



PRIVATE SECTOR ASSESSMENT FOR PALAU

POLICIES FOR SUSTAINABLE GROWTH REVISITED

PRIVATE SECTOR ASSESSMENT FOR PALAU POLICIES FOR SUSTAINABLE GROWTH REVISITED



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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 developing member countries in the Pacific to improve the enabling environment for business and to support inclusive economic growth led by the private sector. PSDI's expert team provides support services in policy and program development, advocacy, legislative and administrative reform, and capacity building.

This PSDI report has been prepared with input from ADB's Pacific Subregional Office, under the supervision of ADB's Pacific Liaison Coordination Office in Sydney, Australia.

All PSDI publications can be downloaded from www.adbpsdi.org and www.adb.org.

FOREWORD

In July 2007, the Asian Development Bank (ADB) published *Palau: Policies for Sustainable Growth, A Private Sector Assessment*, which highlighted the strong potential for viable growth in the country, and provided an overview of the challenges that needed to be overcome to further encourage private sector development. Since then, Palau's economy has shown strong signs of expansion. Per capita gross domestic product is the highest among ADB's Pacific island developing member countries.

Significant progress has been made in several areas. The stability and soundness of regulations in Palau's finance sector have improved substantially. The establishment of the Secured Transactions Framework provided a basis for improving access to finance, although loans to the private sector remain low. The formation of the Economic Advisory Group provided an excellent forum for discussions between the Government of the Republic of Palau and the private sector. Overall, the government's strong commitment to promoting private sector-led growth is an example to the region.

While noting these commendable achievements, this private sector assessment (PSA) also highlights the need for further measures to be taken to ensure that policy prescriptions are translated into growth-producing outcomes. Many of the obstacles that were outlined in 2007 continue to be obstacles to inclusive growth, which emphasizes the need to close the gap between policy formation and implementation.

Palau is known for its pristine environment and world heritage sites. These run the risk of being overrun by a short-term approach to economic prosperity because of the rise of low-value tourism, which threatens the long-term viability of the tourism industry. The PSA contains a detailed analysis of policies that could address this issue. It suggests other measures to promote sustainable growth, through implementing commercial law reform, creating efficient state-owned enterprises, empowering women, further promoting access to finance, and enforcing sound tax policies.

This PSA update—prepared through consultations with representatives of the government and the private sector—is part of the regular update of analytical work produced by the Pacific Private Sector Development Initiative and ADB. While it shows that the private sector still faces significant challenges that need to be overcome for the economy to fulfill its long-term growth potential, it also recognizes the commendable advancements that have been made, and encourages continued discussion between the government and the private sector on reform priorities for the future.

Keeping in mind Palau's strong drive towards self-reliance and commitment to open debate, I am confident that the country can be successfully steered away from the path of dependence, toward an open economy that will continue to benefit the future generations of Palauans.

Xianbin Yao

Director General
Pacific Department
Asian Development Bank

ABBREVIATIONS

ADB	Asian Development Bank
BOA	Bureau of Agriculture
CEDAW	Convention on the Elimination of All Forms of Discrimination against Women
EAG	Economic Advisory Group
FIB	Foreign Investment Board
FIC	Financial Institutions Commission
FY	fiscal year
GDP	gross domestic product
NDBP	National Development Bank of Palau
PNCC	Palau National Communications Corporation
PRC	People's Republic of China
PSA	Pacific private sector assessment
PSDI	Pacific Private Sector Development Initiative
LLC	limited liability company
SOE	state-owned enterprise
US	United States

EXECUTIVE SUMMARY AND RECOMMENDATIONS

The Republic of Palau has recorded 2 years of substantial economic growth. Per capita income has risen to a little over \$16,000—the highest level in the Pacific region—yet the strong performance of the country’s economy masks some pressing issues. Deficiencies are most evident in the tourism industry, but are also present in policy implementation, efficiency of state-owned enterprises (SOEs), access to finance, and the business law framework. It is important that these issues are addressed to ensure that Palau’s recent growth continues and is sustainable, without compromising the country’s pristine environment.

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

Reforms to several of Palau’s laws governing business activity are needed. In particular, the Corporations Act does not contribute to business formation and fails to assist in the development of a viable tourism industry. Reforming the Corporations Act and installing a modern electronic corporations registry will promote private sector development and provide synergies to develop an improved tourism policy.

The Government of the Republic of Palau should consider enacting an American-style limited liability companies (LLCs) act, as the LLC entity type helps formalize small, locally owned businesses. Bankruptcy legislation is also 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, with the banks not prepared to finance local business activity. A major contributor to this reluctance to lend is a ceiling for interest rates on loans to businesses—a ceiling that does not reflect the riskiness of lending. The National Development Bank of Palau (NDBP) is a potential lender, particularly to agriculture, but currently its systems are outdated and it has a liquidity shortage. Improving the NDBP’s operating efficiency, and tapping into savings, will provide Palauan businesses with an additional source of financing.

Palau’s SOEs are inefficient and constitute a drain on the government’s budget. Requiring them to operate under a commercial mandate is a first step in improving productivity. Further steps to outsource the provision of government services, including those provided by SOEs, will reduce costs and generate employment.

SUGGESTED PRIORITY REFORMS

Table 1 identifies priorities that the government should initially focus on to continue improving the country's business climate and drive sustainable economic growth.

Table 1: Reform Priorities for the Improvement of Palau's Business Environment

Area	Priority Recommendations
Tourism	<ul style="list-style-type: none"> Develop a comprehensive national tourism policy. Introduce draft legislation on the construction of new tourist-related facilities to upgrade hotel development in early 2017.
Land	<ul style="list-style-type: none"> For laws governing land leases, add a provision 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. Abolish the requirement that the National Development Bank of Palau can only lend to majority Palauan-owned companies.
Agriculture	<ul style="list-style-type: none"> Develop a national agriculture policy.
Business law and regulation	<ul style="list-style-type: none"> Pass a new Corporations Act, update legislation for other business entity types, and install an electronic registry. Review the 2016 Foreign Investment Act to identify provisions that are harmful to foreign investment and conflict with modern corporations acts. Ensure that new corporations legislation is consistent with the new Foreign Investment Act. This may require amending the Foreign Investment Act so that it is reconciled with the Corporations Act.
Economic empowerment of women	<ul style="list-style-type: none"> Develop legislation to protect women from sexual harassment in the workplace. Through the Palau 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"> Replace the gross receipts tax, which severely distorts the way resources are allocated in Palau, with a value-added tax to increase revenue. Enhance tax collection by enacting the new Corporations Act and implementing the electronic corporations registry.
State-owned enterprises	<ul style="list-style-type: none"> Ensure that state-owned enterprises operate on commercial principles. Introduce competition in the telecommunication sector.

Source: Pacific Private Sector Development Initiative.

KEY RECOMMENDATIONS

Table 2 summarizes the challenges and recommendations contained in this report. Ideally, the 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 to Drive Sustainable Economic Growth in Palau

Challenges	Recommendations
Tourism	<ul style="list-style-type: none"> • Develop a national tourism policy without delay. • Focus policy on ensuring that new tourism facilities do not over strain the water and sewage infrastructure, and provide high end accommodation consistent with Palau’s long-term tourism strategy. • Assess the impact of the new departure tax, and investigate the feasibility of a daily head tax. • Use market mechanisms to auction landing rights for airlines. • Use peak load pricing to spread tourist visits to popular sites over the day. • Improve coordination of tourism policies between the state and national governments. • Improve and enforce licensing requirements, and sharply increase penalties for infractions of tourism licensing and regulations.
Land	<ul style="list-style-type: none"> • Introduce a 90-day window for clan members to file any objection 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.
Access to finance	<ul style="list-style-type: none"> • Abolish the usury ceiling on commercial loans made by foreign-owned lenders. • The Financial Institutions Commission should consider recognizing loans secured by movable assets as secured loans under its regulatory framework. • Widen the discussion of the transition of the National Development Bank of Palau (NDBP) to a deposit taking institution into a comprehensive strategic review of the overall funding of the NDBP. • Build the capacity of the NDBP to improve its systems for granting and monitoring loans. • Abolish the requirement that the NDBP can only lend to corporations that are majority Palauan-owned. • Establish a credit bureau that is also linked to the United States credit bureaus.
Agriculture	<ul style="list-style-type: none"> • Develop a national agriculture policy. • Implement the agriculture policy through a joint venture between the Palau Bureau of Agriculture and the Palau Growers Association. • Establish a permanent market for the sale of organic produce. • Abolish quarantine rules to lower costs and reduce Palau’s vulnerability to supply disruption.
Commercial legal framework	<ul style="list-style-type: none"> • Pass a new Corporations Act, establish an electronic registry, and use this framework to deal with the issue of “businesses nominally owned by Palauans, but in reality are controlled by a non-Palauan front(s).” • Develop a modern business licensing system and integrate it with the electronic corporations registry. • Draft new bankruptcy legislation to better protect individuals. • Amend the November 2016 Foreign Investment Act so that it is consistent with any new corporations legislation; place foreign corporations under the jurisdiction of the Registrar of Corporations; integrate foreign investment registration into the electronic registry to be deployed for all corporations.

continued on next page

Table 2 *continued*

Challenges	Recommendations
Economic empowerment of women	<ul style="list-style-type: none"> • Develop legislation to protect women from sexual harassment in the workplace. • Through the Palau Chamber of Commerce, provide business training specifically designed for women entrepreneurs. • Provide training on the secured transactions framework to assist women in obtaining finance. • Increase awareness of the damaging impact of domestic violence and its economic implications.
Tax policy	<ul style="list-style-type: none"> • Reform the gross receipts tax by replacing it with a value-added tax.
State-owned enterprises	<ul style="list-style-type: none"> • Insist that state-owned enterprises operate under strict commercial principles. • Explore opportunities to contract out or privatize that are currently supplied by the government and government-owned entities. • Vigorously search for additional telecommunication service providers.

Source: Pacific Private Sector Development Initiative.

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 The country's per capita GDP also increased and, at the end of the fiscal year (FY) 2015, it was in excess of \$16,000—the highest among the developing member countries of the Asian Development Bank (ADB) in the Pacific region. Although growth is forecast to be lower in 2016 because of a slowdown in tourist arrivals, it is expected to resume in 2017.

This strong performance, however, masks some urgent issues that could threaten the sustainability of Palau's economy and compromise its long-term prosperity. The country's economy is founded upon tourism, and the exceptional growth of the past 2 years is primarily due to an explosion in visitor numbers. The rapid expansion has placed significant strain on the carrying capacity of Palau's pristine natural sites, and is threatening to overwhelm the country's infrastructure.

OUTLINE OF THE PRIVATE SECTOR ASSESSMENT

This private sector assessment (PSA) focuses on key issues identified at two economic symposia held in Palau in November 2014 and November 2015. It also takes into account an analysis of Palau's business environment, which revealed several issues important to the long-term development of the country's economy. It takes into account an analysis of Palau's business environment, which revealed several issues important to the long-term

development of the country's economy. It also includes information obtained during Pacific Private Sector Development Initiative (PSDI) ongoing work in Palau over multiple visits during 2016.

The assessment begins with a brief overview of the methodology of PSAs. A section follows on the political economy issues that influence policy making in Palau. There is then a discussion of the structure of the country's economy and how it has evolved since 2001. This section includes an analysis of key recommendations of a PSA that was completed in 2007, and the progress made on the proposals contained in that PSA. Following this is a discussion of the four issues—tourism, finance, agriculture, and land—raised at the 2014 and 2015 symposia.

The analysis of Palau's business environment identified several additional factors that are constraints to private sector development. These are factors related to the economic empowerment of women, landownership, the commercial legal framework, tax policy, and the impact of state-owned enterprises (SOEs) on the economy. The discussion is framed by how potential reforms relate to current political economy issues.

METHODOLOGY OF PRIVATE SECTOR ASSESSMENTS

PSAs analyze the key constraints that inhibit investment and entrepreneurship in a given business environment. They take into account ongoing or planned reforms. They assess progress

¹ Palau's fiscal year (FY) runs from 1 October to 30 September of the following year.

made on reforms already implemented, while suggesting priorities for further reforms. PSAs reflect the views and perceptions of the private sector, the government, and development partners regarding key constraints and priority areas.

Some of the factors that a PSA identifies are

- (i) the public goods necessary to support business activity;
- (ii) the rationale and limitations of public initiatives (particularly with regard to market failures, information asymmetry, and market imperfections);
- (iii) the role of the government in removing barriers to private sector activity; and
- (iv) a reform agenda based on the priorities identified in the analysis.

PSAs discuss in detail many or all of the following issues

- (i) **Policy, legal, and regulatory environment.** The legal framework for doing business, including commercial law, business formation, business licensing, and the contracting environment; the extent to which reform measures have contributed to improving the legal and regulatory environment, supporting growth of the private sector.
- (ii) **Public sector institutions.** The extent to which public institutions support the growth of the private sector, including public institutions that regulate, assist, or potentially inhibit the growth of the private sector, and/or institutions that purchase goods and services from, or supply goods and services to, private suppliers.

