although overall tourist receipts have risen, particularly in 2014 and 2015 when they increased by 34%.

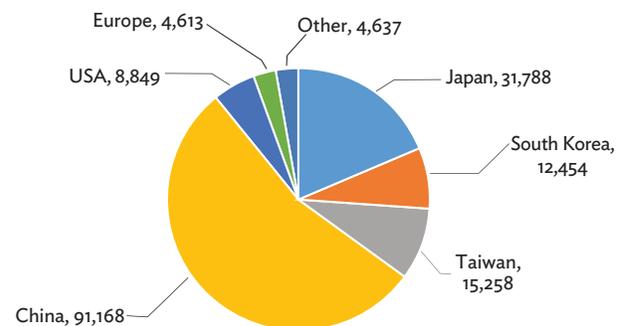
Tourists from Asia tend to spend less time in Palau than those from elsewhere. In 2015, tourists from Japan, South Korea, Taiwan and China all

averaged four nights per visit. By contrast, those from the US averaged seven nights, and those from Europe nine nights.

Tourism Spending

Although Palau's tourism policy is to attract "high value" tourists, actual receipts per night have remained roughly constant since 2008, the first year for which disaggregated data are available. Total spending per tourist has fluctuated a little more over the same period, from a low of \$875 in 2011 to a maximum of \$1028 in 2014. Spending per tourist in 2015 declined to \$891, about the same as it was in 2008. These data show is that Palau has so far not been a high value tourist destination. Considerable effort will be needed for it to achieve its high value tourist goal. Suggestions for how this might be achieved are as follows

Figure 7: The Composition of Tourists by Nationality, 2015



⁶ Data provided by the Palau Tourism Authority.

⁷ Anecdotal accounts suggest that the impact of the moratorium was at least partly offset by charter operators using larger planes.

There are several negative effects from low-end tourism.

- The carrying capacity of Palau’s World Heritage Site attractions is limited. Having large numbers of low-spending tourist viewing the attractions degrades the experience of high spending tourists and risks permanently discouraging this type of visitor, especially in an age where comments on the Internet are regularly read by potential clients.⁸ Thus the sustainability of Palau’s high-end tourist industry is being brought into question.
- The pressure on resources not only degrades the experience, but also degrades the resources themselves, adding to the questions regarding sustainability.
- Given the very limited land space available for tourism development, particularly hotels, the construction of low quality accommodation crowds out the potential for high-end facilities and wastes resources. It is far costlier to either convert a poor facility or demolish it than it is to build a new one on undeveloped land.
- Domestic value added (the financial benefits that accrue to Palau) of low-end tourism is low, which could be exacerbated by the potential for transfer pricing. For example, a tour operator who has a vertically integrated operation that includes the hotel, could pay only a part of the true cost of the food and accommodation to the hotel subsidiary in Palau, and retain the bulk of the revenue outside the country, thus avoiding taxes.⁹
- Related to the second point, such tour operators typically import much that is consumed, and also bring in foreign workers to service low-end hotels, which discourages the development of linkages in the tourist industry as well as growth in local expertise. As a result, the employment effects and skill enhancement associated with tourism growth is limited.
- Low-end tourism detracts from developing an effective marketing campaign based on “Pristine Paradise Palau.” While this is an attractive concept, until the volume of low-end tourists declines, the campaign cannot be effective because sheer numbers degrade the high-end tourism experience.

There have been widespread concerns expressed not only by traditional tourist operators, but also by many levels of Palau society at these recent developments.¹⁰ However, a longer-term strategy is necessary to accrue greater financial and employment benefits from the tourism industry.

THE PRINCIPLES ON WHICH MEASURES TO DISCOURAGE LOW-END TOURISM ARE BASED

The economic problem posed by low-end tourists is that the costs they impose on Palau’s tourism resources in the form of over-crowding and degradation may not be offset by benefits to the country as a whole. Economists describe this economic phenomenon as “social costs outweighing private benefits.” Furthermore, all of the social

⁸ Anecdotal evidence indicates that the number of boats entering Jellyfish Lake has risen tenfold over the past few years and that tourists do not always respect the environment.

⁹ A similar phenomenon has been observed in the Caribbean, particularly Jamaica, where some estimates put the domestic value added from a tourist at an “all-inclusive” resort at less than 20%. The result has been a large tourist industry but little development of linkages into tourism by domestic firms.

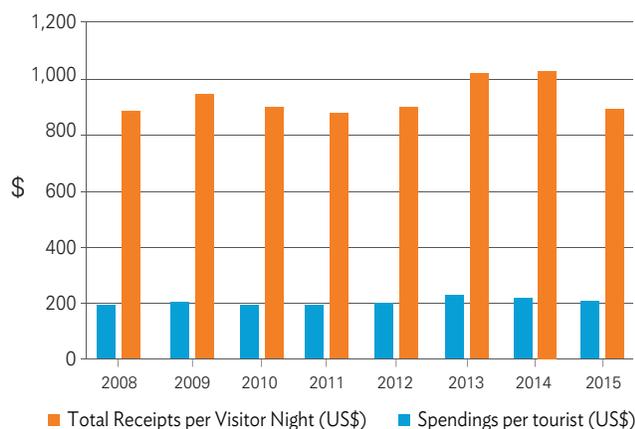
¹⁰ See, for example, the proceedings of the 2015 Economic Symposium held in Koror, Palau in November 2015.

costs are imposed on Palau, while much of the private benefit accrues to the low cost operators domiciled outside the country, making the cost benefit calculation *from the perspective of Palau* even more unequal.

How many charter flight tourists should enter Palau each year is currently unknown. This requires analysis from environmental and tourism experts to calculate the “carrying capacity” of Palau’s environmental tourism attractions. Whatever policies are adopted, this analysis is required urgently and should commence right away.

Once the desired number of tourists has been calculated, available policy instruments to address the problem consist of regulation, taxes, and fees. The next section analyses possible measures and discusses the advantages and disadvantages of each.

Figure 8: Receipts per Visitor Night and Spending per Tourist 2008–2015



¹¹ The carrying capacity can be larger if time of day scheduling is used.

A DISCUSSION OF POSSIBLE POLICY MEASURES

A Moratorium on Building New Tourism Facilities

This is an important step, also recommended by the Tourism Paper. It will allow time for both a tourism policy to be developed and proper accommodation developed to update needed infrastructure. Without the moratorium, the continuation of haphazard accommodation construction that overwhelms the carrying capacity of the environment risks Palau’s social and economic future.

Regulation of Landing Rights

Currently, the Palau Government does not release the number of charter flights landing in Palau. There are four licensed charter operators, but how many flights each send to Palau is not known.

There are a number of ways in which regulations could be introduced to limit the number of charter flights that can land once the carrying capacity of Palau’s tourist attractions has been calculated.¹¹ This could be done on a daily, weekly, monthly or annual basis. The maximum size of a passenger aircraft is known and provides an upper limit on how many tourists can be transported on a single flight. Several issues need to be addressed if this form of limitation is used.

Deciding which operators obtain landing rights is a key issue. Alternatives are:

Option 1. A first come first served approach, which would open applications for charter landings over a specified time period before actual arrival. For example, applications for 2016

landings could be opened in July 2015 and once they are filled, no more charter flights would be given landing rights.

Option 2. However, option 2 forgoes potential revenue for Palau, since the landing rights are valuable. A variant could be to impose a charge for available landing slots, which would then be paid by charter flight operators—again until available spots ran out.

Option 3. While option 2 is an improvement on option 1, it carries with it a problem, namely that it is difficult to determine just how valuable the landing slots are. If the charge is too high, the number of tourists will be lower than determined by the carrying capacity. If it is too low, then Palau is foregoing revenue that it could have earned. An online auction of the right to operate charter flights, plus an auction of the available landing spots is a means of determining just how valuable these landing slots are. This would be implemented in conjunction with a pre-specified number of flights. While there would be many technical details to be worked out, using an online auction is feasible and software for doing so exists.

However, in the longer term, low-end tourist operators could bypass the limitation on charter flights by lobbying commercial airlines to greatly increase the number of flights. Some limitation on landing rights for regularly scheduled flights might have to accompany this approach.

User Fees

Levying user fees has the potential to limit low-end tourism and raise revenue but the way in which the fees are developed and applied has a critical

impact on how effective they can be. Therefore, their design is of paramount importance. There are a number of alternatives that could be used individually or in combination. They are:

- A room tax on hotel rooms.
- A head tax on tourists staying in hotels or other tourist accommodation, which would be levied on the number of days that a tourist stays in Palau.
- User fees on particular tourist attractions. Currently there are fees for Rock Island and Jelly Fish Lake visits only.
- Charges for obtaining a visa or for entering the country.
- Departure taxes, which are already in place.

The advantages and drawbacks of each option are:

A room tax, either percentage or specific amount. A room tax can be levied in a number of ways, in particular as a percentage of the room rate or as a fixed charge. The drawback of a percentage tax is that in dollar terms it impacts high-end tourists more heavily and it can also be by-passed at the lower end by transfer pricing in terms of which the operator could charge a very low rate for the room and recoup expenses by charges on other parts of a package tour. A fixed charge has the advantage of adding to the cost of a room and in percentage terms it impacts lower end tourism more than higher end tourists. However, it has the disadvantage if a tour operator houses many tourists in a room, or in a number of rooms that the operator classifies as a suite.

A fixed daily charge or head tax. This charge would be levied in dollars and would apply to each day that a tourist spends in Palau. This has the advantage of not raising the costs to high-end tourists that a percentage charge would incur, while raising the costs to lower-end tourists. It could encourage longer stays by reducing the rate on a sliding scale depending on the length of time tourists remained in the country. This type of charge is levied in a number of countries that rely heavily on tourism, for example in Italy. A limitation might be problems of enforcement, if hotel operators do not accurately report the number of guests in their hotels.