- (iii) **State-owned enterprises.** The characteristics and efficiency of SOEs; whether SOEs are a drain on the public budget; the potential for public–private partnerships; outsourcing and privatization; the extent to which SOEs impact the efficiency of the private sector.
- (iv) **Trade and investment.** The openness of the economy; the level of trade and investment with other countries; barriers to trade; investment promotion policies, regulations, and procedures, including restrictions and processes surrounding foreign investment.
- (v) **Communications.** Internet connectivity; cost and availability of mobile phone services; air and sea transport infrastructure and costs.
- (vi) **Finance sector.** The structure of the finance sector and how it intermediates between savers and investors; the cost of borrowing and the structure of interest rates; the regulatory and legal framework of the finance sector; the collateral framework for borrowing; the way that financial institutions incorporate secured transactions reform into their lending policies.
- (vii) **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; the extent to which effective regulations and institutions are present.
- (viii) **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 or otherwise of social safety nets; employment creation; migration and short-term labor programs.

- (ix) **Land.** The degree to which restricted access to customary land for economic use impedes the private sector, distinguishing between the impact on small, medium-sized, and large enterprises; the land leasing system and its impact on private sector development.
- (x) **Gender.** The ways in which customary and social practices affect how men and women participate in the private sector; existing legal and regulatory impediments to women's participation, including recommendations to ease such impediments.
- (xi) **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.
- (xii) **Macroeconomic environment.** Inflation and its impact, if any, on businesses; the real exchange rate; the structure of taxation.
- (xiii) **Specific factors.** Barriers to tourism; resource extraction, including booms or busts; agriculture and other specific important sectors of the economy; remittances and their importance.

POLITICAL ECONOMY, GOVERNANCE, AND THE PRIVATE SECTOR ASSESSMENT

Political economy and governance issues are central to translating the PSA's recommendations into meaningful policies. Many Palauans were of the opinion that, even if policies are well-designed, 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 through appropriately designed policies, but those policies require comprehensive and effective implementation. This includes proper training, ongoing support, and the leveraging of technology to automate certain governmental functions. Institutions are emerging that should, over time, improve governance in Palau.

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, the EAG prioritizes actions for the forthcoming 12 months. The fact that such a forum now exists in Palau—and that there is dialogue between the government and the private sector—is a highly beneficial move for policy making in the country.

The EAG has been instrumental in developing policy statements to guide the process of development. This 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

² The Economic Advisory Group (EAG) is jointly chaired by the Minister of Finance and the Executive Director of the Palau Chamber of Commerce. Its members consist of the chair of the ways and means committees in each house of the Olbiil Era Kelulau; directors of finance, infrastructure, and tourism; members of the Palau Chamber of Commerce; and other directors of government departments who attend on an as-needed basis.

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 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.

Combined with policy statements on agriculture, SOEs, and labor, the statement of objectives for development in Palau represents a good first step toward improving governance and implementing policies for sustainable development. Successful implementation of those policies will require strong coordination and concrete protocols for execution that, in the past, have been difficult to achieve. The EAG has a central role to play in this process. The general statements do not specify many details that are of critical importance if Palau is to achieve its potential. These issues are analyzed in further detail in the sections that follow.

OTHER ISSUES OF POLITICAL ECONOMY

Governance issues arise from differences in the protocols, and even the goals, of Palau's state and national governments. For example, some states are able to generate revenue by charging entrance fees to scenic attractions located within their boundaries. This is particularly the case for the state of Koror, which is earning substantial revenue from visitor charges to the Rock Islands. Other states are not blessed with such lucrative natural attractions and, at this point, there is little coordination on division and distribution of tourism revenues or the relative responsibilities of the state and national 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 under which the state and national governments can coordinate their land-use policies, but this has yet to be implemented. The Foreign Investment Act, passed in November 2016, is an example of insufficient technical analysis of legislation that has a strong bearing on Palau's economic future. Legislation affecting the private sector requires rigorous vetting to ensure that it does not undermine future growth.

2 STRUCTURE AND PERFORMANCE OF PALAU'S ECONOMY

STRUCTURE OF PALAU'S ECONOMY

The economy of Palau is dominated by the sectors of tourism and public administration. The breakdown by type of economic activity is shown in Table 3, which also compares the contribution of each activity in 2001 with that of 2015. While the breakdown does not specifically identify tourism, the influence of the sector is evident in the contributions of accommodation and food services; arts, entertainment, and recreation; and transportation. This suggests that tourism accounted for close to 25% of Palau's total output in

2015, a doubling of the contributions made by the same output classifications in 2001.

Other major changes in the 2015 figures included a sharp decline in the importance of construction, which is the result of significant infrastructure projects having been underway since 2001. Interviews with representatives of the private sector and public officials suggest that the slowdown in construction will reverse over the next 3 years. A significant number of private homes are being built, new tourist facilities are being erected, and large sewerage and water projects will be implemented in 2018.

Table 3: Output by Economic Activity in Palau, 2001 and 2015 (%)

	2001	2015
Agriculture and forestry	1.5	1.21
Fishing	2.5	1.8
Mining and quarrying	0.9	0.4
Manufacturing	3.1	1.0
Electricity and gas	2.4	1.6
Water supply and sewerage	0.7	0.4
Construction	12.0	4.3
Wholesale and retail trade	13.9	13.4
Transportation and storage	5.2	6.4
Accommodation and food services	6.4	14.8
Information and communication	3.6	3.2
Financial Intermediation	4.3	2.4
Real estate activities	4.0	5.8
Professional, scientific and technical	2.0	1.7
Administration and support	2.0	1.5

	2001	2015
Public administration	16.6	13.7
Education	5.3	3.9
Human health and social work	3.4	2.9
Arts, entertainment, and recreation	0.7	5.7
Other service activities	0.8	1.3
Private households with employees	1.0	1.4
less intermediate FISIM	-1.5	-0.6
GDP at basic prices	90.9	88.1
Taxes on products	9.5	12.0
less subsidies	-0.4	-0.1
GDP at purchasers' prices	100.0	100.0

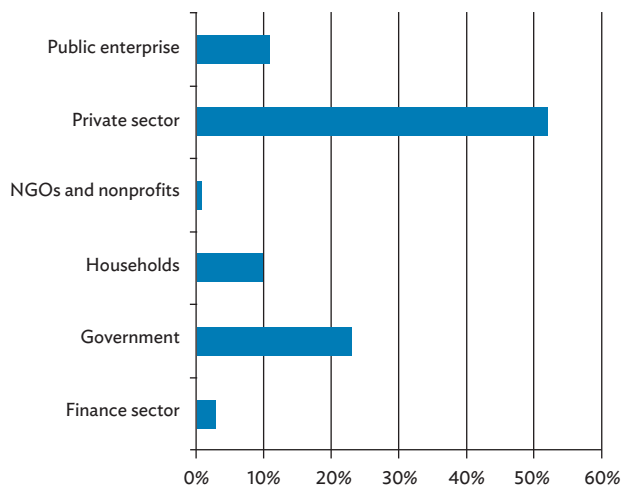
FISIM = financial intermediation services indirectly measured, GDP = gross domestic product.

Source: Republic of Palau. 2015. *Economic Statistics*. Koror.

There was a reduction in the contribution of public administration from 16.6% in 2001 to 13.7% in 2015, although it should be noted that these figures do not include the economic activity of SOEs. Another feature was an increase of approximately 2.5% for taxes on products, indicating a positive tax elasticity associated with the growth of the economy.

The private sector of Palau's economy accounts for more than half of the total output (Figure 1). An additional 10% is produced by households, with the majority of the remainder being attributable to the government and to SOEs (public enterprises).

Figure 1: Output by Sector of Palau's Economy



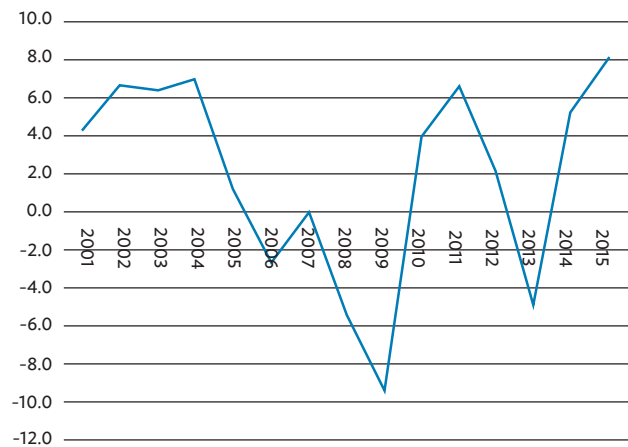
NGO = nongovernment organization.

Source: Republic of Palau. 2015. *Economic Statistics*. Koror.

GROWTH OF PALAU'S ECONOMY

From FY2001 to FY2015,³ the average annual real growth of Palau's economy was 1.23% (Figure 2). There was a high degree of variance in the annual

Figure 2: Real Growth Rate of Palau's Economy, FY2001–FY2015 (% of gross domestic product)



Note: Palau's fiscal year (FY) runs from 1 October to 30 September of the following year.

Source: Republic of Palau. 2015. *Economic Statistics*. Koror.

growth rates, with real gross domestic product (GDP) falling by a total of around 15% across FY2008–FY2009, as the economy was severely buffeted by the global financial crisis and economic recessions over that period.

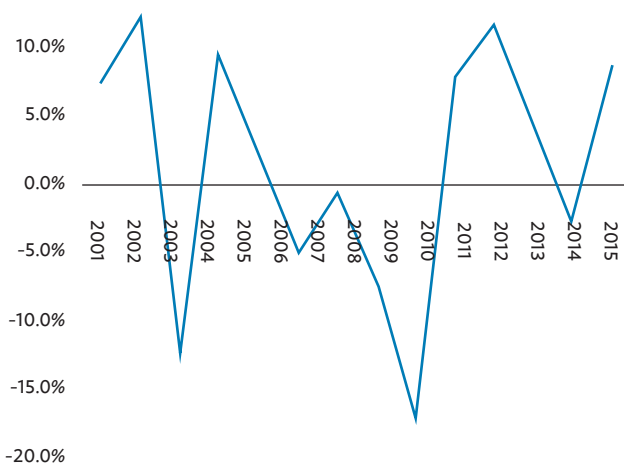
From FY2010 to FY2015, growth was robust, apart from a small decline in 2013. However, this still left the output of the economy lower than it was in FY2005, when real GDP reached \$194 million.

Private sector output has fluctuated substantially more than the output of the Palauan economy as a whole (Figure 3). In FY2003, when real GDP declined by 6%, private sector output fell by more than twice that amount. Similarly, in FY2008–FY2009, private sector output fell sharply, declining by over 17% in FY2009. However, in FY2014, private

³ In referring to GDP data, years cited are fiscal years, which run from 1 October to 30 September of the following year. Thus, 2015 refers to the period October 2014–September 2015.

sector output grew at 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 it is with Palau's overall output. This is not surprising, since the reliance of the Palauan economy on tourism expenditures closely tracks world economic activity. The sharp fall in private sector output in FY2008–FY2009, when the world economic slowdown occurred, confirms this relationship.

Figure 3: Growth Rate of Palau's Private Sector Output, FY2001–FY2014 (%)



FY = fiscal year.

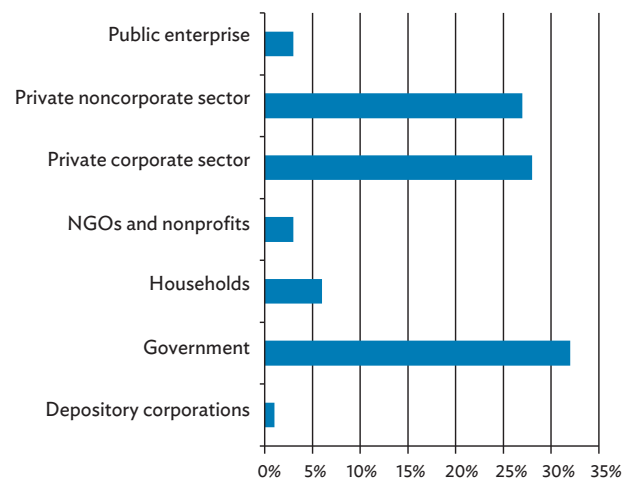
Source: Republic of Palau. 2015. *Economic Statistics*. Koror.

From FY2001 to FY2014, per capita GDP rose at an annual rate of 1.2%. This may be due to the population declining as a result of a net decrease in the number of migrant workers in the country (the population of native Palauans remained roughly constant). Trends in per capita GDP illustrate the countercyclical effect of migrant workers. When demand in the Palauan economy slackens, the number of migrant workers falls so that per capita GDP does not always reflect developments in the overall output of the economy.

LABOR AND EMPLOYMENT

The government sector—comprising governments at the local, state, and national levels—is Palau's largest single employer, although together the private corporate sector and the private noncorporate sector employ just over half of the country's labor force (Figure 4). The extent of unemployment and underemployment is difficult to gauge. Employers interviewed for this private sector assessment (PSA) maintain that it is hard to hire local workers because Palauans appear to favor public sector employment over working in the private sector. These employers also indicated that they were having difficulty recruiting foreign workers as a result of the government's ban of workers from Bangladesh. A tightening of restrictions on workers travelling to Palau, introduced by the Government of the Philippines, is causing concern over the possibility of future labor shortages, especially since public infrastructure investment is set to increase from 2017 to 2018.

Figure 4: Employment by Sector of Palau's Economy, 2015



NGO = nongovernment organization.

Source: Republic of Palau. 2015. *Economic Statistics*. Koror.

3 THE 2007 PRIVATE SECTOR ASSESSMENT: RECOMMENDATIONS AND OUTCOMES

This section reviews briefly the recommendations of the previous private sector assessment (PSA) for Palau, which was completed in 2007 and identified a number of key constraints to the future growth of the country's economy. The 2007 PSA suggested measures that would improve Palau's business environment to increase long-term economic growth. A summary of the 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) **Role of the government.** There was too much involvement by the government in the economy, with budgetary processes funding employment at the expense of investment in infrastructure. Government ownership of utilities added to the problem of underinvestment, while weak public administration hampered the implementation of necessary policies.
Outcome: The government remains the largest employer of Palauans. Despite the government expressing interest in outsourcing certain functions, little progress has been achieved.
- (ii) **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 completely ignored tax rules. The cascading

effects of the gross receipts tax fell heavily on some businesses, such as wholesalers and some retailers, which harmed poorer Palauans. The 2007 PSA recommended that the gross receipts tax be replaced by a value-added tax. Political uncertainty and changes in congress have 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 2007 PSA noted that the private sector had extreme difficulty obtaining funding for investment. It was recommended that a secured transactions framework be introduced.

Outcome: A new secured transactions framework has been implemented, although its impact is limited due to a number of factors that inhibit bank lending (these factors are discussed in the Access to Finance section).

- (iv) **Regulation of the financial system.** The 2007 PSA highlighted that regulation of the Palauan financial system was weak. In 2007, 12 regulations to implement the Financial Institutions Act were awaiting passage through the country's legislature, 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 Palauan financial system. The number of banks in the finance sector has declined, from 13 initially licensed by the FIC, to 5. However, more restrictive legislation by the Government of the United States (US) is causing difficulties, which will require new initiatives to address a national payments system.

- (v) **Business law framework.** The 2007 PSA observed that the legal system for commercial transactions was outdated, with important laws—for example, those covering bankruptcy—not in existence.

Outcome: A number of bills has been drafted to improve the business law framework, but they have not been passed.
- (vi) **Foreign investment.** The 2007 PSA concluded that the foreign investment regime in Palau was inefficient, raised uncertainty, and encouraged foreign investors of dubious merit. The long list of reserved activities in Palau was encouraging the creation of “fronts” (businesses nominally owned by Palauans, but in reality owned and operated by foreigners).

Outcome: Little has transpired to improve foreign investment, but the EAG has proposed a new investment policy in relation to foreign investors.
- (vii) **Foreign workers.** The 2007 PSA suggested that Palau’s system for bringing in foreign workers needed to be rationalized to promote them being employed in more productive activities. In particular, labor regulations should apply equally to domestic and foreign workers.

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 as future infrastructure projects are substantially ramped up. Different rules for domestic and foreign workers still exist.

- (viii) **Land issues.** The 2007 PSA suggested that land rights need to be clarified, and that an efficient framework for long-term leases needs to be developed. Land values had increased substantially as a result of uncertain land rights and higher demand from foreign investors, which was causing some displacement for Palau residents.

Outcome: Little progress has been made.
- (ix) **Tourism policy.** The 2007 PSA recommended that an upmarket tourism policy be developed to limit the number of package tours and charter flights to the country. The PSA pointed out that environmental regulations and land-use planning were insufficient to protect the environment, which endangered the natural beauty of Palau—the prime attraction for tourists.

Outcome: There has been a moratorium on charter flights landing in Palau. Positive developments include the establishment of the Palau Bureau of Tourism, and funding has been increased to develop a tourism policy. Ongoing discussions indicate a keen awareness of the need for a comprehensive tourism policy, but, as of April 2016, 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 PALAU'S PRIVATE SECTOR

The analysis that follows examines four issues that the 2014 and 2015 economic symposia and the Economic Advisory Group (EAG) identified as being of primary importance to the development of Palau's private sector. However, while undertaking background investigation for this private sector assessment (PSA), several other issues were identified as also being of significant importance.

ISSUES IDENTIFIED BY THE ECONOMIC ADVISORY GROUP

The EAG identified four areas of importance for the Palau economy. They are

- (i) tourism,
- (ii) access to finance,
- (iii) land, and
- (iv) agriculture.

OTHER CHALLENGES

While the four issues noted above are undoubtedly significant, the analysis undertaken as part of this PSA revealed additional challenges that affect the performance of Palau's economy. The main issues are

- (i) the commercial law framework,
- (ii) the economic empowerment of women,
- (iii) tax policy, and
- (iv) the efficiency of state-owned enterprises.

5 TOURISM

Recommendations:

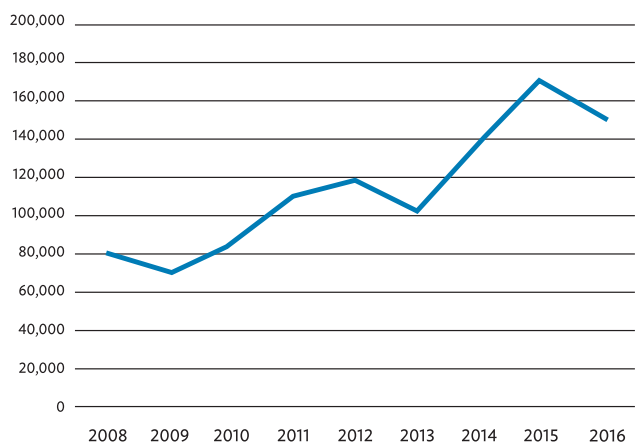
- Develop a national tourism policy without delay.
- Focus policy on ensuring that new tourism facilities do not over strain the water and sewage infrastructure, and provide high end accommodation consistent with Palau’s long-term tourism strategy.
- Assess the impact of the new departure tax, and investigate the feasibility of a daily head tax.
- Use market mechanisms to auction landing rights for airlines.
- Use peak load pricing to spread tourist visits to popular sites over the day.
- Improve coordination of tourism policies between the state and national governments.
- Improve and enforce licensing requirements, and 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 natural beauty. Several areas within the country have been declared World Heritage sites. In the past, high-end tourism, which accounts for a substantial portion of private sector activity, has made a significant contribution to economic activity in Palau. More recently, however, there has been explosive growth in lower-end tourism, particularly from the People’s Republic of China (PRC). This rapid expansion in tourism has the potential to threaten the sustainability of Palau’s unspoiled natural environment, and, in the longer term, to undermine the viability of the tourism industry as a whole.

This chapter discusses some policy options to restrain the influx of tourists on low-end packages. It does not address issues related to the longer-term

Figure 5: Number of Visitor Arrivals to Palau, 2008–2016



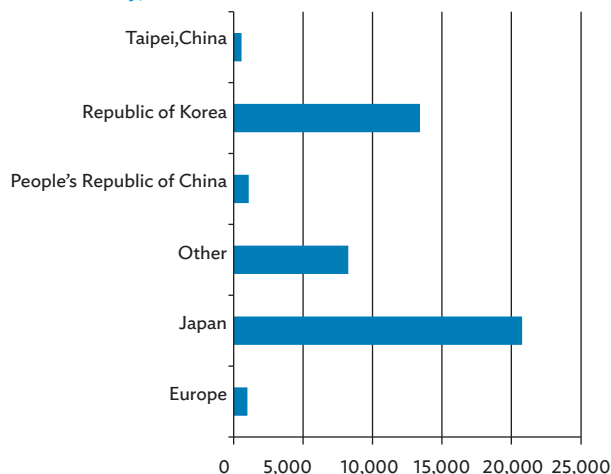
Source: Palau Visitors Bureau.

development and marketing of the tourism sector. Those issues are discussed comprehensively in a recent report by a renowned tourism experts.⁴ This chapter focuses on providing economic and regulatory measures to discourage low value-added tourism. It also suggests the development of a longer-term strategy to encourage high-end tourism, as recommended in the Jamieson and Francisco report, which will provide benefits to Palau's population as a whole.

GROWTH IN TOURISM

The growth in tourism to Palau has been explosive. In 2000, around 56,500 tourists visited the country. By 2015, this number had risen to approximately 170,000.⁵ The bulk of low-end tourists arrive on charter flights, the frequency of which increased sharply until 2015. A moratorium on the number of charter flights to Palau was implemented in 2015.⁶

Figure 6: Volume of Tourists to Palau by Nationality, 2000

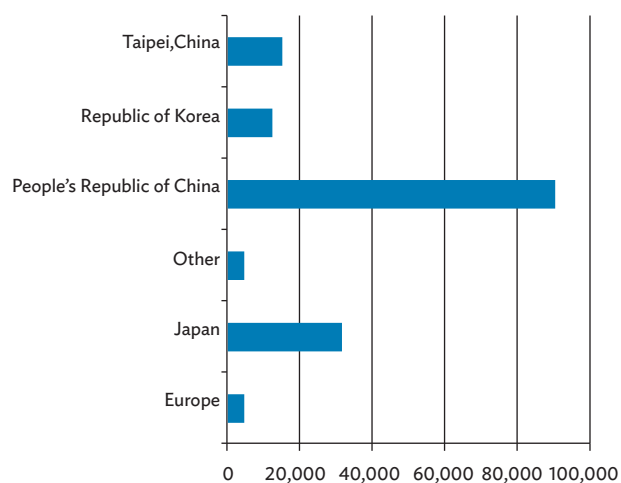


Source: Republic of Palau. 2015. *Economic Statistics*. Koror.

In addition, the country's departure tax was increased to \$150 in March 2016, but the increase was subsequently reversed.

The composition of Palau's tourism has also changed. In 2000, more than 50% of tourists came from Japan or the Republic of Korea, with over 20,000 visitors from Japan and over 13,000 from the Republic of Korea. In 2000, only 1,100 tourists came to Palau from the PRC (Figure 6). By 2015, over 90,000 tourists came from the PRC (Figure 7). Since tourists from the PRC tend to spend far less per night than do many other nationalities, per capita tourist spending in Palau has declined, although overall tourist receipts have risen. This was particularly evident in 2014 and 2015, when tourist receipts increased by 34%. However in 2016, the number of tourists visiting Palau declined sharply. In the 12 months to June 2016, the number of visitor

Figure 7: Volume of Tourists to Palau by Nationality, 2015



Source: Republic of Palau. 2015. *Economic Statistics*. Koror.

⁴ W. Jamieson and R. Francisco. 2015. Policy Options for Tourism Development in Palau. Unpublished.

⁵ Data provided by the Palau Tourism Authority.

⁶ Anecdotal accounts suggest that the impact of the moratorium was partly offset by charter operators using larger planes.

arrivals fell by nearly 9%, although receipts fell by only 6% and revenue per visitor night increased.

Tourists from Asia tend to spend less time in Palau than those from elsewhere in the world. In 2015, tourists from Japan; the Republic of Korea; Taipei, China; and the PRC all averaged four nights per visit. By contrast, those from the US averaged seven nights, and those from Europe averaged 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 over the same period, from a low of \$875 in 2011 to a maximum of \$1,028 in 2014. Spending per tourist in 2015 declined to \$891, about the same as it was in 2008. These data show that Palau has, to date, not achieved its goal of becoming a high-value tourist destination. Considerable effort will be needed for the country to achieve this goal. Suggestions for how this goal might be achieved follow.

There are several negative effects from low-end tourism.

- (i) The carrying capacity of Palau's World Heritage attractions is limited. Having large numbers of low-spending tourists viewing the attractions degrades the experience for high-spending tourists. Excessive visitor numbers risks permanently discouraging high-spending

tourists, especially in an age where comments on the internet are regularly read by potential clients.⁷ This brings into question the sustainability of Palau's high-end tourism industry.

- (ii) The pressure on resources not only degrades the visitor experience, but also degrades the resources themselves, adding to questions regarding sustainability.
- (iii) Given the very limited land space available in Palau for tourism development, particularly for hotels, the construction of low-quality accommodation crowds out the potential for high-end facilities and wastes resources. It is far costlier to demolish or convert a poor facility than it is to build a new one on undeveloped land.
- (iv) Domestic value added (the financial benefits that accrue to Palau) from low-end tourism is minimal. This could be exacerbated by the potential for transfer pricing. For example, a tour operator, who has a vertically integrated operation including hotels, could pay only part of the true cost of food and accommodation to the hotel subsidiary in Palau, then avoid paying taxes in Palau by retaining the bulk of the revenue outside the country.⁸
- (v) Some tour operators import much of what is consumed, and bring in foreign workers to service low-end hotels, discouraging the development of linkages in the tourism industry as well as growth in local expertise. As a result, the employment

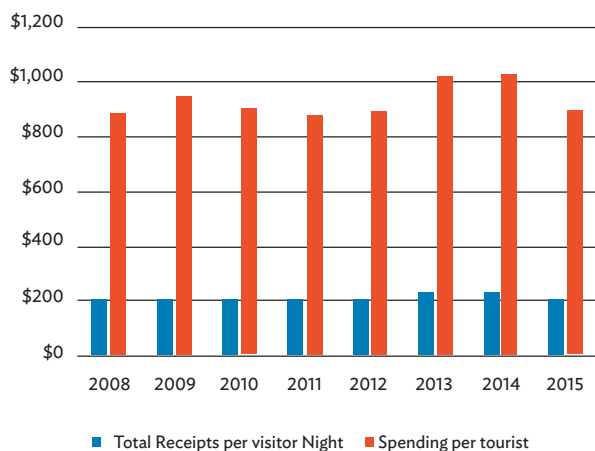
⁷ Anecdotal evidence indicates that the number of boats entering Jellyfish Lake has risen tenfold between 2002 and 2015, and that tourists do not always respect the environment.