User fees on specific attractions. The State of Koror already levies user fees on visitors to Jellyfish Lake and Rock Island. It has become a significant revenue source for the State. At this point, however, it has done little to stem the number of visitors.

A further issue is whether there is a true capacity problem, or whether it is a “peak load” problem, in the sense if the bunching could be reduced, natural resources would not be endangered. For example, time of day permits could be issued that would spread out visitations to the most popular sites

Visa charges. Charges could be levied for obtaining a visa. However, since it would be prohibitively costly for Palau to establish a network of embassies or consulates around the world, the visa would be obtained on arrival. Or online once Internet infrastructure has been upgraded. However, this could incur delays at immigration that might detract from the experience of visiting the country.

Departure taxes. This is a variant of visa charges. Currently, there is a fixed departure tax, which in March 2016, was increased from \$50 to \$150. Given that the data indicate that stays in Palau of lower end tourists tend to be relatively short, the departure tax increase will impact lower end tourists more heavily. Analysis of the impact of the increase on lower end tourism is important, suggesting that detailed tourism statistics continue to be needed.

These suggestions are based on the assumption that over the demand curve for tourism, the price elasticity is lower at the upper end of the price spectrum than it is at the lower end. This assumption is not unrealistic and is born out by the development of high end tourism in other countries.

Licensing of Travel Companies

Much stricter licensing of tourist operators is an alternative to ensure the quality of the tourist experience and could also promote eco-tourism more effectively. Currently, operators are licensed by the Palau Visitors Authority, but there are no enforcement provisions and the standards of competence are low.

Botswana is one of the world leaders in promoting high-end eco-tourism. Would-be tourist companies are required to complete an environmental impact report as part of their application process and to meet high standards of operation.¹² There is also a national eco-tourism certification program that further encourages tourism businesses to be more eco-friendly.

¹² To access Botswana’s Application Requirements, go to http://www.mewt.gov.bw/DOT/article.php?id_mnu=97.

Box 1: Conclusions of the Jamieson Report

- There is limited understanding of the concept of “high value” tourism. Currently the concept is interpreted in Palau as a notion, rather than as a policy objective for the long term.
- High value tourists are not the same as high-spend tourists. The former are also experiential tourists.
- Tourism policy needs to be developed with these considerations in mind.
- In the short term, a reduction or moratorium that limits charter flights should be considered.
- In conjunction with the moratorium on flights, there should be a suspension of all new tourism building projects because the carrying capacity of water and sewage facilities has been exceeded.
- This will provide a breathing space for longer term policy to be developed.
- It is impossible to think about dealing with tourism issues without a coherent framework for policymaking, implementation, and evaluation.
- One of the key factors to address is creating opportunities for local people to become part of the tourism economy through entrepreneurship and ownership.
- Policies must take the following issues into account.



These policies mean that fewer people are visiting Botswana’s tourist attractions such as the Okavango Delta and Chobe National Park, but their payments are kept within the country and add significantly to national income. This high-cost/low-volume approach has kept tourist numbers down while keeping profits at a level that benefits local businesses. Botswana’s low-volume, high-cost strategy is a powerful example for countries that want to develop their eco-tourism industry while not harming the environment. It is something that could well be emulated in Palau.

While Palau has put in place licensing of operators, but the standards are low and there is no enforcement to ensure that only licensed tour guides take tourists. An important policy implementation issue is to ensure that there is adherence to licensing requirements. A limited number of Palauans have the required skills in areas such as tour booking agencies, travel agencies, and tour operation, especially at the higher end of the tourist business where specific expertise (as well as substantial capital) is needed to satisfy high paying clients. Such clients typically have strong

expectations regarding the quality of service they receive, which are justifiable given the high prices they are charged. A few Palauans may have learned these skills as the tourist industry has grown, but their number is relatively limited. Frictions have the general effect of limiting the spread of training. This in turn results in mass tourism, rather than high-end tourism, which pays high prices for the very best in service and facilities.

Enforcement

Without appropriate enforcement, few of these measures will be effective. Therefore, in selecting the appropriate combination of instruments, ease of enforcement must be an important factor. The recommendations of this Chapter are:

CONCLUSION

The PSA has outlined some measures to protect the sustainability and viability of Palau's natural wonders and to ensure that a high-end tourism industry continues to develop. It suggests a combination of regulation based on market mechanisms, together with substantial penalties for breaches.

At the same time, many additional steps need to be completed. In particular, analysis by tourism and environmental experts is needed to determine the carrying capacity for Palau's attractions. Current arrivals of low-end tourists risk the future of the whole industry, which constitutes an important contribution to the prosperity of the country.

Once the carrying capacity of the country has been determined, the appropriate level of charges suggested above can be determined. However, arriving at the correct price will be something of a hit and miss process. It is therefore important that the regulations that will be needed to enforce the measures be sufficiently flexible to allow changes to be easily imposed. Only in this way will the great natural beauty of the country be preserved for future generations.

6 LAND

Recommendations:

- Introduce a 90-day window for any objection to be filed by clan members, to leases signed on behalf of the clan
- Make more government land available for leasing
- Ensure that the structure of leases does not penalize future generations
- Develop a land use planning system

Land issues were identified by the Economic Advisory Group as being a key constraint to private sector development in Palau. Land issues are both difficult and sensitive in the Pacific as they involve not only property rights and ownership, but also cultural factors that have evolved over hundreds of years. Any solution that purports to increase access to real property must take these into account. In particular, the communal ownership of much of the land in the Pacific requires measures for which experience from other parts of the world does not provide guidance.

Nevertheless, there are potential solutions that could make resolution of land issues more straightforward without impinging on cultural and traditional factors. The following paragraphs outline some directions in which these could go, but far deeper analysis is required than there is space for in this PSA.

OWNERSHIP

Land ownership in Palau is restricted to Palauan citizens, but foreigners are permitted to lease land with lease terms up to 99 years. Historically, during the period of Japanese colonization, most of the

country was surveyed. However, during the Second World War most records were destroyed and as a result there are a large number of land disputes, which are adjudicated by a Land Court. By the end of 2014, about 14,000 of a total of 18,000 parcels of land had been processed.

Land holdings in Palau are complex. Land can be owned either individually, by families, by Chiefs of the Village or by clans. In addition, both the national and state governments own land.

The concept of individual ownership among Palauans has spread rapidly as the value of land has risen. However, a significant amount of privately held land is still owned by clans. Landholding within clans is matrilineal but the influence of women over land sales, leases, and other land issues is only indirect and is exercised through their influence in clans. Additionally, land court judges are central to the system of land adjudication and their role in deciding on land disposition is powerful.

Land can be bought or sold by Palauans, either individually or between clans. Land transactions with foreigners have to be on a leasehold basis.

There are no transfer or property taxes on land holdings or transactions. One implication of land ownership being confined to Palauans is that foreign owned financial institutions cannot repossess property in the event of default of a loan secured by either a mortgage or a land lease, although this stricture can be overcome through the use of trusts. However, trusts are rarely used. This issue is discussed in more detail in the Finance section.

Government owns a substantial proportion of land in Palau, but similar issues have arisen as for privately held land. A number of parcels in government possession are under dispute. However, when cases are brought against the government, the burden of proof is on the claimant so that they are not often successful in court. Once government ownership is conclusively established, the potential for leasing land to investors provides both an increase in the supply of available property, and a significant potential source of revenue. This course should be explored and adopted as government policy.

LAND LEASING ISSUES

In common with most Pacific Island economies, most investors lease land. Thus the leasing framework is central to an effective property market.

The Structure of Leases

There are several issues related to lease structures. The principles of an effective and equitable leasing framework are

- A well-structured lease should set out the terms under which the lease might be renewable.
- For communally held land, there is a case to be made for intervention by the state to protect the rights of future generations. Under this thinking, there should be time consistency of leases in terms of which future generations will benefit from a land lease. Thus, the leasing framework could provide for a relatively small upfront payment with the bulk of lease payments spread over the life of the lease. This requires that time discounting take place as explained in the footnote.¹⁴
- There is a stronger case to be made that leases of individually-owned land should be at the discretion of the owner in the same way as inheritance decisions. However, it must be recognized that even for leases on individually held land, if lease payments are structured in the form of a very large upfront payment, future heirs will be disadvantaged. Consideration should be given as to whether there should be laws that specify how lease payments for individually-owned land should be structured.
- The success of a venture on leased land should be at least partly reflected in lease payments, in order to ensure that lessors have a stake in the success of a business that is located on leased land. This could include a type of “percentage rent” formula being built into the lease, whereby the lessor obtains a percentage of the revenues generated by the development.
- Leases should be long term in order to encourage investment. This is not a problem in Palau where 99 year leases are allowed.

¹⁴ An upfront payment is more valuable than a stream of payments that add up to the same amount spread over a number of years. Thus for long term lease payments to have the same value as an upfront payment, the stream of income must use a discount rate to determine the present value.

The Reliability of Leases

Discussions with land court judges, real estate agents, and financiers revealed that the Land Court process and adjudication functions effectively. However, a significant problem arises as a result of the Court deciding only on ownership of land parcels by clans and not on the membership of a clan. While it is probably beyond the remit of the Court to adjudicate on clan membership, some process that makes lease agreements more certain is needed.

A serious issue arises because individuals claiming to be clan members can sue the lessee for lease payments, even though they were not parties to the original lease. This presents a substantial problem for both the reliability of leases that have been entered into with clans as well as for lenders who have taken the lease as security for loans. Court cases on this issue can drag on for years, with the lessee not knowing exactly who is the rightful recipient of the lease payments that are being made. To solve this problem, a provision needs to be added to laws governing land leases that provides for a time during which any disputant can come forward and that upon the expiry of such time no further claims can be made. An appropriate notice period is probably 90 days. Until this issue is resolved, leasing by clans will continue to be difficult and clan members who wish to lease the land are compromised by the uncertainty arising out of possible “hidden” claimants.