⁸ A similar phenomenon has been observed in the Caribbean, particularly in 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 tourism industry, but little development of linkages into tourism by domestic firms.

effects and skills enhancement associated with tourism growth are 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 visitor 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 Palauan society at these recent developments.⁹ A longer-term strategy is necessary to generate greater financial and employment benefits from the tourism industry.

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



Source: Pacific Private Sector Development Initiative.

RATIONALE FOR DISCOURAGING LOW-END TOURISM

Low-end tourists represent an economic problem for Palau because the costs they impose on the country’s tourism resources—such as overcrowding and environmental degradation—may not be

offset by the financial benefits to the country as a whole. Economists describe this phenomenon as “social costs outweighing private benefits.” All of the social costs are imposed on Palau, while most of the private benefits accrue to low-cost operators domiciled outside the country, making the cost-benefit calculation from the perspective of Palau even more inequitable.

The number of tourists on charter flights that could sustainably enter Palau each year is currently unknown. This requires analysis from environment and tourism experts to calculate the carrying capacity of Palau’s environmental tourism attractions. The analysis is urgently required.

Once the desired number of tourists has been calculated, available policy instruments to keep numbers in check include regulation, taxes, and fees. The next section analyzes possible policy measures and discusses the advantages and disadvantages of each.

A DISCUSSION OF POSSIBLE POLICY MEASURES

A Moratorium on Building New Tourism Facilities

Ensuring that new tourist facilities do not overstrain Palau’s water and sewerage infrastructure is an important step for Palau; one that was also recommended by the Jamieson and Francisco report. A moratorium will allow time both for a tourism policy to be developed and for important tourism infrastructure to be updated. Without the moratorium, the construction of haphazard accommodation, which overwhelms the carrying capacity of the environment,

⁹ See, for example, the proceedings of the 2015 Economic Symposium held in Koror, Palau, in November 2015.

will continue and Palau's social and economic future will be at risk.

Regulation of Landing Rights

Currently, the Government of Palau does not release data on charter flights landing in the country. There are four licensed charter operators, but the number of flights each operator sends to Palau is not known.

There are several ways in which limitations could be placed on charter flights, once the carrying capacity of Palau's tourist attractions has been calculated.¹⁰ 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. Flight numbers could be restricted on a daily, weekly, monthly, or an annual basis. Several issues need to be addressed if this form of limitation is used.

Deciding how to allocate landing rights to charter operators is a key issue. The alternatives are

Option 1. Introduce a first-come-first-served approach, which would open applications in advance for charter landings over a specified period. For example, applications for 2018 landings would be opened in July 2017 and, once they are filled, no further charter flights would be given landing rights for 2018. This option forgoes potential revenue for Palau, since the landing rights are valuable and no cost is attached to them under this model.

Option 2. Impose a charge for landing slots, which would be paid by charter flight operators, until all available slots are filled. This option is flawed in

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 the destination's carrying capacity. If it is too low, then Palau is forgoing revenue that it could have earned.

Option 3. Conduct an online auction of the rights to operate charter flights to Palau. This is a means of determining just how valuable the landing slots are. The auction would be conducted in conjunction with a predetermined number of flights. While many technical details would need to be resolved, using an online auction is feasible and the software for doing so exists. In the longer term, low-end tourist operators could bypass the limitation on charter flights by lobbying commercial airlines to greatly increase their number of passenger flights. Some limitation on landing rights for commercial flights might have to accompany this approach.

User Fees

Levying user fees has the potential to limit low-end tourism and raise revenue for Palau, but the way in which the fees are developed and applied will have a critical impact on how effective they are. Their design is of paramount importance. There are a number of alternatives that could be used in isolation or in combination. They are

- (i) a tax on hotel rooms;
- (ii) 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;

¹⁰ The carrying capacity can be larger, if time of day scheduling is used.

- (iii) user fees on particular tourist attractions (currently, there are entrance fees for visitors to Rock Island and Jellyfish Lake);
- (iv) charges for obtaining a visa or for entering Palau; and
- (v) increases to departure taxes, which are already in place.

Each option has its own particular advantages and drawbacks.

A room tax. A tax on hotel rooms could be levied as a percentage of the room rate or as a fixed charge. The drawback of a percentage tax is that, in dollar terms, it more heavily impacts on higher-end tourists. It could also be bypassed at the lower end by “all inclusive” operators charging a very low rate for the room and recouping expenses on other parts of a package tour. A fixed charge has the advantage of deterring lower-end tourism by adding to the general cost of accommodation in Palau. It would also impact lower-end tourists, in percentage terms, more than higher-end tourists. However, a fixed charge would have limitations if a tour operator were to house many tourists in a single room, or in a number of rooms that the operator then classifies as a single suite.

A fixed daily charge or head tax. This charge would be levied as a set dollar amount, and would apply to each day that a tourist spends in Palau. As a percentage of total tourism spend, this tax would have more impact on lower-end tourists than on higher-end tourists. It could encourage longer stays in Palau by reducing the daily rate on a sliding scale, depending on the length of time a tourist remains in the country. This type of tax is levied in a number of countries, such as Italy, that rely heavily on tourism. This option has limitations in terms of policing and the reporting of accurate guest numbers in hotels.

User fees on specific attractions. The state of Koror already levies user fees on visitors to Jellyfish Lake and Rock Island. The fees have become a significant source of revenue for Koror, but have done little to stem the number of visitors. Where there are peak load problems because an attraction is endangered by visitor overload at certain times of the day, it may be necessary to issue visitation permits for those times.

Visa charges. A charge could be levied for obtaining a visa to Palau. However, since it would be prohibitively costly for Palau to establish a network of embassies or consulates around the world, the visa would need to be obtained on arrival in the country. Online visa application and payment may also be possible once the country’s internet infrastructure has been upgraded. A possible downside might be delays at immigration, which could detract from the visitor experience, especially for higher-end tourists.

Departure taxes. Palau currently has a fixed departure tax. With data indicating that the stays of lower-end tourists to Palau tend to be relatively short, increases in the departure tax should impact more heavily, as a proportion of total spend, on lower-end tourists. An analysis of the impact of the increase on lower-end tourism is vital, and detailed tourism statistics are urgently required.

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

Box 1: Conclusions of the Jamieson and Francisco Report on Tourism Policy Options in Palau

- There is a limited understanding of the concept of high-value tourism. The concept is currently 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. High-value tourists 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 be effective in dealing with tourism issues, without a coherent framework for policy making, implementation, and evaluation.
- One of the key factors to address is the creation of opportunities for local people to become part of the tourism economy through entrepreneurship and ownership.
- Policies must take the following issues into account:



Source: W. Jamieson and R. Francisco. 2015. Policy Options for Tourism Development in Palau. Unpublished.

Licensing of Travel Companies

Much stricter licensing of tourist operators is an alternative that may help to ensure the quality of the tourist experience in Palau, and could more effectively promote ecotourism. Operators are currently licensed by the Palau Visitors Authority; however, there are no enforcement provisions. Tourism operations are often poorly organized and conducted, and many operators do not comply with licensing restrictions.

Botswana is one of the world leaders in promoting high-end ecotourism. Would-be tourist companies are required to complete an environmental impact

report as part of their application process, and to meet the high standards of operation.¹¹ There is also a national ecotourism certification program that further encourages tourism businesses to be more environment-friendly.

These policies mean that fewer people are visiting Botswana's tourist attractions, such as the Okavango Delta and Chobe National Park, but visitor 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 strategy is a powerful example for countries that want to

¹¹ To access Botswana's application requirements, go to http://www.mewt.gov.bw/DOT/article.php?id_mnu=97

develop their ecotourism industry while not harming the environment. It is a strategy that could well be emulated in Palau.

Although Palau has put in place the licensing of tour operators, there are no enforcement measures to ensure that only licensed guides take tourists to attractions. An important policy implementation issue is to ensure that there is adherence to licensing requirements. A limited number of Palauans have the skills required to work in businesses 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 more discerning expectations regarding the quality of service they receive, which is understandable given the higher amounts that they are spending on their tourism experience. A limited number of Palauans may have learned these skills as the tourism industry has grown, but tourism fronts have generally limited the spread of training.

Enforcement

Without appropriate enforcement, few policy measures to limit visitor numbers will be effective. In selecting the appropriate combination of instruments, ease of enforcement must be an important factor.

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 regulations based on market mechanisms, together with substantial penalties for breaches to these regulations.

Palau has many crucial steps to take to implement an effective tourism policy. In particular, an analysis by tourism and environment experts is needed to determine the carrying capacity for Palau's natural attractions. The current level of low-end tourism risks the future of the whole industry, which constitutes an important contribution to Palau's prosperity.

Once the carrying capacity of the country's attractions has been determined, the Palau authorities will be able to determine the appropriate level of the charges and levies suggested above. It must be stated, however, that arriving at the correct price will not be an exact science and may require some trial and error. It is, therefore, important that the regulations set in place be sufficiently flexible to allow price changes to be easily made. Only in this way will the great natural beauty of Palau be preserved for future generations.

6 LAND

Recommendations:

- Introduce a 90-day window for clan members to file any objection 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 (EAG) 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 sensitivities into account. In particular, the communal ownership of much of the land in the Pacific requires unique measures, with no parallel experience in other parts of the world to provide guidance.

Nevertheless, there are potential solutions that could make the resolution of land issues in Palau more straightforward, without impinging on cultural and traditional factors. The following paragraphs outline some directions for policy makers, but far deeper analysis is required than there is space for in this private sector assessment (PSA).

OWNERSHIP

Landownership in Palau is restricted to Palauan citizens, but foreigners are permitted to lease land with terms up to 99 years. During the period of Japanese colonization, most of Palau was surveyed. However, during World War II, most of these records were destroyed and, as a result, there are a large number of land disputes. These disputes are adjudicated by a Land Court.¹² By the end of 2014, about 14,000 of 18,000 parcels of land had been processed through the court.

Landholdings in Palau are complex. Land can be owned either individually, by families, by chiefs of the village, or by clans. Both the state and national governments also own land.

The concept of ownership by individual 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 passed by women down the generational line, but the influence of women over land sales, leases, and

¹² Decisions by the Land Court are final and cannot be appealed.

other land issues is only indirect and is exercised through their influence in clans. Land court judges are central to the system of land adjudication, and their role in deciding property rights 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 landholdings or transactions. One implication of landownership being confined to Palauans is that foreign-owned financial institutions cannot repossess property in the event of a default on a loan secured by either a mortgage or a land lease. This restriction can, however, be overcome through the use of trusts, but these are rarely used. This issue is discussed in more detail in the Finance section.

State and national governments own a substantial proportion of land in Palau, but similar issues have arisen as those for privately held land. A number of parcels in government possession are under dispute. When cases are brought against the government, the burden of proof is on the claimant and they are seldom successful in court. Once government ownership is conclusively established, the potential for leasing land to investors increases the supply of available property and provides a potentially significant source of revenue. This scenario should be explored and adopted as government policy.

LAND LEASING ISSUES

As is the case in most Pacific island economies, most investors in Palau lease land. The leasing framework is, therefore, central to an effective property market.

Structure of Leases

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

- (i) Leases should be long term in order to encourage prolonged investment. This is not a problem in Palau, where 99-year leases are allowed.
- (ii) A well-structured lease should set out the terms under which the lease might be renewable.
- (iii) For communally held land, there is a case to be made for intervention by the government to protect the rights of future generations. Consideration should be given to having consistent lease lifecycles, to determine which future generations will benefit from a land lease. The leasing framework could provide for a relatively small upfront payment, with the bulk of lease payments spread over the lifetime of the lease. This requires that discounting over time takes place as explained in the footnote.¹³
- (iv) 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 are made. However, it must be recognized that, even for leases of 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 to introducing laws that specify how lease

¹³ An upfront payment is more valuable than a stream of payments that add up to the same amount spread over a number of years. 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.

payments for individually owned land can be structured.

- (v) The success of a venture located on leased land should be at least partly reflected in lease payments. This helps ensure that lessors have a stake in the success of businesses on leased land. The structure of these lease payments could include a type of “percentage rent” formula, whereby the lessor obtains a percentage of the revenues generated by the development or commercial enterprise.