Land Use Planning

For a country blessed with the natural beauty, the lack of any comprehensive planning structure for land use and for environmental preservation is striking, especially since Palau’s future as a tourist destination depends on conservation measures ensuring that degradation of its World Heritage Sites does not occur.

There is some planning oversight in Koror. Much of the country, however, lacks even the most fundamental set of land-use controls. Factors that need to be embedded in a planning structure include

- Environmental vulnerability;
- The impact of development on communities;
- The establishment of land-use patterns related to tourism;
- Planning a building essential infrastructure capacity (sewer, water, power, etc.); and
- An institutional structure at all levels of government that incorporates mechanisms to ensure that Palau’s natural beauty is conserved.

Developing systems such as these will ensure that visitors and Palauans alike enjoy the maximum quality experience from Palau’s environment.

7 ACCESS TO FINANCE

Recommendations:

- Abolish the usury ceiling on foreign owned lenders on lending to business
- The FIC should consider downgrading unsecured loans when assessing the financial soundness of the commercial banks. If commercial banks secure all loans above a \$5000 threshold, the quality of their portfolios will be higher and they will become more familiar with the secured transactions framework
- Undertake analysis to ascertain if the the National Development Bank should borrow from the commercial banks using the secured transactions framework through loans secured by its portfolio or prepare to accept deposits
- Undertake capacity building for the Development Bank of Palau to improve its systems for granting and monitoring loans
- Establish a credit bureau that is also linked to the US credit bureaus

There are five banks operating in Palau: four commercial banks¹⁵ and the National Development Bank of Palau (NDBP). While the National Development Bank is the only institution able to take land as security, all banks are able to make both consumer and business loans. However, the financial system in Palau does not finance growth that supports private sector development. The reluctance of most financial institutions to lend constrains businesses accessing credit for growth. This chapter analyzes reasons for the low access and offers policy proposals to make business financing more readily available.

Commercial banks had high levels of liquidity at the end of 2015. The ratio of total deposits to total loans increased from 573% to 761% during the course of the year.¹⁶ The ratio of private sector credit to GDP is less than 15%, which is significantly

below the average of 40% for the Pacific region, where accessing credit is generally difficult. With loans amounting to only 20% of deposits, a good case could even be made that the financial system is actually disintermediating. Foreign owned banks that have branches in Palau transfer deposits to their head or regional offices outside the country. Of their \$213 million in liquid assets, approximately \$210 million are held in the form of demand deposits due from their head offices in Guam and Hawaii.

At the same time, the Development Bank of Palau, the main source of mortgage lending, is liquidity constrained.

There are a number of reasons for commercial banks' reluctance to lend to businesses. The most important are:

¹⁵ These banks are Bank of Hawaii, Bank of Guam, Pacific Islands Development Bank, Bank of the Pacific.

¹⁶ Financial Institutions Commission, 2015, Annual Report.

(i) **Usury laws.** In terms of Chapter 3 of the Republic of Palau Law on Business and Business Regulation/11 PNC, the interest rate on lending to individuals is capped at 18%, and the interest rate on lending to businesses is capped at the prime rate on corporate loans at large US Money Center Banks¹⁷ plus 4 percentage points. As of October 1, 2015 the prime interest rate was 3.25%. This implies that the highest interest rate that a commercial bank in Palau can charge a business is 7.25%.

How does this compare with interest rates to small businesses in the United States? (Small businesses are the only suitable comparator, because there are no businesses in Palau that would qualify even as a medium sized business, as this definition is generally understood in larger countries.) An informal search of Internet lenders reveals interest rates that range from 8% to 40% on small business loans.¹⁸ Furthermore, traditional lenders are often reluctant to lend to small businesses, as more formal analysis of

Box 2: Small Business Lending

Bank loans are critical for small businesses. Without access to credit, they have to rely on retained earnings which is not a stable source of capital. Yet obtaining business loans is a difficult and often prolonged process even in advanced economies. Furthermore, it is a mistake to think that issues facing business financing in Palau are unique. In the United States, bankers often say that they are interested in lending to small businesses but have trouble finding creditworthy borrowers. As a result, a substantial proportion of loan applications to the traditional banking industry are denied. Search costs in small business lending are high for both borrowers and lenders—transactions costs form a significant portion of the expense of small business loan. As a result, smaller loan amounts are frequently not profitable for traditional commercial banks. There are a number of reasons for this:

- Loan processing costs are high.
- Small business lending is riskier than large business lending.
- Assessing credit worthiness of small businesses is difficult due to information asymmetry. Business owners will always know more about their businesses than the lender and frequently small businesses lack detailed balance sheets and income statements because of poor record-keeping.
- Transactions costs for processing a \$50,000 loan are little different from those necessary to process a \$500,000 loan. Since the majority of small business loan applications are for amounts well below that upper limit, lenders are reluctant to even consider loan processing.
- However, in a number of countries, non-traditional lenders have appeared to fill in this financing gap in the market for small business loans. In the United States, Lending Tree, Fundera, Biz2Credit and Lendio are examples of this new type of lending institution. Interest rates that they charge range from 12% to 40%.

¹⁷ As published in the Wall Street Journal.

¹⁸ As of October 1, 2015. See for example, <http://www.thesimpledollar.com/best-small-business-loans/>, <http://smallbusiness.chron.com/average-interest-rate-small-business-loans-15342.html>. All analysts report that only between 15% and 20% of small business loan applications are approved.

small business lending reveals. However, in the United States for example, new types of lenders have emerged to fill the gap (see Box 2).¹⁹

If small businesses in the United States, where the legal and institutional structure is far more developed than in Palau, are borrowing at rates that are far higher than the Palau usury laws permit, it is unsurprising that there are few business loans being made. The usury law is one of the most important reasons why credit is hard to come by for businesses.

These strictures do not apply to the Development Bank. In terms of the National Development Bank Act, the National Development Bank of Palau is specifically exempted from provisions of Chapter 3, referred to above.

- (ii) **Information problems.** Lenders reviewing loan applications have to decide on the creditworthiness of borrowers. In the case of small businesses, this is difficult. The performance, financial statements and growth prospects of small businesses are generally hard to interpret. Asymmetric information issues arise because business owners always know more about their business than anyone else, and could be concealing important facts from the lender.

Information is often unreliable in the best of circumstances. Little, if any, public information exists about the performance of small businesses and many small businesses also lack detailed financial information. In Palau, some

bankers report that the problem is confounded by many businesses not filing accurate tax returns. The gross receipts tax provides a strong incentive for inaccurate record keeping. Bankers report being confronted with two separate sets of financial statements– one that is used for a tax return and a “real” one. Since any assessment of financial soundness has to be based on formal tax returns, businesses that would otherwise qualify for loans are unable to obtain financing. This informational opacity of small businesses further adds to the riskiness of small business lending, making it difficult for bankers to determine a creditworthy borrower from a non-creditworthy borrower. It is difficult to assess how widespread a problem this is. Others report that gross receipts tax returns are relatively accurate. It is furthermore surprising that in a country with a per capita GDP of \$16000, lending opportunities are limited.

The foreign banks, the Bank of Guam and the Bank of Hawaii, are both branches of their offshore headquarters. The Bank of Hawaii uses credit-scoring models for loans up to \$50,000, all of which are unsecured. Few borrowers in Palau qualify for these types of loans.

Both offshore banks have access to US credit bureau reports, an advantage that local banks, including the National Development Bank of Palau, do not have.²⁰ These are used extensively in making consumer loans. Both banks indicated that they would like to make more business loans but the usury ceiling and information problems predated against doing so.

¹⁹ See Karen G Mills and Brayden McCarthy, 2014, “The State of Small Business Lending: Credit Access During the Recovery and how Technology May Change the Game,” Harvard Business School, Working Paper 15-004.

²⁰ Palauans have 9-digit identity numbers, which are consistent with US social security numbers that are the identifying numbers used in credit bureau reports in the United States. Incentives to repay loans to the foreign banks is increase by the fact that if a borrower leaves the country and goes to a former Trust Territory, or the US, the adverse information will be on record if they attempt to obtain credit in their new place of residence.

Mortgage Lending

Some banks in Palau offer lending on fixed property, which consists of land and buildings. However, complications with respect to who can own land limit the usefulness of real property as security. Since non-Palauans cannot take title to fixed property and foreign owned financial institutions fall into this category, repossession is complicated and expensive in the event of default.

This does not apply to locally owned banks, or to the Development Bank of Palau (NDBP). As a result, the latter dominates lending for the purpose of purchasing fixed property, to the extent that liquidity is an issue, since approximately 50% of its loan portfolio consists of mortgages over land and buildings. The Bank of Guam has entered into an agreement with the NDBP for it to hold repossessed land through a trust agreement. However, this raises transactions costs and complicates legal processes.²¹

All lenders engaged in mortgage lending view loans made on land leased by clans as being fraught with risk because of the issues identified in the preceding chapter. They strongly support a limitation on the period during which clan members can challenge leases.

Secured Transactions Reform

A Secured Transactions Act was passed in 2012 and in January 2013, the electronic registry was launched. So far, however, use has been limited. By end 2015, 663 security interests had been registered. Furthermore, the rate of increase has declined sharply, with only 76 new security interests being registered in 2015. When

banks do lend, they prefer to take business cash flow as security, rather than business moveable property.