Reliability of Leases

Discussions with land court judges, real estate agents, and financiers suggest that the Land Court processes and adjudication functions are effective. However, a significant problem arises because the court can adjudicate only on ownership of land parcels by clans, and not on the membership of any given clan. While it is probably beyond the remit of the Land Court to adjudicate on clan membership, some process is needed to make lease agreements more certain.

Individuals claiming to be clan members can currently sue the lessee for lease payments, even though they were not parties to the original lease agreement. This undermines the reliability and credibility of leases that have been entered into with clans, and dramatically devalues leases that have been taken by lenders as security for loans. Court cases on this issue can be unresolved for years, with the lessee not knowing who is the rightful recipient of lease payments that are being made. To solve this problem, a provision needs to be added to laws governing land leases that establishes a period during which any claimant can come forward and, upon expiry of such time, no further claims can be made. An appropriate period of notice for claimants

is potentially 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 of random and unexpected claims on ownership.

Land-Use Planning

For a country blessed with great natural beauty, the lack of any comprehensive planning structure for land use and environmental preservation in Palau is striking. This is especially so considering that Palau’s future as a tourist destination depends on conservation measures to prevent the degradation of its World Heritage sites.

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

- (i) environmental vulnerability;
- (ii) the impact of development on communities;
- (iii) the establishment of land-use patterns related to tourism;
- (iv) planning of building essential infrastructure (sewerage, water, power, and other infrastructure, and
- (v) an institutional structure at all levels of the government that incorporates mechanisms to ensure that Palau’s natural beauty is preserved.

Developing systems such as these will ensure that visitors and Palauans alike can enjoy the best possible experience from the country’s environment and natural attractions.

7 ACCESS TO FINANCE

Recommendations:

- Abolish the usury ceiling on commercial loans made by foreign-owned lenders.
- The Financial Institutions Commission should consider recognizing loans secured by movable assets as secured loans under its regulatory framework.
- Widen the discussion of the transition of the National Development Bank of Palau (NDBP) to a deposit taking institution into a comprehensive strategic review of the overall funding of the NDBP.
- Build the capacity of the NDBP to improve its systems for granting and monitoring loans.
- Abolish the requirement that the NDBP can only lend to companies that are majority Palauan-owned.
- Establish a credit bureau that is also linked to the United States credit bureaus.

There are six banks operating in Palau: five licensed commercial banks and the NDBP.¹⁴ All banks are able to make both consumer and business loans, but the NDBP is the only institution able to accept land as security. Overall, commercial banks in Palau are reluctant to lend for commercial purposes. This constraint on business access to credit, in turn, constrains private sector development and economic growth. This chapter analyzes reasons for the low access, and offers policy proposals to make business financing more readily available in Palau.

Commercial banks had high levels of excess deposits at the end of 2015. The percentage of total deposits in relation to total loans increased from 573% to 761% during the course of the year,

as deposit growth continued to outpace loan growth.¹⁵ The percentage of private sector credit as a proportion of gross domestic product (GDP) is less than 15%. This 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, intermediation is clearly low, and a good case can even be made that the financial system is actually disintermediating. Of the \$213 million held in liquid assets by branches of foreign banks, approximately \$210 million is held in the form of demand deposits due from head offices in Guam and Hawaii.

At the same time, the NDBP, which is the country's main source of mortgage lending, has constrained liquidity. The NDBP is highly liquid in a

¹⁴ Bank of Hawaii, Bank of Guam, Pacific Islands Development Bank, Asia Pacific Commercial Bank, Palau Construction Bank, and Bank Pacific.

¹⁵ Republic of Palau Financial Institutions Commission. 2015. 2015 Annual Banking Industry Report. Koror.

technical sense—it has sufficient liquidity to cover short-term obligations to creditors and fund normal operations—but it does not have a source of regular cash inflows. This means that it cannot easily fund additional loans and has to carefully manage existing funds to meet undisbursed loan commitments.

It is, nonetheless, surprising that, in a country with a per capita GDP of \$16,000, lending opportunities are limited. There are a number of reasons for the reluctance of commercial banks to lend to businesses. The most important are

- (i) **Usury law.** The usury law is one of the most important reasons why it is difficult for local businesses to obtain credit. Under 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% per annum, and the interest rate on lending to businesses is capped at the prime rate on corporate loans at large US Money Center Banks plus 4 percentage points.¹⁶ As of 1 October 2015, the prime interest rate was 3.25% per annum. This implies that the highest interest rate that a commercial bank in Palau can charge on a business loan is 7.25% per annum.

How does this compare with interest rates charged to small businesses in the US? Small businesses are the only suitable comparator because there are no businesses in Palau that would qualify as medium-sized enterprises as that definition is generally set in larger countries. An

informal search of internet lenders reveals interest rates that range from 8% to 40% on small business loans in the US.¹⁷ More formal analysis of small business lending reveals that traditional lenders are often reluctant to lend to small businesses. However, in the US, new types of lenders have emerged to fill this gap (Box 2).¹⁸

If small businesses in the US—where the legal and institutional structures are far more developed than in Palau—are borrowing at interest rates far higher than the Palauan usury laws permit, it is not surprising that there are few business loans being made in Palau.

These restrictions do not apply to the NDBP. Under the National Development Bank of Palau Act, the NDBP is specifically exempted from the provisions of Chapter 3 referred to above.

- (i) **Information problems.** Little, if any, public information exists about the performance of small businesses in Palau, and many small businesses lack detailed financial data. This makes it difficult for lenders to interpret the performance, financial statements, and growth prospects of small businesses, and therefore to assess the creditworthiness of small business borrowers. Asymmetric information issues arise because business owners always know more about their businesses than anyone else. These owners may also be concealing important commercial facts from the lenders.

Information is often unreliable in the best of circumstances, and, in Palau,

¹⁶ As published in the *Wall Street Journal*.

¹⁷ As of 1 October 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.

¹⁸ K. G. Mills and B. McCarthy. *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. Massachusetts.

Box 2: An Assessment of Small Business Lending Globally

Bank loans are critical for driving the growth of small businesses. Without access to credit, small businesses have to rely on retained earnings, which is seldom a stable or reliable source of capital. Yet obtaining business loans is a difficult and often prolonged process, even in advanced economies. It is a mistake to think that the issues facing business financing in Palau are unique. In the United States, bankers often indicate that they are interested in lending to small businesses but have trouble finding creditworthy borrowers. As a result, a substantial proportion of small business loan applications made to traditional banks are denied. Search costs associated with lending to small business are high for both borrowers and lenders, with transactions costs forming a significant portion of the expense in small business loans. 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.
- Lending to small business is riskier than lending to large business.
- Assessing credit worthiness of small businesses is difficult due to information asymmetry. Business owners will always know more about their businesses than the lenders. Because of poor record-keeping, small businesses frequently lack detailed balance sheets and income statements.

Transactions costs for processing a loan of \$50,000 are not much different from those necessary to process a loan of \$500,000. 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, nontraditional lenders have emerged to fill in this financing gap. In the United States, Lending Tree, Fundera, Biz2Credit, and Lendio are examples of a new type of lending institution in the market for small business loans. The interest rates that these institutions charge range from 12% to 40%.

Source: Pacific Private Sector Development Initiative.

some bankers report that the problem is exacerbated by many businesses not filing accurate tax returns.

Bankers report being confronted with two separate sets of financial statements; one that is used for tax returns, and one that represents the true state of the business. 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 lack of transparency in small business reporting adds to the riskiness of lending to small business, making it difficult for bankers to determine a creditworthy borrower from

one that is not creditworthy. It is difficult to assess how widespread this problem is across Palau.

The two large foreign banks in Palau—Bank of Guam and Bank of Hawaii—are both branches of offshore headquarters. The Bank of Hawaii uses credit-scoring models for loans up to \$50,000, all of which are unsecured, but few borrowers in Palau qualify for these types of loans. Both offshore banks have access to US credit bureau reports. This is an advantage that local banks, including the NDBP, do not have but which could be remedied with the establishment of a locally domiciled credit bureau that was also linked to US bureaus.¹⁹ These reports

¹⁹ Palauans have nine-digit identity numbers, which are consistent with US social security numbers that are the identifying numbers used in credit bureau reports in the US. Incentives to repay loans to the foreign banks is increased 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.

are used extensively in making consumer loans. Both banks indicated that they would like to make more business loans, but Palau's usury ceiling and information problems made it difficult to do so.

Mortgage Lending

Some banks in Palau offer lending on fixed property consisting of land and buildings. However, the ability to use fixed property as security is complicated by limitations on who can own land. 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 on a loan.

Restrictions on title possession do not apply to locally owned banks or to the NDBP. As a result, the NDBP, which is the most active lender, dominates lending for the purpose of purchasing fixed property, with approximately 50% of its loan portfolio consisting 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, but this raises transactions costs and complicates legal processes.²⁰

All lenders engaged in mortgage lending perceive loans made on land leased by clans as being fraught with risk, due largely to unexpected claims of landownership being made by previously unrecognized clan members. These lenders strongly support a limitation on the time frame clan members have to challenge leases.

Secured Transactions Reform

The Secured Transactions Act was passed in Palau in 2012, and the electronic registry was launched in January 2013. So far, however, registration has been limited. By the end of 2015, only 663 security interests had been registered. The rate of increase has also 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 movable property.

During 2015, use of the secured lending framework declined substantially. The Financial Institutions 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 \$1.1 million during the 2015 calendar year.”²¹

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

- (i) Business lending is limited, due to the ceilings imposed by the usury law.
- (ii) Many consumer loans are unsecured.
- (iii) 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. Some large loans are, inexplicably, still being made as unsecured loans.
- (iv) For the foreign banks, credit decisions are made by headquarters outside the country. These head offices do not

²⁰ 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 three-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.

²¹ Republic of Palau Financial Institutions Commission. 2015. *Annual Palau Banking Sector Report*. Koror. p. 9.

appear to consider the use of the secured transactions framework by their local office as being important.

On a more positive note, available evidence indicates that there has been an increase in the number of women borrowing money using non-land assets as collateral. There has also been an increase in the number of men and women borrowing jointly. Such transactions are worth noting for two reasons: (i) they allow loans secured by personal property to be approved, which is essential in an economy where much of the land is customary, and where title to land is heavily contested; and (ii) they assist women to build up their credit histories, facilitating future borrowing at lower interest rates.

The National Development Bank of Palau

The NDBP's mandate is to promote the economic development of Palau. It is the only financial institution able to directly take land as security, and is by far the biggest mortgage lender in the country. The NDBP 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.²²

Amending legislation governing the operations of the NDBP was signed by the President of the Republic of Palau in December 2014. It allows the NDBP to take deposits, and brings the NDBP within the regulatory framework of the country's Financial Institutions Commission (FIC). The motivations for this change were to increase the opportunity for NDBP to raise funds domestically, to strengthen NDBP, and to provide a basis for

the later development of a domestic clearing mechanism centered on NDBP.

Overdue loans have been rising and systems for monitoring loans have deteriorated. An FIC review of the NDBP's loan portfolio, conducted in November 2015, found that the nonperforming portion of the NDBP has risen to close to 12%. Borrowing criteria are often not in accord with the mandate of the NDBP to promote business. Borrowers are often 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 in order to secure the loan. This requirement does not promote the funding of entrepreneurship. As of mid-2016, the NDBP's new management is addressing these issues, and since the NDBP was placed under the FIC regulatory umbrella, the bank has started to realign its policies with FIC's prudential requirements for licensed banks.

The NDBP will have to improve service delivery to attract customers, and to reduce existing lengthy delays in processing loan applications. The FIC review also found that loan processing is slow, and all loan applications, whatever the size, have to be approved by the board of directors, further adding to processing times.²³

National Development Bank of Palau Funding

The NDBP does not currently take deposits and is funded primarily through long-term borrowings. This means that its only ongoing source of cash is the funds made available through customer loan repayments. This constrains its capacity to make

²² See S122 Financial Institutions Title 26.

²³ FIC, Bank Examiner's Report, Unpublished.

new loans. The ability to take deposits has the potential to alleviate this constraint and increase NDBP lending.

Legislation passed in December 2014 was definitive in incorporating the NDBP into FIC's regulatory framework. Under that framework, a bank is a deposit-taking institution. The amending legislation stipulated that the NDBP should start taking savings accounts deposits and issuing bonds 2 years from the effective date on 5 December 2016, and take demand deposits 3 years from the effective date on 5 December 2017.

The scale of the business transformation that was needed for NDBP to be able to take deposits and issue bonds, and the associated capacity constraints, meant that NDBP was not in a position to meet these targets. It consequently sought approval from the President of the Republic of Palau to delay the respective target dates to 31 December 2017 and 31 December 2018. The legislation to give effect to these changes is currently before the Congress.

As noted earlier, 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 these banks are not lending locally. Palauan savings are therefore not financing investment in the country. The effects of the usury law, referred to above, make it easy to understand the reluctance of the commercial banks to lend to businesses.