During 2015, use of the secured lending framework actually declined substantially. The Financial Services Commission Annual Report states *“Notwithstanding the establishment of a Secured Transactions Registry, the volume of secured loans continues to decline. Secured loans fell 30%, or by \$1.1MM during the 2015 calendar year.”*²²

The underutilization of the secured transactions framework is the result of several factors:

- Limited business lending, due to the ceilings imposed by the usury law.
- Many consumer loans are unsecured.
- Despite attending several workshops on the scope of the law when enacted, some lenders still do not appreciate the implications and uses of the secured transactions act, with the result that even some large loans, inexplicably are unsecured.
- For the foreign banks, credit decisions are made outside the country by headquarters, which appear not to consider the use of secured transactions framework by their local office to be important.

Available data demonstrates that there has been an increase in the number of women borrowing money using non-land assets as security. There has also been an increase in the number of women and men borrowing jointly. Such transactions are

²¹ An instrument that is used in a number of states in the US is the “deed of trust”. When the loan is given it is actually a 3-party transaction: the lender, the borrower and then a trustee who is empowered to seize and sell the land in the event of a default. The trustee is often a lawyer nominated by the lender and a cottage industry exists for this service and costs are reasonable.

²² Republic of Palau Financial Institutions Commission 2015, Annual Palau Banking Sector Report, p.9.

worth noting for two purposes: (1) it allows loans secured by personal property to be made, which is essential in an economy where much of the land is customary, and where title to land is heavily contested; (2) it assists women build up their credit histories facilitating future borrowing on lower interest rates.

The National Development Bank of Palau

The NDBP's mandate is to promote the economic development of the country. It is the only financial institution able to directly take land as security and is by far the biggest mortgage lender in Palau. It also has been making loans for agriculture, aquaculture, and small start up businesses, as well as industrial and housing loans, in accordance with its mandate.²³

The legislation governing the operations of NDBP was signed by the President of the Republic of Palau in December 2014 to allow NDBP to take deposits and to bring NDBP within the regulatory framework of the Palauan Financial Institutions Commission (FIC).

Low levels of liquidity have hampered the NDBP since it is only able to lend from funds that are received from loan repayments. Therefore, the ability to take deposits, the legal foundation for which was granted at the end of 2014, has the potential to increase its loan making ability. However, this has to be considered against the costs of setting up a deposit taking framework, which could require very substantial investment. There may also be options regarding of alternative sources of finance. Undertaking a cost benefit analysis of the alternatives as soon as possible is warranted, since it will provide the necessary information on which to base a decision.

Since the NDBP came under the FIC regulatory umbrella, policies are being realigned to conform with prudential requirements. However, the NDBP will have to improve service delivery to attract customers and to reduce the existing lengthy delays in processing loan applications. Furthermore, overdue loans have been rising and systems for monitoring loans have deteriorated. A bank examiner review of NDBP's loan portfolio in November 2015, found that the non-performing portion of the NDBP has risen to close to 12%.

Currently, the bank's systems are under strain. Loan processing is slow and all loan applications, whatever the size, have to be approved by the Board of Directors adding to processing time.²⁴ Furthermore, borrowing criteria are often not in accord with the mandate of the NDBP to promote business. Often, borrowers are required to show that they are employed and receive a regular salary that can service the loan, or seek the support of a guarantor with a secure job that can service the loan. This requirement does not promote the funding of entrepreneurship.

Should the National Development Bank of Palau Take Deposits?

The National Development Bank of Palau (NDBP) has the potential institution to improve financial intermediation. Legislation passed in 2015 gives NDBP the ability to start taking deposits, which would increase its liquidity.²⁴ Although taking deposits would improve the liquidity of NDBP, however, a deposit taking function raises the bank's costs, through the need to install systems to take and manage the deposits. In addition, it requires

²³ See s 122 Financial Institutions Title 26.

²⁴ The statute does not require NDBP to take deposits but allows NDBP to apply to the FIC to do so.

substantial managerial inputs in order to ensure that these function effectively.

A feature of the Palau financial system is the substantial amount of financial disintermediation that occurs. Foreign owned commercial banks take deposits and send them offshore because they are not lending locally. Thus, Palauan saving is not financing investment in Palau. The effects of the usury law, referred to above, make the reluctance of the commercial banks to lend to businesses understandable. One way to improve intermediation could be for the commercial banks to lend to NDBP, secured by NDBP loans that are themselves secured using the secured transactions framework. This would also give NDBP significant flexibility in managing its liquidity.

Other ways of increasing the bank's lending capacity exist. The secured transactions framework gives borrowers in Palau, potentially including NDBP, an advanced framework for pledging assets against collateral, and therefore an alternative to deposit taking to increase liquidity.

The basis for using the secured transactions framework to raise liquidity is that NDBP's loan portfolio constitutes a substantial and secure asset, against which funds could be borrowed from commercial banks, or even from pension funds. Using a floating charge against this asset as security for lines of credit from commercial banks would enable NDBP to increase or reduce its borrowing against its portfolio depending on the demand for loans. This provides much more control over its liquidity position than does taking deposits.

This PSA recommends strongly that the pros and cons of deposit taking be analyzed before embarking on expanding the bank's functions in this area. A comprehensive analysis would focus on:

- The costs of establishing deposit taking facilities, both in terms of personnel and physical facilities, relative to the increase in liquidity that this will bring.
- The managerial resources that will be required to monitor deposit taking—many NDBP systems require strengthening. Implementing deposit-taking facilities would distract from other urgently needed improvements.
- Whether deposit-taking facilities should be available to a small number of large customers, or to anybody—the costs of the former will be much lower than the costs of the latter.
- Additional issues that the analysis should consider are:
 - Whether taking deposits would make NDBP a commercial bank in terms of the legislation, and therefore subject it to the usury ceiling on business loans.
 - Whether Palau's pension funds could lend to NDBP, secured by some of NDBP loans.
 - Are there any implications for dealing with money laundering?

The advantages of not taking deposits, but rather using the secured transactions framework to raise additional funds for lending is that it would provide NDBP with a means of managing its liquidity, because the bank would only need to draw on credit facilities under the possible arrangement described above when it is necessary to do so.

While deposit taking may ultimately prove to be the best means of increasing NDBP liquidity, a full cost benefit analysis should be undertaken before a final decision is made.

The Financial Institutions Commission

The Financial Institutions Commission (FIC) supervises commercial banks and the National Development Bank.²⁵ It has done a laudable job in restoring financial soundness to finance in Palau. It has closed a number of banks (a decade ago there were more than 20 commercial banks in Palau). With additional resources the FIC could provide additional supervision that would strengthen the system even further.

The FIC also serves as the Registrar under the secured transactions act. The FIC could also improve the soundness of the financial system by increasing the risk weighting for loans that are not secured either by a mortgage on fixed property, or by the use of the secured transactions framework. This could accelerate the use of the secured transactions framework and ensure that most loans are secured.²⁶

Pension Funds

Social Security Administration Retirement Fund and the Civil Service Pension Fund administer pensions in Palau. Both funds have significant unfunded liabilities, particularly the Civil Service Pension Fund. The FIC is not empowered to regulate pension funds and the only safeguard is independent audit reports. Administrators of the Funds and the FIC agree that a sound regulatory framework is needed. In the meantime, provisions for refunding the Retirement Funds need to be made, through higher contributions and budgetary allocations.²⁷ The solvency of the

Funds will be helped by the abolishment of the 30-year mandatory retirement program for government employees.

²⁵ The FIC acquired supervisory authority at the end of 2014.

²⁶ Both the Bank of Guam and the Bank of Hawaii have their own prudential oversight from their head offices. While this could reduce the need for securing loans, a single policy regarding the use of the secured transactions framework is desirable.

²⁷ See International Monetary Fund 2014, Republic of Palau, 2014 Article IV Consultation, and Economic Update, 2015 Economic Monitoring and Analysis Program.

8 AGRICULTURE

Recommendations:

- Develop a national agricultural policy
- Implement the policy through a joint venture between the Bureau of Agriculture and the Growers Association
- Establish a permanent market for the sale of organic produce
- The quarantine rules raise costs, increase Palau's vulnerability to supply disruption and should be abolished

Palau has a small agricultural and aquaculture sector, which, (together with forestry) produced the equivalent of 1.2% of GDP in 2014. The sector consists of a few commercial farms, informal growers, and subsistence production for household consumption and government extension activities. Little is known about non-commercial production, and estimates are projected in relation to population change. With the recent estimated declines in population, production estimates are down, although backward linkages from the tourism sector might afford opportunities for increased output because demand for agriculture produce is growing as the tourism industry expands. Agricultural produce also retains importance in traditional social exchange. This demand is being met almost entirely by imports.

Social Security Administration data indicates that the number of people employed in agriculture and aquaculture has declined steeply over the last 5 to 6 years, with only 57 people recorded as being formally employed in the sector and paid full-time in 2012.

Palau imports the majority of its agricultural produce, primarily from the United States. Food imports, valued at over \$40 million in 2015 are 125% higher than in 2004²⁸, and represent 82% of the value of all food available in the economy.²⁹ Licensing is required only for agricultural and health reasons. Nevertheless, inefficient regulation is hampering the operation of the trade regime. Quarantine rules require that agricultural, and other goods requiring health clearance, must be imported only from the United States, which substantially raises the cost of imported agricultural produce. It also increases the vulnerability of the economy to unexpected events. In 2013, a vessel bringing fruits and vegetables from California was delayed for 4 weeks, and the country exhausted its stocks of fresh produce.

Palau's climate is well suited for year round production of fruit and vegetables, and has the possibility for increasing aquaculture output. Small plot sizes and the difficulty of consolidating plots to an economically viable size is an important factor in

²⁸ USA Graduate School, 2016, Republic of Palau Fiscal Year 2015, Economic Review USDOJ.

²⁹ FAO and SPC (2014) Food Security Indicators database.

the failure of the agricultural sector to develop. An additional factor is that much of the soil in Palau is clay and requires extensive investment in order to make it fertile.