One broad potential solution to these problems is to make greater use of the secured transactions framework to intermediate this liquidity through NDBP. In theory, commercial banks could lend to the NDBP, where these loans were themselves

secured by NDBP loans, where NDBP's secured interest in these loans were registered under the secured transactions framework. Borrowing from pension funds and social security funds in this way is also a possibility. The mechanism would to use a charge against this asset as security for lines of credit from commercial banks. This would enable the NDBP to increase or reduce its borrowing against its portfolio, depending on the demand for loans, thereby giving it more control, and flexibility, in managing its liquidity. The NDBP would only need to draw on credit facilities when it is necessary to do so.

In practice, there are several obstacles to using the secured transactions framework in this way. These include potential AML-related restrictions on the ability of US-supervised banks to loan to a Palauan bank, and also the management of pension and social security fund investments by investment managers domiciled in the US. In these circumstances, the emphasis being placed on NDBP deposit-taking is understandable.

The extended timeframe for NDBP taking deposits brings with it the opportunity for NDBP to take a more strategic approach to the funding constraint it faces. This PSA recommends strongly that deposit-taking and bond issuance can be discussed within a wider discussion of improving financial intermediation in Palau, and that these discussions be separated from any discussion on establishing a local clearing mechanism centered on NDB. This PSA also recommends that the NDBP Board and management develop a viable business model based on the strategic direction that is identified. This will require NDBP to identify whether deposit-taking facilities should be available to a small number of large customers, or to everyone (the costs of the former will be much lower than the costs of the latter).

Other issues that need to be investigated more thoroughly are whether:

- (i) The licensing of NDBP as a bank under FIC's regulatory framework means that NDBP is subject the usury ceiling on business loans;
- (ii) Palau's pension funds and social administration fund could lend to the NDBP, secured by NDBP loans;
- (iii) Whether there are any anti-money laundering-related constraints that would prevent Bank of Guam and Bank of Hawaii lending to NDBP;
- (iv) whether NDBP, once it is a licensed bank, can still only lend to companies that are majority Palauan-owned. This denies financing to companies that could assist in the development of the country through business growth and expanding employment, and should be abolished.

The Financial Institutions Commission

The FIC supervises commercial banks and the NDBP.²⁴ It has done a commendable job in restoring stability to Palau's finance sector. 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 Palauan financial system even further.

The FIC also serves as the registrar under the Secured Transactions Act. A greater use of the secured transactions framework would improve the stability of the financial system, if the FIC recognized these loans as secured loans in its regulatory standard. This would encourage banks to make loans secured by movable assets recognized under the secured transactions framework, in addition to the more traditional loans secured by a mortgage on fixed property. Lenders could be expected to reduce the amount of unsecured lending, as unsecured loans would have a higher-risk weighting, requiring higher a higher capital offset, than secured loans.²⁵ If commercial banks secure all loans above a \$5,000 threshold, for example, the quality of their portfolios will be higher and they will become more familiar with the secured transactions framework.

Pension Funds

The 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 independently audited reports. Administrators of the two funds and the FIC agree that a sound regulatory framework is needed. In the meantime, provisions for replenishing the pension funds need to be made through higher contributions and budgetary allocations.²⁶ The solvency of the two funds will be helped by the abolition of the 30-year mandatory retirement program for government employees.

²⁴ The FIC acquired supervisory authority at the end of 2014.

²⁵ 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.

²⁶ International Monetary Fund. 2014. Republic of Palau, 2014 Article IV Consultation. Washington, DC; and Economic Update. 2014. Economic Monitoring and Analysis Program. Washington, DC.

8 AGRICULTURE

Recommendations:

- Develop a national agriculture 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.
- Abolish quarantine rules to lower costs and reduce Palau's vulnerability to supply disruption.

Palau has a small agriculture and aquaculture sector, which, together with forestry, contributed the equivalent of 1.2% to Palau's gross domestic product (GDP) in 2014. The sector consists of a few commercial farms, informal growers, subsistence farming for household consumption, and government extension activities. Little is known about noncommercial production, and projections in relation to population change are estimates only. With a recent estimated decline in population, production estimates are also down. Supply linkages to the tourism sector might afford opportunities for increased agricultural output, as demand for foodstuffs expands in line with growth in the tourism industry. Agricultural produce also retains importance in traditional Palauan social exchanges, but this demand is being met almost entirely by imports.

Studies undertaken by the Social Security Administration indicate that the number of people

employed in agriculture and aquaculture in Palau has declined steeply from 2010 to 2015, with only 57 people recorded as being formally employed full-time in the sector in 2012.

Palau imports the majority of its agricultural produce, primarily from the United States (US). Food imports, valued at over \$40 million in 2015, are 125% higher than in 2004 and represent 82% of the value of all food available in the Palauan economy.²⁷ Licensing is required only for agricultural and health reasons, and inefficient regulation is hampering the operation of the country's trade regime. Quarantine rules require that agricultural produce, and other goods requiring health clearance, must be imported only from the US, which substantially raises the cost of imported food. It also increases the vulnerability of the economy to unexpected events. In 2013, a vessel bringing fruit and vegetables from California was delayed for 4 weeks, and Palau exhausted its stocks of fresh produce.

²⁷ Graduate School USA, Pacific Islands Training Initiative. 2016. *Fiscal Year 2015 Economic Review*. United States Department of the Interior, Office of Insular Affairs, Honolulu.

Palau's climate is well suited for year-round production of fruits and vegetables, and has the possibility for increasing aquaculture output. Small plot sizes, and the difficulty of consolidating plots to economically viable sizes, have contributed to the failure of the agriculture sector to develop. An additional factor is that much of the soil in Palau is clay, with extensive investment required to make it fertile.

There are a number of key issues that impact Palau's agriculture sector.

- (i) Palauan interest in farming has declined steadily, as illustrated by the low levels of employment in the sector.
- (ii) A few earlier-generation Chinese employ imported labor to farm vegetables, fruits, and traditional produce on a commercial basis.
- (iii) Some subsistence farming of traditional foods continues.
- (iv) Much of the commercial farming in Palau is done under short-term lease arrangements, often of only 1-year duration, which also deters extensive investment in the sector.
- (v) There is a substantial amount of unused land, but soil quality is low and pests abound.
- (vi) Market access for farm produce is limited. There are some direct farm-to-supermarket sales, but they are limited. The overall demand for fresh produce greatly exceeds domestic supply, but the extent to which agriculture might provide

a return on investment is limited by prices for imported produce. Improved efficiency in Palauan agriculture is a prerequisite for this policy to succeed.

- (vii) The NDBP provides lending for agricultural ventures, including a Farm Loan Program, but few loans have been approved.

There is a nascent organic farming sector in Palau, but there are only around 100 full-time and part-time farmers producing organic fruits and vegetables in both the formal and informal sectors. There is a need for a formal and periodic market structure, which could be used as an outlet for this fresh produce. With a regular market in place, incentives to invest in produce of higher quality would increase.

AGRICULTURE AND AQUACULTURE POLICY STATEMENT

In November 2015, a sector policy statement was approved for the Palauan agriculture and aquaculture sector. It contains many of the objectives and policy options outlined in this document. 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. The Palau Chamber of Commerce is seen as an intermediary in the process, bringing together food producers and potential purchasers such as supermarkets and hotels.

While these are sensible and appropriate goals, further initiatives will be needed to expand the supply of locally produced foodstuffs in Palau.

CONSTRAINTS AND POLICY MEASURES

Governance issues hamper the development of the agriculture sector in Palau. These issues include a lack of land-use planning and no support for agricultural research. Several government agencies are also involved in the sector, with conflicting aims and objectives, and limited or no coordination between them. As a result, policy and strategy have been guided by intermittent and often ineffectual donor assistance.

Agricultural development in Palau requires a coherent and long-term strategy; one that is owned and institutionally supported by the various organizations involved in the sector. It also requires additional support from the government more generally.²⁸

Out-grower farming and contracting schemes vary according to market circumstances.²⁹ There are also many alternatives to these operations. The agriculture sector in Palau is insufficiently developed to consider formal purchase agreements, management contracts, joint ventures, or any significant sharecropping. Alternatives include plantations, government ownership, and cooperatives. While plantation agriculture could possibly suit forestry and production of tree crops, sufficient land may not be readily available. Government ownership and agriculture

cooperatives have not proven viable over the long term in the Pacific islands.

Whether Palau's agriculture 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. The country's current 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 growers and/or foreign investors.
- (ii) Government and growers could work with selected supermarkets and hotels, through the Palau Chamber of Commerce, to develop the market through produce contracting.²⁹
- (iii) In return for government support, the selected nuclear, commercial growers share their broad agribusiness models, and work with the government to expand operations, including establishing a scheme for smallholder out-grower farming.

²⁸ 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.

²⁹ 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 the contracted commercial farms' output. The commercial farmer(s) would act as an intermediary between market and smallholder. 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*. Koror.

- (iv) Under the leadership of the director of the Bureau of Agriculture (BOA), all relevant government departments, nongovernment organizations, and the managers of donor-supported agriculture programs would be invited to commit their support to the policy.³⁰
- (v) BOA staff and resources; research (especially on soils, land use, husbandry, pest control, and economics); extension and training; preparation 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, access finance, negotiate market contracts, assess gross margins, and plan and manage farming businesses.
- (vii) Establish a market where organic produce could be offered for sale on an ongoing basis.

Agriculture is one sector in which Palau can generate value-added in its economy, but it remains questionable as to whether or not agriculture should be a primary focus of development policy for the country. While a number of the policy measures outlined earlier can improve the efficiency of the sector, it is unlikely to become a major contributor to growth in Palau's economy.

A key issue in implementing an agriculture sector policy in Palau will be the oversight necessary to ensure that the steps outlined above are being followed, and that the agriculture policy statement becomes meaningful. The EAG has an important role to play in ensuring that the momentum for developing the sector continues. The director of the BOA should provide regular updates to the EAG, including problems encountered in implementing the goals of the policy statement. This is an essential step in promoting the development of agriculture in Palau.

³⁰ The FAO report (footnote 7) calls for the formation of a "Food Policy Council." The Medium-Term Development Strategy chapter on agriculture, para. 17, also refers. Government of Palau. 2008. *Facility for Economic & Infrastructure Management Project Agriculture Sector Report*. Koror.

9 COMMERCIAL LEGAL FRAMEWORK

Recommendations:

- Pass a new Corporations Act, establish an electronic registry, and use this framework to deal with the issue of “businesses nominally owned by Palauans, but in reality are controlled by a non-Palauan front(s).”
- Develop a modern business licensing system and integrate it with the electronic corporations registry.
- Draft new bankruptcy legislation to better protect individuals.
- Amend the November 2016 Foreign Investment Act so that it is consistent with any new corporations legislation; place foreign corporations under the jurisdiction of the Registrar of Corporations; integrate foreign investment registration into the electronic registry to be deployed for all corporations.

This section focuses on Palau’s business law framework, where reform is urgently needed. Priority areas include the Corporations Act and registry, bankruptcy issues, business licensing issues, and foreign investment legislation and reform. At the same time, detailed diagnostic analysis is needed in the 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 (US). A comprehensive 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.³¹

In the absence of written law or local customary law, the courts of Palau apply common law.³² In practice, the majority of 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 US, commercial transactions are governed by the Uniform Commercial Code (UCC), which was adopted in 1953. Palau has no equivalent of the UCC. Its courts are forced to search for precedents in the US, among decisions that were taken prior to the adoption of

³¹ Described in D. P. Ryan. 2005. *Essential Principles of Contract and Sales Law in the Northern Pacific*. New York: New York University. p. 30.

³² Although local customary law and acts take precedence over common law.

the UCC. Since commercial practice in the US has evolved substantially over the past 50 years, Palau's system of commercial law is hampered by having to rely on outdated precedents.

As Palau becomes further integrated into the world economy, the importance of having a modern legal system will increase. To increase commercial transactions with foreign businesses and individuals, it is necessary that all parties know with whom they are dealing. They must be confident that they can enter into contracts in the knowledge that, if one of the parties fails to fulfill their obligations, there is 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 creating a business environment that would foster private sector growth in Palau.

THE CORPORATIONS ACT

The country's Corporations Act is outdated and not suitable for modern commerce. An internal review by the Pacific 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 were

- (i) 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.

- (ii) 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 to modernize the legal framework for company formation. For example, to incorporate a company, three incorporators must currently present themselves to a clerk of the Supreme Court or a notary to sign application documents. This is an outdated approach to corporate formation and is no longer followed in an overwhelming majority of jurisdictions.
- (iii) The President of the Republic of Palau must approve all new companies, including articles of incorporation and bylaws. This is an extremely inefficient requirement, delaying incorporation and wasting the valuable time of a head of state. A far superior process, which conforms with modern registries, is to pass legislation that states clearly the requirements for the creation of a company. Standard forms, which could be completed online, are then produced to act as a checklist to incorporation. The 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 accelerated. Experience in Samoa, Solomon Islands, Tonga, and Vanuatu has demonstrated the value of this process, with a significant reduction in time and costs required to register a business.³³

³³ In all of these countries, businesses can be created online in a day or less.