There are a number of key issues that impact the agricultural sector. The most important are:

- Palauan interest in farming has declined steadily as illustrated by the low employment in the sector.
- A few earlier generation Chinese employing imported labor farm vegetables, fruit and traditional produce on a commercial basis.
- Some subsistence farming of traditional foods also continues.
- Much of the commercial farming is done under short-term lease arrangements, often of only one-year duration, which also predicates against extensive investment in the sector.
- There is a substantial amount of unused land, but soil quality is low and pests abound.
- Market access for farm produce is limited. There are some direct farm to supermarket sales, but they are limited. Overall the demand for fresh produce greatly exceeds domestic supply. However, the extent to which investment might be stimulated by higher prices of agricultural products is limited by import prices. Improved efficiency in Palau agriculture is prerequisite for this policy to succeed.
- The National Development Bank of Palau provides lending to agriculture including a Farm Loan Program, but few loans have been approved.

There is a nascent organic farming sector, but there are only some 100 full and part time farmers producing organic fruits and vegetables. There is a need for a regular market structure, which could be used as an outlet for this produce. With a market in place, incentives to invest in higher quality produce would increase.

AGRICULTURAL AND AQUACULTURE POLICY STATEMENT

In November, 2015 a sector policy statement was approved for the agriculture and aquaculture sector. It contains many of the objectives and policy options outlined in this section. At the core of the policy is a desire to have the government and the private sector work together to promote agriculture as a viable sector. In particular, the Chamber of Commerce is seen as an intermediary in the process, bringing together growers on the one hand and potential purchasers in the form of supermarkets and hotels.

While these are sensible and appropriate goals, more will be needed to expand the supply of locally produced agriculture.

CONSTRAINTS AND POLICY MEASURES

Governance issues hamper the development of the agriculture sector, including a lack of land use planning, no agricultural research support, and several agencies being involved in the sector that have conflicting aims and objectives, with limited or no coordination between them. As a result, policy and strategy has been directed by intermittent and often ineffectual donor assistance.

Agricultural development in Palau therefore requires a coherent overall development strategy that is owned and institutionally supported by the various organizations involved in the sector, as well as support from government more generally.

Out-grower and contracting schemes vary according to market circumstances. There are also many alternatives to these operations. Palau agriculture is insufficiently developed to consider formal purchase agreements, management contracts, joint ventures, and any significant sharecropping. Other alternatives include plantations, state ownership, and cooperatives. While plantation agriculture could possibly suit forestry and tree crop production, sufficient land may not be readily available. State ownership and agriculture cooperatives have commonly not proven viable over the long-term in the Pacific islands.

Whether the Palau agricultural sector can generate significant additional growth is an open question. A universal characteristic of development is that as economies grow, the share of agriculture in total output declines. Nevertheless, the present uncoordinated policies directed at the sector will certainly not lead to agricultural development. The following policy actions will lead to improved productivity and higher output.

- (i) Focus coordinated government support on a few leading, nuclear commercial growers of fresh produce, helping them to expand their operations, both in area and in crop enterprise. These may be existing producers, and/or new domestic, and/or foreign investors.
- (ii) Both government and growers could work with selected supermarkets and hotels through the Palau Chamber of Commerce to develop the market through a form(s) of produce contracting.³⁰
- (iii) In return for government support, the selected nuclear, commercial growers share their broad agribusiness models, and work with government to expand operations, including establishing a scheme(s) for smallholder out-grower farming.^{31 32}
- (iv) Under the leadership of the Director of the Bureau of Agriculture (BOA), all relevant government departments, NGOs and the managers of donor supported agriculture programs would be invited to commit their support to the policy.³³
- (v) BOA staff and resources, research (especially soils, land use, husbandry, pest control, and economics), extension and training, preparation

³⁰ Contract farming involves agricultural production being carried out on the basis of an agreement between the buyer and farm producers. Sometimes it involves the buyer specifying the quality required and the price, with the farmer agreeing to deliver at a future date. More commonly, however, contracts outline conditions for the production of farm products and for their delivery to the buyer's premises. The farmer undertakes to supply agreed quantities of a crop or livestock product, based on the quality standards and delivery requirements of the purchaser. In return, the buyer, usually a company, agrees to buy the product, often at a price that is established in advance. The company often also agrees to support the farmer through, e.g., supplying inputs, assisting with land preparation, providing production advice and transporting produce to its premises.

³¹ The term out-grower farming is used here to define the intended relationship between the nuclear commercial farm(s) and smallholder farms with the produce of smallholders being added to contracted commercial farms' output. The commercial farmer(s) would act as an intermediary between market and smallholder.

³² The recent FAO report endorses this chosen option, most especially recommendations # 3,4,5,6, and 8: FAO 2014. Linking farmers to markets: Realizing opportunities for locally produced food on domestic and tourist markets in Palau.

³³ The FAO report (footnote 7) calls for the formation of a "Food Policy Council." The Medium-Term Development Strategy chapter on agriculture paragraph 17 also refers. Government of Palau 2008. Facility for Economic & Infrastructure Management Project Agriculture Sector Report. Koror.

of contracts and, or loan submissions and other support would be directed toward the new policy.

(vi) The Small Business Development Centre, with the assistance of external organizations, would work with farmers to help them develop business plans and access finance, negotiate market contracts, assess gross margins, plan and manage farming businesses.

(vii) Establish a market where organic produce could be offered for sale on an ongoing basis.

Commercial demand for agriculture produce is growing as the tourism industry expands, and agricultural produce also retains importance in traditional social exchange. This demand is being met by imports. Currently, there are few alternatives to public sector activity, tourism, construction, and related services. Agriculture is one of sectors where additional value added can be generated. Nevertheless, it remains an open question whether agriculture should be a primary focus of development policy. A universal characteristic of development is that as economies grow, the share of agriculture in total output declines. While a number of the policy measures outlined above can improve the efficiency of the sector, it is unlikely to become a major contributor to growth in the country.

A key issue in implementing an agriculture sector policy will be oversight to make sure that the steps outlined above are being followed and that the agriculture policy statement will become meaningful. The Economic Advisory Group has an important role to play in the process, in making sure that momentum for developing the sector continues to grow. Regular updates on

progress should be provided to the EAG by the Director of the Bureau of Agriculture, including the identification of problems encountered in implementing the goals of the policy statement. This is an essential step in promoting agricultural development in Palau.

9 THE COMMERCIAL LEGAL FRAMEWORK

Recommendations:

- Prepare a Companies Bill as soon as possible; establish an electronic registry; use this framework to deal with the issue of “fronts”
- Develop a modern business licensing system and integrate it with the electronic Companies Registry
- Once passed, seek assistance with bankruptcy legislation
- Amend the foreign draft foreign investment legislation so that domestic and foreign companies are subject to the same company law, and place foreign companies under the jurisdiction of the Registrar of Companies. Integrate foreign companies into the electronic registries.
- Remove the requirement that foreign companies commence operation within 12 months of approval.

This section focuses on areas of Palau’s business law framework, where reform is needed urgently, namely; the companies act and registry; bankruptcy issues; business licensing issues; and foreign investment legislation and reform. At the same time, more detailed diagnostic analysis is needed in the in areas of; enforcement of contracts; legislation governing employment; and trusts.

Palau’s legal system is based on its Constitution, customary law, and common law as applied in the United States. An in-depth analysis of contract law in the North Pacific states that:

*The statutory elevation of the Restatements to the level that the Restatements are the rule of decision is a unique regional development and a remnant of the Trust Territory Code, 1 TTC 103. This regional adoption is unique because in the United States, the Restatements of Law are not the rule of decision.*³⁴

In the absence of written law or local customary law, the courts of Palau apply common law.³⁵ In practice, much commercial law is based on common law because neither the Constitution nor customary law address commercial issues to any great degree. This situation causes significant practical problems. In the United States, commercial transactions are governed by the Uniform Commercial Code (UCC), which was adopted in 1953. Palau has no equivalent of the UCC. Therefore, courts are forced to search for precedents in the United States among decisions that were taken prior to the adoption of the UCC. Since commercial practice in the United States has evolved substantially over the past 50 years, Palau’s commercial legal system is hampered by having to rely on outdated precedents.

Furthermore, as Palau becomes integrated into the world economy, the importance of having a modern legal system increases. To increase

³⁴ Described in Ryan, D.P. 2005. Essential Principles of Contract and Sales Law in the Northern Pacific. New York University, pp. 30

³⁵ Although local customary law and written statutes take precedence over common law.

transactions and dealings with foreign businesses and individuals, it is necessary that all parties know with whom they are dealing, and that they can enter into contracts with the knowledge that if one of the parties fail to fulfill their obligations, that they have recourse to a modern legal system to enforce contract provisions. This requires legislation that reflects the needs of modern commerce. As it currently stands, there are many gaps in both the law and processes in Palau.

The following sections discuss specific legal impediments to a well-functioning environment that would foster private sector growth.

THE COMPANIES ACT

Currently, the Companies Act is outdated and not suitable for modern commerce. An internal review by the Private Sector Development Initiative concluded that the law is ill-suited to modern company formation, and that the paper-based company registry is functioning poorly. The most important findings of the review are:

- The primary legislation governing corporations is found in Title 12 of the Palau statutes, which governs “business associations.” The statute is short and contains only general guidelines, with the important details governing the formation and governance of companies contained in the regulations.
- In general, the regulations contain a mixture of both modern and antiquated provisions related to corporate formation and governance. Some of these provisions need to be changed in order to modernize the legal framework for

company formation. For example, currently in order to incorporate a company, three incorporators must front up to a Clerk of the Supreme Court, or a notary to sign application documents. This is an outdated approach to corporate formation that is no longer followed in the overwhelming majority of jurisdictions.