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

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, or to identify who the true shareholders are or 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 corporations 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.

An electronic registry would also greatly increase risks for anybody trying to create a front. It would remove any ambiguity with respect to shareholding and directorships. Anybody attempting to use a Palauan as a front person would risk having to surrender the business without recourse to any legal protection.

Source: Pacific Private Sector Development Initiative.

- (iv) Current regulations require that all requests to search the registry be submitted in writing. This makes the process slow and costly. It is also counterproductive, since an important function of a corporations registry is that it presents information about the shareholders, officers, and directors of a company in an efficient manner. This allows the public to determine who is authorized to enter into agreements on behalf of the company, and to ascertain an official address to which correspondence and legal documents can be delivered to the company. This knowledge provides for more reliable contracting and reduces the risk of transacting outside the country—an essential function for an economy like that of Palau, which relies on foreign transactions for its prosperity.
- (v) The Pacific Private Sector Development Initiative (PSDI) has been asked by the

government to draft a new Corporations Bill³⁴ that modernizes Palau’s business framework and allows for the creation of an electronic corporations registry, which would be developed as part of a reform.

LICENSING

The section on tourism suggested that improved standards for tourism businesses and operators are needed in Palau. It suggested that Botswana’s business licensing framework is a model worth emulating. Policy makers and bona fide tourism operators interviewed for this PSA pointed out the drawbacks of the current system, in Palau, which has overlapping jurisdictions and lacks a centralized system of licensing. Many of these problems could be dealt with by changing the licensing regime and using the electronic corporations registry to record tourism business licenses as well.

³⁴ The request to PSDI was received in April 2016, with policy design work commencing in May 2016. Work on a draft bill commenced in late 2016 and will continue into 2017.

BANKRUPTCY

Palau lacks a bankruptcy statute for individuals. This has a significant impact on the risks of doing business. The proof-of-debt procedure is long and complicated for the average debtor or creditor. Even when small or insignificant sums are involved, legal practitioners must be employed to assist clients in navigating through a maze of procedures. Debtors, who cannot afford lawyers for themselves, are faced with large legal bills from their creditors' lawyers. There are 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 foreign investment system, which is outlined in the Foreign Investment Act passed in November 2016. However, many provisions of the new act may harm the development and growth of Palau's economy.

The Foreign Investment Regime

When starting a business enterprise in Palau, it is a requirement that all foreign investment and foreign investors go through an approval process. Applications must be submitted to the 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.

- (i) The act specifies that in order to obtain approval, the minimum foreign investment

should be \$500,000. Or in the case of a hotel, \$5 million. The business must have at least 20% of its workforce consisting of Palauans.

- (ii) The act requires a very extensive business plan, financial projections, details regarding employment generation, and justification that such skills are not available locally.
- (iii) 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.
- (iv) Permission to operate foreign businesses is granted for a fixed period, thereby shortening the investment horizon.
- (v) 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 itself, has the skills to evaluate.

In spite of, or perhaps because 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 restrictions on foreign investment. These fronts occur in all areas nominally reserved for Palauans.

The New Foreign Investment Act

Palau recently enacted sweeping amendments to its Foreign Investment Act.³⁵ These amendments had been under consideration since at least 2013 and

³⁵ The amendments originated in House Bill No. 9-6-1, HD1, SD2, PD2.

legislative action was taken at the end of 2016. The first section of the amending legislation contains this narrative setting forth the intent of the new law:

Legislative findings. The Olbiil Era Kelulau finds that one of the best available means to encourage the expansion of Palau’s private economic sector so as to help create a more broad-based and sustainable economy is to modernize and incentivize the Foreign Investment Act. The creation of a broad-based sustainable private sector economy in Palau will help lessen our people’s dependence on government as the preferred and primary source of employment and livelihood in Palau by creating alternative, private sector jobs and other business opportunities for Palauan citizens and residents.

The Olbiil Era Kelulau further finds that private business within the Republic of Palau must be protected. In effect, a proper balance must be found that encourages foreigners to invest money in the Republic of Palau to create a vibrant economy and lift up the livelihoods of all, while at the same time protecting Palauans from foreigners who could swallow up their ability to compete. This bill maintains the local ownership requirements set forth in 28 PNC § 105, while expanding the incentives for foreigners to invest and easing the bureaucracy toward obtaining a license.

The amendments make several changes to the law regarding foreign investment and it will take some time to determine whether these changes work for the overall economic benefit of Palau. The

following are some of the significant elements of the new law in Palau:

There is an emphasis placed upon trying to capture identities of the beneficial or “true” owners of businesses. These changes are in response to the perception that many foreigners own local businesses through “fronts.” The Foreign Investment Board is given new powers of inspection and enforcement in this regard, and there are harsh penalties for the failure to disclose a beneficial ownership. There are a number of factors listed that a court could use to determine if a local business is in fact a “front,” some of which may be more relevant than others.

A foreign investor must obtain board approval if it intends any “sale, assignment, encumbrance, or transfer of any 5% or greater beneficial interest in such grantee.” This is a tremendous overreach. It appears that this language means that if an international hotel chain like Hilton were to operate in Palau, it would need board approval to engage in what really are normal corporate activities, such as having a new investor purchase shares in the open market pledging shares to stand good for a loan. It is hard to see how any large overseas hotel chain would ever consider investing in Palau in light of this provision.

All foreign investments are to be assessed by the Board under a variety of rather subjective criteria, including whether there is an economic need for the proposed activity, and the likely impact on existing local businesses. This is not consistent with a free-market society: it is not up to bureaucrats to determine whether there is a need for a particular business. Further, it serves to entrench local

businesses which may not be serving the people by promoting monopolistic pricing power.

Foreign investors are required to hold a board meeting in Palau each calendar year. Again, it is difficult to see how a multinational hotel chain would submit to this.

Each foreign investor will be required to pay \$500 to the government for each noncitizen they employ. Obviously, this is an additional expense to be borne by foreign investors. This requirement also applies to independent contractors as well. It is unclear whether this would include someone brought in from overseas to complete work on some equipment where no local skills exist to complete such work.

A new minimum investment threshold appears in the law. No foreign investor will be granted authority to invest unless they “make and maintain” an investment of “\$500,000 or, in the case of a hotel, \$5,000,000. The investment may be in cash or cash equivalents. It is uncertain what research or analysis went into setting these levels, which seem extraordinarily high. There is also a requirement that a CPA acceptable to the Board must certify the investment levels each year. This is an additional expense that foreign investors will have to incur.

As with the existing law, business activities that are reserved for Palauan citizens are listed in the act. Economic conditions change over time, and what may be appropriate for inclusion on a restricted

list today may not be a few years’ time. A better practice would have been to list these activities in regulations, and then provide a directive for a regular review of the list, with public input, so that the list maintains its relevancy.

The Foreign Investment Board is given broader regulatory authority over “minimum employment” levels, which may now be done on a sector basis.

Making Legislation Available

All of Palau’s legislation should be available for review without charge. The current practice of requiring a paid subscription for access to the country’s statutes is counterproductive, generates very little revenue, and makes access to the law exclusionary. This practice increases the risk of restricting investment and discourages bona fide investors. This provision should be abolished without delay.

Small Business Entities

Most businesses in Palau are very small, employing fewer than 15 people. A corporate form that is favored by many small businesses in the US is a limited liability company. This type of commercial entity has simplified procedures for establishment and fewer formalities to maintain than does a full-fledged corporation. It may be well-suited for small businesses in Palau.

10 ECONOMIC EMPOWERMENT OF WOMEN

Recommendations:

- Develop legislation to protect women from sexual harassment in the workplace.
- Through the Palau Chamber of Commerce, provide business training specifically designed for women entrepreneurs.
- Provide training on the secured transactions framework to assist women in obtaining finance.
- Increase awareness of the damaging impact of domestic violence and its economic implications.

Promoting greater participation of women in the private sector is generally recognized as smart economics. As well as utilizing an untapped economic resource, it increases the incomes of families and individuals. While women in Palau are engaging with the private sector, their ability to participate is adversely impacted by lack of skills and training, lack of business knowledge, institutional practices, and customary norms.

Strategies that encourage business start-ups include transparent and easy-to-understand company laws, featuring business forms that emerging entrepreneurs can interpret and use. Access to finance is equally important. Providing skills, training, and assistance with business development will also increase the ability of women to participate in the private sector.

Gender-disaggregated data are limited in Palau. The Census 2015 addressed this limitation by

collating information on the participation of men and women in the informal business sector and unpaid employment activities. Greater coordination between the Gender Division in the Ministry of Community and Cultural Affairs, the Palau Chamber of Commerce, and other government departments will help to address the data deficit, resulting in 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 conventions,³⁶ it has not ratified the Convention on the Elimination of All Forms of Discrimination against Women (CEDAW).³⁷ As of March 2015, Palau remains the only Pacific country not to have ratified CEDAW.³⁸ This convention calls for measures to overcome barriers to discrimination

³⁶ United Nations. 1948. Universal Declaration of Human Rights. Paris; United Nations. 1989. Convention on the Rights of the Child. New York (signed on 20 November 1948, ratified on 4 August 1995, and effective on 2 September 1990); and Fourth World Conference on Women. 1995. The Platform for Action. Beijing.

³⁷ The Convention for CEDAW was signed on 20 September 2011, but has not been ratified.

³⁸ On 6 March 2015, Tonga ratified CEDAW, leaving Palau as the only Pacific country not to have done so.

in political, social, economic, and cultural spheres, including addressing domestic violence. The reason for Palau's reluctance to ratify CEDAW 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 of sex."³⁹ Likewise, the Constitution commits to universal education.⁴⁰ 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 the participation of women within communities and in gaining employment. Palau is traditionally 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 of the country's states. The chiefs constitute the Council of Chiefs, which advises the President on matters of custom. However, such traditions have at times impinged on women's participation in the workplace. Customary laws on inheritance still operate in Palau. These laws directly discriminate against women, reducing their ability to control assets—something that is essential for entrepreneurial activity.

The Pacific Regional Millennium Development Goals Tracking Report, 2013, found that women remain underrepresented in national congress and cabinet. While there are currently three women out of 13 positions in Palau's Senate, there have been no women in the 16-person House of Delegates for 30 years.

A Gender Division has been established under the Bureau of Aging and Gender within the Ministry of Community and Cultural Affairs. This division acts to support initiatives that promote gender equality. Its mandate includes activities to develop a national gender policy; establish a database for reporting on gender quality issues; and serve as a focal point for national, regional, and international entities. However, the organization is poorly funded, with 0.01% of the national budget being invested in the promotion of gender equality and the empowerment of women.⁴¹

Discriminatory Laws and Practices

Customary practices and discriminatory laws can impact on the ability of women to engage with the private sector. One example is the laws on inheritance of land, which prioritize the oldest living male (or male child) over women.⁴²

Women's attitudes toward gender roles have been clearly framed by Palau's customary norms. This was reflected in a recent study, which found that nearly half of all women agreed with the statement that "a good wife obeys her husband,

³⁹ Article IV, Section 5 of the Palau Constitution.

⁴⁰ Article VI of the Palau Constitution.

⁴¹ B. Temengil. 2014. National Review of the Implementation of the Beijing Declaration and Platform for Action (1995) The Outcomes of the 23rd Special Session of the General Assembly (2000) in the context of the 20th Anniversary of the 4th World Conference on Women; and the Adoption of the Beijing Declaration and Platform for Action 2015. Government of the Republic of Palau, Ministry of Community and Cultural Affairs. Koror.

⁴² S301 Title 25 of the Palau National Code.

even if she disagrees.”⁴³ 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.⁴⁴

Major customary events, including funerals and celebrations of first births, require women of rank in the family (*buchel sechal*), or women who are married to men with important roles in the family, to be the principal providers of food, service, and gifts. Many women reported that they would be expected to contribute as much as \$10,000 for such ceremonies.

Such duties prevent women from being actively involved in the private sector because they have to take leave from work to perform such tasks.

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 underreporting, the issue remains unaddressed. A recent study revealed that there had been a rise in the number of women who suffered from partner violence, and that the majority of these women did not seek help from formal services or authorities. This has a substantial social and economic cost.⁴⁵ The Gender Division, under the Bureau of Aging and Gender, is engaged in working with police and courts to implement legislative provisions against domestic violence by developing a special victims unit. The Ministry of Community and Cultural

Affairs 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 than men are engaged in the labor force in Palau, with only 60% representation for women compared with 77% for men. Women are concentrated in the 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 in the public service, including as directors of bureaus and as executive governors.⁴⁶ A study on Palau’s state-owned enterprise 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 this 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, and restaurants related to the

⁴³ Palau Ministry of Health . 2014. *Belau Family Health and Safety Study: National Research Project on Violence Against Women in Palau*. Koror (p. 43).

⁴⁴ Footnote 41.

⁴⁵ Palau Ministry of Health. 2014. *Belau Family Health and Safety Study: National Research Project on Violence Against Women in Palau*. Koror.

⁴⁶ Beijing + 15. 2010. *Review of progress in implementing the Beijing Platform for Action in Pacific Island countries and territories*. p. 83, < http://www.spc.int/images/stories/publication/beijing_15-report.pdf>

tourism industry. However, lack of credit facilities and skills development further constrain the engagement of women with the private sector.