- The President of Palau must approve all new companies, including articles of incorporation and bylaws. This is an extremely inefficient requirement in that it delays incorporation and wastes the valuable time of the Head of State. A far superior alternative process that conforms with modern registries would be for legislation that states clearly the requirements for the creation of a company. Standard forms are then produced that amount to a checklist and that can also be completed online. These forms are then checked by the Registrar of Companies to ensure that all requirements are satisfied. In this way, the process of creating companies is simplified and speeded up. Experience in Samoa, Vanuatu, Solomon Islands and Tonga has demonstrated the value of this process as reflected in the significant reduction in the amount of time and costs required to register a business.³⁶
- Current regulations require all requests to search the registry be submitted in writing. This makes the process slow and costly. It is also counter productive since an important function of a Companies registry is that it presents information regarding who are the shareholders, officers and directors of a company in an efficient manner. This is important for many reasons, not the least of which is that it allows the public to determine

³⁶ In all of these countries, businesses can be created online in a day or less.

Box 3: Dealing with the Problem of “Fronts” through Companies Act Reform

An ongoing problem in Palau is the bypassing of foreign investment regulations through the creation of so-called “fronts”, which consist of businesses that are nominally owned by Palauans, but which in reality are owned and operated by foreigners. Because of the opaqueness of the current registry and the fact that inquiries are costly, there is no systematic way to investigate the existence of fronts, who are the true shareholders, nor who is authorized to sign contracts on behalf of a company.

An electronic registry would go a considerable distance towards making ownership transparent, and making the creation of a “front” far more difficult. Since electronic companies registries are searchable online by anybody from anywhere in the world, it is easy to ascertain who the shareholders and the directors are, and who is empowered to sign contracts on behalf of any registered company or corporate entity.

It would also greatly increase risks for anybody trying to create a “front”, because it would remove any ambiguity with respect to shareholding and directorships. Anybody attempting to use a Palauan as a front person would be subject to the ongoing risk that they would have to surrender the business without recourse to any legal protection.

who is authorized to enter into agreements on behalf of the company, and its official address to which correspondence and legal documents can be delivered. This knowledge allows for more reliable contracting, and reduces the risk of transacting outside the country—an essential function for an economy like that of Palau, that relies on foreign transactions for its prosperity.

- PSDI has been asked by the government to draft of a new Companies Bill ³⁷ that modernizes the framework and allows for the creation of an electronic registry, which would be developed as part of a reform.

LICENSING

The chapter on tourism suggested that improved standards for tourism businesses and operators

are needed. It suggested that Botswana’s business licensing framework is a model worth emulating. However, both policymakers and bona fide tourism operators interviewed pointed out the drawbacks of the current system, with overlapping jurisdictions and the lack of a centralized system of licensing. Many of these problems could be dealt with by changes in the licensing regime, and using the electronic database for the Companies registry to record business licenses as well.

A further issue with the company law framework is that the Foreign Investment Act governs foreign corporations, which means that there are separate laws that apply to the operation of companies depending on whether they are domestic or foreign. This creates additional burdens for foreign investors, such as the requirement that the Foreign Investment Board approve any transfer of shares.

³⁷ The request to PSDI was received in April 2016 with policy design work commencing in May 2016

BANKRUPTCY

Palau also lacks a bankruptcy statute for individuals. This has significant effects on the riskiness of doing business. The proof of debt procedure is long and complicated for the average debtor or creditor. Even when only insignificant sums are involved, legal practitioners must be employed to assist clients in navigating through the complex maze of procedures. Debtors who cannot afford lawyers are still faced with large legal bills from the creditors' lawyers. There is no means by which any debts can be discharged, so that many people have no hope of getting out of debt. A bankruptcy law could help resolve this, although any legislation must protect the rights of creditors

REFORMING FOREIGN INVESTMENT LEGISLATION

Like most Pacific island economies, Palau has a comprehensive system of foreign investment regulations, which are specified in the existing Foreign Investment Act.

The Existing Foreign Investment Regime

It is a requirement that all foreign investment and foreign investors go through an approval process when starting a business enterprise in Palau. Applications must be submitted to the Foreign Investment Board (FIB) for review. Successful applicants are issued a foreign investment approval certificate. The Act contains a substantial list of activities in which foreigners may not engage.

- The Act specifies that in order to obtain approval, the minimum foreign investment should be \$500,000, or the business must have at least 20% of its workforce consisting of Palauans.

- The Act requires a very extensive business plan, financial projections, details regarding employment generation, and justification that such skills are not available locally.
- The Act requires that foreign-owned businesses submit a quarterly report to the FIB of activities and earnings. The FIB has an ongoing regulatory function to monitor compliance with the Foreign Investment Act.
- Permission to operate foreign businesses is granted for a fixed time period, thereby shortening the investment time horizon.
- One of the criteria adopted by the FIB is to review whether foreign business proposals might impact future investment by Palauans, something that nobody, including the FIB, has the skills to evaluate.

In spite of these requirements, the existing Foreign Investment Act appears to be ineffectual. A visitor to the country quickly learns of the large number of “fronts” that have been established to bypass existing restrictions on foreign investment. These “fronts” occur in all areas nominally reserved for Palauans.

Proposed Foreign Investment Legislation

A bill to reform foreign investment has been before the OEK (House Bill No. 7-46-2, HDI) for many years. It proposes a complete overhaul of the system of approval of foreign investment. The preamble to the House Bill states:

The Foreign Investment Act is a hindrance to investment in the Republic of Palau. Bureaucratic restrictions hamper the inflow of capital, though there is not enough local money to fully develop the Republic's resources.

The complicated and burdensome system for foreign investment approval certificates has induced abuses such as false filings and front businesses, and has continued to discourage foreign investment. The preamble thus recognizes problems with the existing legislation, which is currently failing to achieve its aims of promoting investment and entrepreneurship within the country.

The main elements of the Bill include:

- (i) Transferring the Office of the Registrar of Corporations to the Ministry of Finance and the transfer of employees of the Foreign Investment Board to the Office of the Registrar of Corporations.
- (ii) The revocation of the regulations implementing the Foreign Investment Act.
- (iii) A clarification to exempt franchises from the provisions of the Foreign Investment Act, provided that franchisors do not engage in other businesses in Palau.
- (iv) Allowing foreign investors to obtain 50-year permits to operate businesses in the country.
- (v) The merging of the Office of the Corporate Registrar, the Foreign Investment Board staff, and the current staff of the Division of Revenue and Taxation (which issues and processes business licenses) into a new Bureau of Commercial Licensing. All applications and registrations for domestic and foreign corporations and other business enterprises would be filed at the Bureau. The Bureau would also issue foreign investor permits, which would

be referred to as “Authorization to Conduct Business in the Republic of Palau.”

- (vi) The reserved list of activities would be reduced to: wholesale importing of goods; wholesale distribution of goods; retail importation, sale and distribution of goods; gift and handicraft shops; bakeries; land and water transport; commercial fishing; and fishing in territorial waters in each state. However, the draft bill states that if a citizen of the Republic of Palau has 25% of the equity and is entitled to 25% of the profits of any company engaged in the preceding list, the business may have foreign ownership of the remaining equity in the business and engage in the prescribed activities. This step should reduce the number of front businesses and result in greater formal participation of Palauans in formal business activities.
- (vii) Penalties for the operation of front businesses would be increased.

Deficiencies in the New Foreign Investment Bill

There are, however, a number of problems and ambiguities with the House Bill, the most significant of which is that if business has not commenced operation within a year of a license being granted, the license could be revoked. In the case of hotels and larger investment projects, this could result in the withdrawal of a license even though investment is underway. This provision is potentially damaging to foreign investment and requires modification. A further comprehensive review of the legislation is warranted before resubmitting it for passage.

Making Legislation Available

All Palau's legislation should be available for review without charge. The current practice of requiring a paid subscription for access to all statutes is counter productive, generates very little revenue, and makes access to the law exclusionary, which increases the risks of contracting and investment and discourages bona fide investors. This provision should be abolished without delay.

Small Business Entities

Most business in Palau are very small, employing fewer than 15 people. A corporate form that is favored by many small businesses in the United States is a limited liability corporation, which has simplified procedures for establishment and maintenance, and which combines limited liability with pass through taxation of partnerships or sole proprietorships. This type of business entity has fewer formalities to maintain than does a fully fledged corporation. It may be well suited for small businesses in Palau.

10 THE ECONOMIC EMPOWERMENT OF WOMEN

Recommendations:

- Develop legislation to protect women from sexual harassment in the workplace
- Through the Chamber of Commerce, provide business training specifically designed for women entrepreneurs

Promoting greater participation of women in the private sector is generally recognized as “smart economics”, utilizing an untapped economic resource and at the same time increasing the incomes of families and individuals. While women in Palau are engaging with the private sector, their participation is adversely impacted by lack of skills training, lack of business knowledge, institutional practices, and customary norms.

Strategies that encourage business start-ups include transparent, and easy to understand company laws that contain business forms that nascent entrepreneurs can use, and providing access to finance. Additionally, providing skills, training and assistance with business development will increase the ability of women to participate in the private sector.

Gender disaggregated data is limited in Palau. The Census 2015 addressed this limitation by collating information on participation of men and women in the informal sector, and un-paid employment activities. Greater coordination between the Gender Division in the Ministry of Community and

Cultural Affairs, and the Chamber of Commerce and other government departments will be useful in addressing the data deficit, and bringing better coordination on policies aimed at economically empowering Palauan women.

Commitment to Gender Equality in Palau

While Palau has become a signatory to a number of human rights conventions³⁸, it has not ratified the Convention for the Elimination of Discrimination Against Women (CEDAW).³⁹ As of May 2016, Palau remains the only Pacific country not to have signed but not ratified CEDAW.⁴⁰ This Convention calls for measures to overcome barriers to discrimination in political, social, economic and cultural spheres including addressing domestic violence. The reason for this reluctance is likely to be the manner in which some of the Conventions’ provisions are perceived to conflict with religious and customary practices, including customary inheritance laws.

Palau’s Constitution prohibits sex discrimination and states that the “government shall take no action to discriminate against any person on the basis

³⁸ Universal Declaration of Human Rights 2011, Convention on the Rights of the Child (ratified 4 August 1995), Beijing Global Platform for Action (1995)

³⁹ This Convention was signed on 20 September 2011, but has not been ratified.)

⁴⁰ On 6 March 2015, Tonga ratified CEDAW leaving Palau as the only Pacific country not to have done so.

of sex”⁴¹ Likewise, the Constitution commits to universal education.⁴² Many Palauans maintain that there is gender parity in accessing education at all levels.

Customary norms are a strong form of regulation in Palau, impacting on women’s participation within communities and in employment. Traditionally Palau is a matrilineal society in which women have important roles in the family, clan, and community. Women have the power to influence decisions about land, as they have an important role in the appointment of the chiefs in each state. It is the chiefs who constitute the Council of Chiefs that advises the President on matters of custom. However, such norms have at times impinged on women’s participation in the workplace. Custom laws on inheritance still operate in Palau and directly discriminate against women, reducing their ability to control assets— essential for entrepreneurial activity.

The Pacific Regional Millennium Development Goals Tracking Report, 2013, found that women remain under represented in national congress and cabinet. While there are currently three women out of 13 positions in the Senate, there have been no women in the 16-person House of Delegates for thirty years.

A Gender Division has been established under the Bureau of Aging and Gender within the Ministry of Community and Cultural Affairs to support initiatives to promote gender equality. Its mandate includes: the development of a National Gender Policy; establish a database for reporting on

gender quality issues; and to serve as a focal point for national, regional and international entities. However the organization is poorly funded, as reflected by the statistic that 0.01% of the national budget is invested in the promotion of gender equality and the empowerment of women.⁴³

Discriminatory Laws and Practices

Customary practices and discriminatory laws can impact on women’s engagement with the private sector. One example is the laws on inheritance of land that prioritize the oldest living male (or male child) over women.⁴⁴

Women’s attitudes towards gender roles were clearly framed by customary norms, as reflected in a recent study that found that nearly half of all women agreed with the statement that “a good wife obeys her husband even if she disagrees”.⁴⁵ It has been recognized that changing cultural norms and perceptions of women’s roles is necessary if women are going to be economically empowered in the private sector.⁴⁶

Major customary events including funerals and first birth celebrations require women of rank in the family (buchel sechal), or women who are married to men with important roles in the family to play an important role by providing food, service, and gifts. Many women reported that they would be expected to contribute up to \$10,000 for such ceremonies.

Such duties impact on women the private sector, as they have to take leave from work to perform such tasks.

⁴¹ Article IV, Section 5 of the Palau Constitution.

⁴² Article VI of the Palau Constitution.

⁴³ Palau Review of Beijing 20 p.14.

⁴⁴ s 301 Title 25 of the Palau National Code.

⁴⁵ Belau Family Health and Safety Study: National Research Project on Violence Against Women in Palau, 2014, P 43.

⁴⁶ Palau review of Beijing 20, p.12.

The Economic Impact of Domestic Violence Against Women

The Government acknowledges that violence against women is a problem as reflected by the Family Protection Act 2012. However, partially due to under reporting, the issues remain unaddressed. A recent study revealed that there had been a rise of women who suffered from partner violence and the majority of these women did not seek help from formal services or authorities, also resulting in a substantial economic cost. The Gender Division is engaged in working with police and courts to implement legislative provisions against domestic violence by developing a special victims unit. The Ministry is also working on building awareness of domestic violence and developing appropriate protocols to protect families affected by domestic violence.

Women and Employment

Fewer women are engaged in the labor force, with only 60% representation compared to 77% of men. Women are concentrated in administrative, tourism, and retail sectors.

There are many more women in the public service than in the private sector. Women are taking up senior positions of the public service, including as Directors of Bureaus and as Executive Governors. A study on Palau's State Owned Enterprise's Boards found that seven out of 36 board members were women, which accounts for 19% of the total.

The Civil Service Pension Fund and the Social Security Fund, which are available to public servants, have motivated many women to stay in government service. Because such benefits are not common to the private sector, women reported that they would be reluctant to leave the public service. Plans to

extend the Civil Service Pension Fund to the private sector are underway, and may see women move to start up businesses in the future.

Tourism is a substantial employer of women in the private sector. Many work in retail, accommodation provision, and restaurants related to the tourism industry. However, the lack of credit facilities and skills development operate to constrain further engagement with the private sector.

There have been widespread reports of workplace discrimination and currently there is no specific sexual harassment legislation in place to protect women from such conduct. Such legislation, with appropriate grievance mechanisms, would assist women seek redress and encourage cultural change within institutions.

Women's Access to Finance

Only a small percent of women has been able to access business loans. A business loan requires security, and credit scoring based on the financial system used in the United States by the financial institution. As foreign banks cannot take land as security, local practice is to focus on business cash flow when evaluating creditworthiness. Women who are seeking to start a business are usually not able to access such loans, and are directed to the National Development Bank. Many of these borrowers resort to consumer loans that they use to fund businesses. These loans are for sums less than \$50,000, accessible for a period of five years on an unsecured basis. Such loans usually attract a higher interest rate of up to 15%. As they can be accessed on an unsecured basis, both women and men commonly use them for business purposes.

The secured transactions framework is intended to address this problem. It enables lenders to take

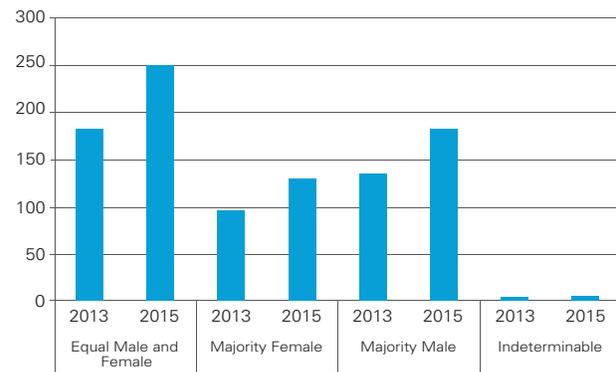
charges over movable assets, thus widening the scope of creditworthiness analysis. Movable assets can be tangible items such as cars or inventory, but also intangible items such as accounts payable. If lenders would better use the secured transactions framework, women would be likely beneficiaries of this move, as they often lack access to land to use as collateral. Figure 9 indicates the gender breakdown of current debtors within the Palau secured transactions registry.

Skills Development and Business Networks

Women seeking to start businesses often require assistance in developing business plans and loan applications. The Small Business Development Centre is the main entity offering such services and its clientele are predominantly women. It is effective, and the services provided include assisting women-owned business with tools and resources, including the Business Resource Guide, and mentoring business start-ups. The Palau Chamber of Commerce serves as the advocate for business. Other bodies representing businesses include the Tourism Association and the Palauan Small Business Association.

There is demand for financial management training and skills training on tourism, and for assistance in preparing documentation accompanying loan applications. These bodies have collaborated in organizing the National Business and Finance Conference and Tourism Conference in 2015. Support from these bodies to introduce legislation and policies that encourage women's participation in the private sector is essential.

Figure 9: Security Interests Registered by Men and Women



11 TAX POLICY

Recommendation:

- Reform the goods and services tax by replacing it with a value added tax

From a private sector development perspective, the gross receipts tax of 4% is especially distorting. It “cascades” because the tax is on the gross amount of any transaction, and does not take into account taxes already paid. Thus tax is paid on tax, with the following effects:

- It penalizes high turnover, low profit margin businesses. For example, for a high margin retailer, the sale (for \$100) of a single item that has a profit margin of 50% would incur a gross receipts tax payment of four dollars, or 8% on profits.⁴⁹ A low margin retailer such as a grocer, however, faces a very different tax rate: gross profit margins on groceries are typically 10%. The impact of the gross receipts tax on a \$100 sale thus attracts a tax rate of 40%.⁵⁰ If the grocer’s inputs were bought from a wholesaler, they already contain a 4% tax. This cascading tax rate therefore substantially raise the prices of goods in Palau, impacting in particular those with low incomes.

- It encourages evasion, especially by low margin businesses. This was already referred to in the section on access to finance.
- It distorts resource allocation away from high volume businesses, which typically are patronized by poorer members of the community.

The gross receipts tax is therefore even more regressive than most taxes on expenditure: it falls especially heavily on those with low incomes. As a result of the above factors, tax reform is an urgent priority. However, the government has postponed action for many years.

⁴⁹ The IMF prepared a detailed analysis of the implications for Palau of various scenarios surrounding Compact renewal. See IMF. 2006. Republic of Palau, Staff Report for the 2005 Article IV Consultation. Washington, D.C.

⁵⁰ Calculated as follows: The gross receipts tax on a \$100 sale is \$4. Profit on \$100 sales is \$10. Thus the tax rate is $4/10 = 40\%$.

12 STATE-OWNED ENTERPRISES

Recommendations:

- Insist that state-owned enterprises operate under strict commercial principles
- Explore opportunities for contracting out services that are currently supplied by government and government owned entities.
- Vigorously pursue finding additional telecom service providers

The Government of Palau owns and manages three SOEs⁵¹ that are providing telecommunications, water and power and banking services to the people of Palau. These SOEs have struggled to operate on commercial principles, and as a result have generated consolidated losses of US\$34 million over the 2002–2012 period. These losses were entirely due to the Palau National Communications Corporation and the Palau Public Utilities Corporation, and amount to the equivalent of approximately 18% of annual GDP. Furthermore, the lack of efficiency of these entities imposes a substantial cost on the economy in terms of misallocation of resources that could be used more effectively.