There have been widespread reports of workplace discrimination in Palau, 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 to seek redress and encourage cultural change within institutions.

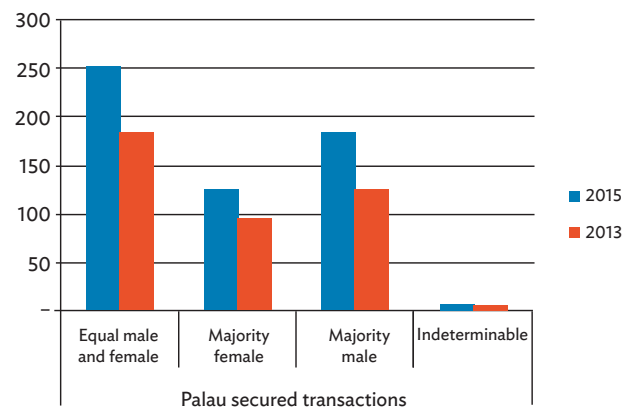
Access to Finance for Women

Only a small percentage of women have been able to access business loans in Palau. A business loan requires security and credit-scoring based on the financial system used in the US. As foreign-owned banks in Palau cannot take land as security, the local practice is to focus on business cash flow when evaluating creditworthiness. In most cases, steady business cash flow does not exist, so women who are seeking to start a business are usually not able to access commercial loans and are directed to the National Development Bank of Palau (NDBP). Many of these borrowers resort to consumer loans. These loans are for sums of less than \$50,000, accessible for a period of 5 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 expand access to business finance in Palau. It enables lenders to take charges over movable assets, thus widening the interpretation of creditworthiness. Movable assets can be tangible items such as cars or inventory, but also intangible items such as accounts payable. If lenders made better use of the secured

transactions framework, women would be the likely beneficiaries of this system, as they often lack access to land for use as collateral. Figure 9 indicates the

Figure 9: Security Interests Registered by Men and Women in Palau



Source: Palau Financial Institutions Commission.

gender breakdown of current debtors within the Palau secured transactions registry.

Skills Development and Business Networks

Both women and men seeking to start businesses often require assistance in developing business plans and preparing loan applications. The Small Business Development Centre is the main entity offering such services, and its clientele are predominantly women. The facility is effective and the services provided include assisting businesses owned by women 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, skills training in tourism, and assistance in preparing documents that accompany loan applications. In 2015, the bodies mentioned collaborated to organize the National Business and

Finance Conference and the National Tourism Conference. Support from these bodies is essential to introduce legislation and policies that encourage women's participation in the private sector.

11 TAX POLICY

Recommendation:

- Reform the gross receipts tax by replacing it with a value-added tax.

From the perspective of developing the private sector in Palau, 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 along the production or supply chain. Tax is paid on tax, with the following effects

- (i) The gross receipts tax penalizes businesses with high turnover and low profit margins. For example, for a high-margin retailer, the sale of a single item at \$100, with a profit margin of 50%, would incur a gross receipts tax payment of \$4 or 8% on profits.⁴⁷ A low-margin retailer, such as a grocer, faces a very different tax rate. Gross profit margins on groceries are typically 10%. The impact of the gross receipts tax on a \$100 grocery sale, which would be \$4 on a \$10 profit, therefore, attracts a tax rate of 40%.⁴⁸ If the grocer’s

goods were bought from a wholesaler, they already contain a 4% tax. This cascading tax rate substantially raise the prices of goods in Palau, impacting in particular on those with low incomes.

- (ii) The gross receipts tax encourages evasion, especially by low-margin businesses. This was already referred to in the section on Access to Finance.
- (iii) The gross receipts tax distorts resource allocation away from high-volume businesses, which typically are patronized by poorer members of the community.

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

⁴⁷ The International Monetary Fund prepared a detailed analysis of the implications for Palau of various scenarios surrounding Compact renewal. International Monetary Fund. 2006. Republic of Palau, Staff Report for the 2005 Article IV Consultation. Washington, DC.

⁴⁸ 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 to contract out or privatize that are currently supplied by the government and government-owned entities.
- Vigorously search for additional telecommunication service providers.

The Government of Palau owns and manages three state-owned enterprises (SOEs).⁴⁹ These SOEs provide telecommunication, water and power, and banking services to the people of Palau. SOEs have struggled to operate on commercial principles and, as a result, have generated consolidated losses of \$34 million over 2002–2012. These losses were attributed to the Palau National Communications Corporation (PNCC) and the Palau Public Utilities Corporation, and represent the equivalent of around 18% of Palau's annual gross domestic product (GDP). The lack of efficiency of these entities imposes a substantial cost on the economy, with resources that could be used more effectively being poorly allocated.

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

Although power generation is quite reliable, with few outages, 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.⁵⁰ In 2012, it earned a return on assets of –2.1% and return on equity of –1.3%.

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 on a proposed submarine cable for internet activity is a significant step toward improving Palau's connectivity. The laying of the new cable, which will be facilitated by an ADB loan, will offer a major boost for promoting private sector development in Palau.

These principles were included in a policy statement on SOEs, adopted in November 2015 (Box 4).

⁴⁹ Palau National Telecommunications Corporation, National Development Bank of Palau, and Palau Public Utilities Corporation.

⁵⁰ Pacific Power Utilities. 2012. *Benchmarking Report*. Suva.

Box 4: Features of Palau's Policy Statement on State-Owned Enterprises

The main features of the policy statement are:

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 will guide the government when it makes SOE ownership decisions. For example, when selecting directors, suitable candidates would be persons who are considered to be the best qualified to assist the SOE to achieve its primary objective.

Community service obligations (CSOs) generally arise when the government directs an 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.

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 government's ownership interest. This minister will focus on preserving the government's investment in the SOE, and 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 of Finance in Palau 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;
- to 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;
- to oversee any other operational or procedural matters that would normally be undertaken by the owner of a business corporation;
- to execute documents on behalf of the government dealing with the formation or management of SOEs, including subscribing for shares; and
- to act as the shareholder, which would include voting at annual general meetings and approving the issue of shares and other administrative functions.

Source: Government State Owned Enterprise Policy Statement, 2015.

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 operational performance of SOEs.

- (i) 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 regarding the functions and operations of a board. No SOE (with the exception of the Palau Water & Sewer Corporation) has an explicit obligation to operate profitably. 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 SOEs.
- (ii) There is no mechanism for monitoring the performance of 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, or in monitoring SOE results.

- (iii) There is no public disclosure of SOE financial performance.

The three main utilities: power (Palau Public Utilities Corporation), water (Palau Water & Sewer Corporation), and telecommunication (PNCC) are corporate entities. The country's airport and port are not.

- (iv) The port is owned by the Koror state government, which has awarded a 25-year concession for stevedoring services to a private company that is owned by a former President of the Republic of Palau. The same company also provides security services at the airport, which is owned by the central government.
- (v) Legislation to create an airport authority has been pending in Congress for several years.
- (vi) SOEs tend to price goods and services below the cost of delivery, as their enabling acts typically require them to provide "affordable" services.
- (vii) Tariff increases in the water, sanitation, and electricity sectors have been rare. This has meant that the utilities are unable to conduct the necessary maintenance and upgrading of their assets.

The labor productivity of the Palau Public Utilities Commission in generating electricity is among the lowest in the region. Labor productivity is typically measured in gigawatt-hours (GWh) per full-time employee. For the Pacific region, in 2012, the average output per employee was 2.2 GWh, while for Palau it was only slightly above 1.1 GWh, or 50% of the regional average.⁵¹ This means that already

⁵¹ Pacific Power Utilities. 2012. *Benchmarking Report*. Suva.

scarce resources of skilled labor and capital are being used inefficiently, representing a substantial deadweight 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 telecommunication. A good example of successful outsourcing is the privatization of the mortuary services of the Koror Hospital.

Even in an economy as small as that of Palau, opportunities for competition exist. The entry of Digicel into the Pacific telecommunication market has transformed the costs of communication services in the region. Exploring the possibility of another telecommunication provider entering Palau should be an urgent priority. Even if the size of the market mitigates against more than one provider, privatizing the PNCC (and introducing an

appropriate competition framework that stipulated cost and service quality) has immense potential to improve communication. While arguments against this course of action have been made on the ground that it might affect employment of PNCC workers, experience in other Pacific island economies has shown that employment tends to expand following privatization because improved service and expanded product range increases demand, which in turn generates jobs. In practice, few jobs would be at risk by privatizing the PNCC.

Not only would such measures improve the efficiency and cost of supplying services—freeing up public funds for social goals such as health, education, and protection of the environment—they 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 to increase SOE efficiency will contribute to changing the culture of Palauans focusing on obtaining jobs in the public sector.

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

One common misconception about the operation of state-owned enterprises (SOEs) is that, if they earn a positive return on equity and assets, the price of the services they provide will be higher than if they operate at a loss. This does not necessarily follow. When entities such as SOEs are protected from competition and are not required to operate on commercial principles, productivity and efficiency are almost always low. The ability to efficiently supply services such as telecommunication, power, and water, at the lowest attainable cost, almost never happens under protected monopolies. This is particularly so 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 because governments are usually poor operators of businesses. SOEs in Palau supply essential services at a high cost, which lowers the efficiency of the economy. Some alternatives—such as outright privatization, public-private partnerships, and outsourcing services to the private sector—are far more efficient ways of ensuring the supply of essential services in a competitive manner.

Source: Pacific Private Sector Development Initiative.

13 HOW DOES THE CURRENT BUSINESS ENVIRONMENT DISADVANTAGE PALAUANS?

The preceding sections outlined issues with the business environment in relation to developing the private sector in Palau. The discussion pointed out that, while progress has been made, several issues require progress in order for business investment and entrepreneurship to be encouraged. What the analysis did not focus on was the extent to which the issues of business environment specifically impact Palauans. A brief discussion of these issues follows.

Palauans are disadvantaged in business in several ways.

Access to finance. Although Palau is the most prosperous country in the Pacific, the ratio of private sector credit to gross domestic product (GDP) is one of the lowest in the region, and one of the lowest in the world for a country at Palau's per capita GDP. This implies that business is not being financed by lenders, and that Palauans do not have access to capital for their businesses. It reinforces the need for alternative sources of business funding, which makes the National Development Bank of Palau especially important as a financial institution.

Starting a business is currently slow and expensive. The cost of starting a business in Palau disadvantages start-ups, in particular local start-

ups. This means that Palauans are disadvantaged in opening their own businesses. It also encourages the formation of fronts. While Palau appears to be attracting foreign investment, it is often through the channel of the aforementioned fronts. Other foreign investors are discouraged by the lack of finance (the NDBP can only lend to majority-owned Palauan businesses) and the uncertain foreign investment regime. In the long term, this disadvantages Palauans because they cannot acquire the business skills that ultimately allow them to open their own businesses.

Underdeveloped telecommunication. The state of telecommunication in the country restricts the ability of Palauans to connect with the outside world, develop business contacts, and engage in trade. It favors vertically integrated businesses that require substantial amounts of capital.

Poor regulation of the tourism industry. The lack of enforcement of reserved activities in the tourism sector also reinforces vertically integrated businesses, and penalizes Palauans who have the capability to operate in the tourism sector.

Prior sections have suggested policy measures that address these issues. Action is needed in all of these areas to bring to the fore the benefits of economic development for all Palauans.

CONCLUSION

The significant growth rates achieved in 2013–2015, 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-term and long-term issues. The high growth rates in 2014–2015 is 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 of people visiting them. This means that, over time, Palau will become less attractive to tourists and visitor numbers will decline. This is the most pressing issue facing the country's economy and its private sector.

If investment in facilities and services that cater to low-end tourists continues to expand, resistance will grow exponentially to policies aimed at reducing the size of this market segment. Palau may find it increasingly difficult to change course, and this is a further reason to immediately deal with the current influx of low-end tourists.

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 a significant lack of capacity within the government and within the private sector to effectively implement policy. 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 a growing recognition of the need for action in Palau. If it does occur, the combination of the country's natural beauty and the determination and self-reliance of the Palauan people will hold the country in good stead. This will ensure that the future of Palau is not only preserved for the coming generations, but that the prosperity of the country will continue to blossom.

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Private Sector Assessment for Palau

Policies for Sustainable Growth Revisited

Palau's economy expanded strongly, with real gross domestic product (GDP) rising 5.3% in 2014 and 8.2% in 2015. Per capita GDP also increased; at the end of fiscal year 2015 it was in excess of \$16,000—the highest among Asian Development Bank (ADB) developing members in the Pacific. This strong performance, however, masks urgent issues threatening the sustainability of Palau's economy. This private sector assessment is based on in-depth consultation with the government and private sector. It recommends further reform, most notably in the areas of tourism policies and business law, as well as in the agriculture and finance sectors. It suggests that Palau's state-owned enterprises are inefficient and need to operate on commercial principles. Measures to promote equal access to economic opportunities for women and fiber optic connectivity with other countries are also provided.

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