While detailed analysis of the productivity of Palau’s SOEs is not possible because of a lack of data, interviews with the business community revealed deep frustration with their inefficiency, particularly in telecommunications.

Power generation is quite reliable, with few outages. Nevertheless, the inefficiencies cited by the private sector are confirmed by the benchmarking analysis of electricity generation in the Pacific region. Palau ranks below the midpoint of efficiency for power generation in the region.⁵² It earned a return on assets of -2.1% in 2012 and on equity of -1.3%.

Box 4: Features of the State-Owned Enterprise Policy Statement

The main features of the policy statement are:

- (i) The Primary Objective of each state-owned enterprise (SOE) is to operate as a successful business and to that end to recover all of its costs, including its costs of capital. All decisions made by SOE directors must be consistent with the Primary Objective, which will not only provide guidance for all decisions made by the board and management but also for the Government when it makes “ownership” decisions. For example, when selecting directors, suitable candidates would be persons who, in the opinion of those appointing him or her, are considered to be the best qualified to assist the SOE to achieve its Primary Objective.

⁵¹ Palau National Telecommunications Corporation, National Development Bank of Palau, Palau Public Utilities Corporation..

⁵² Pacific Power Utilities, 2012, Benchmarking Report.

- (ii) Community Service Obligations (CSOs) generally arise when the Government directs a SOE to provide goods or services to consumers at prices below their true cost. If SOEs are to fulfill their full cost recovery mandate, they cannot undertake CSOs without compensation. A framework will therefore be put in place to allow SOEs to deliver CSOs without violating their Primary Objective.
- (iii) The Executive will appoint the Minister of Finance as the Responsible Minister, with financial and operational oversight over all SOEs. In Palau, there is no Minister with responsibility for the SOE portfolio, but one should be appointed to represent the state's ownership interest. This Minister will focus on preserving the state's investment in the SOE, and as such will focus on the financial and operational performance of the SOE. In most small economies, the Minister of Finance is responsible for safeguarding the Government's ownership interest. The Minister will have the following functions
- To recommend persons as directors, with the consent of the President and Senate, whom the Minister considers are best skilled to assist the SOE achieve their mandate to operate commercially
 - To recommend the removal of directors
 - Approve the establishment of new SOEs and the disestablishment of existing SOEs
 - To be consulted upon and provide comment on the SOE's Statement of Corporate Intent
 - To ensure that audited annual accounts are tabled in Congress promptly after the end of the SOE's financial year, and are made available to the public
 - Any other operational or procedural matters that would normally be undertaken by the owner of a business corporation
 - Execute documents on behalf of the Government dealing with the formation or management of the SOEs, including subscribing for shares
 - Act as the shareholder which would include voting at AGMs, approving the issue of shares etc

Palau's Internet and mobile phone networks are among the poorest in the Pacific in terms of speed, access, and cost. In a digital age, the inability to connect electronically with the outside world places the country at a substantial competitive disadvantage.

The passage in 2015 of new legislation regarding a proposed submarine cable is a significant step towards improving Palau's connectivity. The laying of the new cable, which will be facilitated by an ADB loan, is a major step towards improving connectivity and promoting private sector development.

These principles were included in a Policy Statement adopted in November 2015 (Box 4).

As of mid-January 2016, there was no indication of how the Policy Statement would be translated into specific policy measures. The urgency of translating the policy statement into practical measures is illustrated by the following factors that contribute to the poor financial and operating performance of SOEs.

- SOE governance practices are weak and require immediate attention. These weaknesses stem from the absence of a legal framework to support the commercial

operation of SOEs, the presence of politicians on SOE boards, and the general lack of experience of SOE directors with the functions and operations of a board. No SOE—with the exception of Palau Water and Sewer Corporation (PWSC)—has an explicit obligation to operate profitably. Moreover, the Constitution gives the President exclusive right to appoint SOE directors, who must then be confirmed by the Senate. Very few directors have expertise in the sectors in which their SOE operates. While all directors sign contracts setting out their roles as directors, these contracts tend to focus on compliance with existing laws, and not on the fiduciary responsibilities of the directors. Directors are rarely held accountable for the financial performance of the SOEs.

- There is no mechanism for monitoring the performance of the SOEs apart from the presentation of their financial accounts to Congress. There is no corporate planning process in most SOEs, and no role for the Ministry of Finance in nominating, appointing or evaluating the performance of directors, nor in monitoring SOE results.

- There is no public disclosure of SOE financial performance.
- The three main utilities: Palau Public Utilities Corporation (PPUC), Palau National Communications Corporation (PNCC), and PWSC are corporate entities. The airport and port are not.
- The port is owned by the Koror state government, which has awarded a 25-year concession for stevedoring services to a private company owned by a former President of Palau. The same company also provides security services at the airport, which is owned by the central government.
- Legislation to create an Airport Authority has been pending in Congress for several years.
- SOEs tend to price goods and services at below the cost of delivery, as their enabling acts typically require them to provide “affordable” services.
- Tariff increases in the water, sanitation, and electricity sectors have been rare. This has meant that the utilities are unable to effect the needed maintenance and upgrading of their assets.

Box 5: Should State-Owned Enterprises Aim for Profitability?

One common misconception regarding the operation of SOEs is that if they earn a positive return on equity and assets the price of the services that they provide will be higher than if they operate at a loss. This does not necessarily follow. When entities such as state owned enterprises are protected from competition and are not required to operate on commercial principles, productivity and efficiency is almost always low. The ability to supply services such as telecommunications, power and water efficiently, and therefore at the lowest attainable cost,¹ almost never happens under protected monopolies particularly if the entities are not required to operate under a commercial mandate. If effective regulation and competition are introduced and productivity rises, it is quite possible for prices to go down at the same time as operating margins improve

The productivity of SOEs around the world is generally low since governments are usually poor operators of businesses.¹ SOEs in Palau supply essential services at high cost, which lowers the efficiency of the economy. Alternatives, such as outright privatization, public private partnerships and contracting out services to the private sector are far more efficient ways of ensuring the supply of essential services on which the competitiveness of the economy depends

The labor productivity of the Palau Public Utilities Commission in generating electricity, for example, is among the lowest in the region. Typically, labor productivity is measured in gigawatt hours per full time employee (GWh). For the Pacific region, in 2012, the average output per employee was 2.2 GWh, while for Palau it was only slightly above 50% of the regional average.⁵³ This means that already scarce resources of skilled labor and capital are being used inefficiently, representing a substantial dead weight loss to the economy.

Opportunities for alternative means of supplying these essential services exist. A government outsourcing program could be extended to such activities as health services, the running of the airport, public works, and telecommunications. A good example of successful outsourcing is the privatization of the mortuary services of the Koror Hospital.

Furthermore, even in an economy as small as that of Palau, opportunities for competition exist. The entry of Digicel into the Pacific telecoms market has transformed the costs of telecommunications in the region. Exploring the possibility of another telecommunications provider entering Palau should be an urgent priority. Even if the size of the market mitigates against more than one provider, privatizing PNCC (and introducing an appropriate competition framework that stipulated cost and service quality) would have the potential to improve communications immensely. While arguments against this course of action have been made on the grounds that it might affect employment of PNCC workers, experience in other Pacific island economies has shown that employment tends to expand following liberalization because normally the

improved service and expanded range of products increases demand. In practice few jobs would be at risk.

Not only would such measures improve the efficiency and cost of supplying services (thereby freeing up more of the government budget for social goals, such as health, education and protection of the environment), it would also create employment opportunities for Palauans. As discussed earlier, private employers bemoan the lack of interest of Palauans to work in the private sector, and measures such as these will contribute to changing the culture of Palauans focusing on obtaining public sector jobs.

⁵³ Pacific Power Utilities, Benchmarking Report, 2012.

CONCLUSION

The significant growth rates achieved over the past few years and the relatively high per capita income of Palauans is indicative of the potential of the country to provide prosperity to its citizens. The current issues facing Palau are a classic example of the tension between short and long run issues. The high growth rates of the past 2 years are at least partly the result of the rapid expansion of the number of visitors to Palau. A short term view would imply that the growth in tourism numbers should continue unabated. However, tourism experts, as well as visitor surveys suggest that this growth is not sustainable in the longer term. The World Heritage sites that attract visitors are becoming overwhelmed by the sheer numbers visiting them. Over time, Palau will become less attractive and visitor numbers will decline. This is the most pressing issue facing the economy and the private sector.

A further issue is the path dependence that the current situation is creating. As investment in facilities and services that cater to low cost tourists, the resistance to policies that reduce the size of this segment of the market will grow and it will become increasingly difficult to change course. This is a further reason why dealing the the current influx is so important.

This private sector assessment has covered a broad range of issues and suggested a substantial number of policy initiatives. They cannot all be tackled at once. The purpose of this document is not only to undertake analysis, but also to encourage discussion between the government and the private sector on priorities for reform. Palau is unusual in the extent to which debates and

symposia are held to discuss policy issues. In some areas, significant progress has been made, while in others little has been achieved. An overriding problem identified by Palauans is that in a number of areas, there is significant lack of capacity within government and within the private sector to implement policy effectively. Until governance and capacity are improved, any policies directed at solving Palau's economic challenges will be less effective than they could be.

There is, however, growing recognition of the need for action. If it does occur, the combination of Palau's natural characteristics and Palauans determination and self reliance will ensure that the future of the country is not only preserved for upcoming generations, but that the prosperity of the country will continue to increase.

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