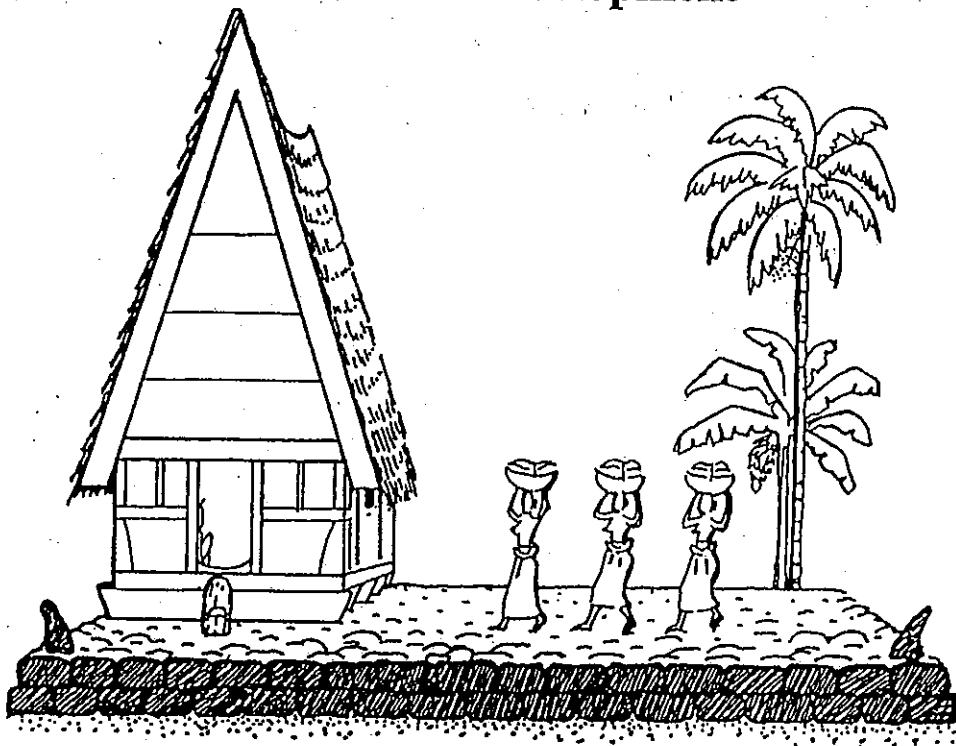


PALAU

2020

**NATIONAL MASTER
DEVELOPMENT PLAN**

**Issues, Options and Strategies
for Palau's Development**



**The Foundation for Development
Final Report**

April 1996

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FINAL REPORT

The Foundation for Development

April 1996

Prepared For

The Republic Of Palau
Through a Project Jointly Funded by
United Nations Development Programme
and United States Department of Interior

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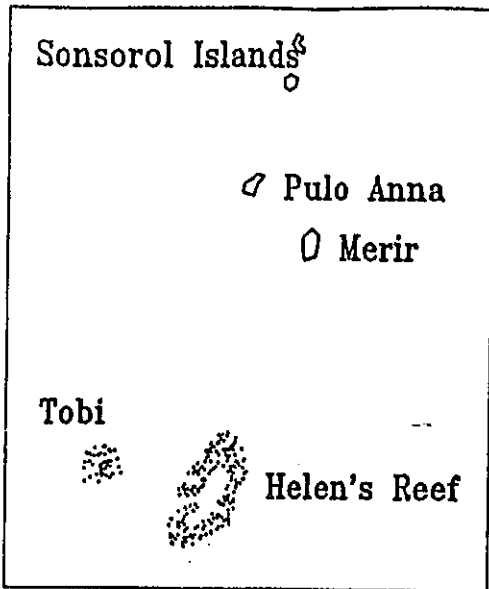
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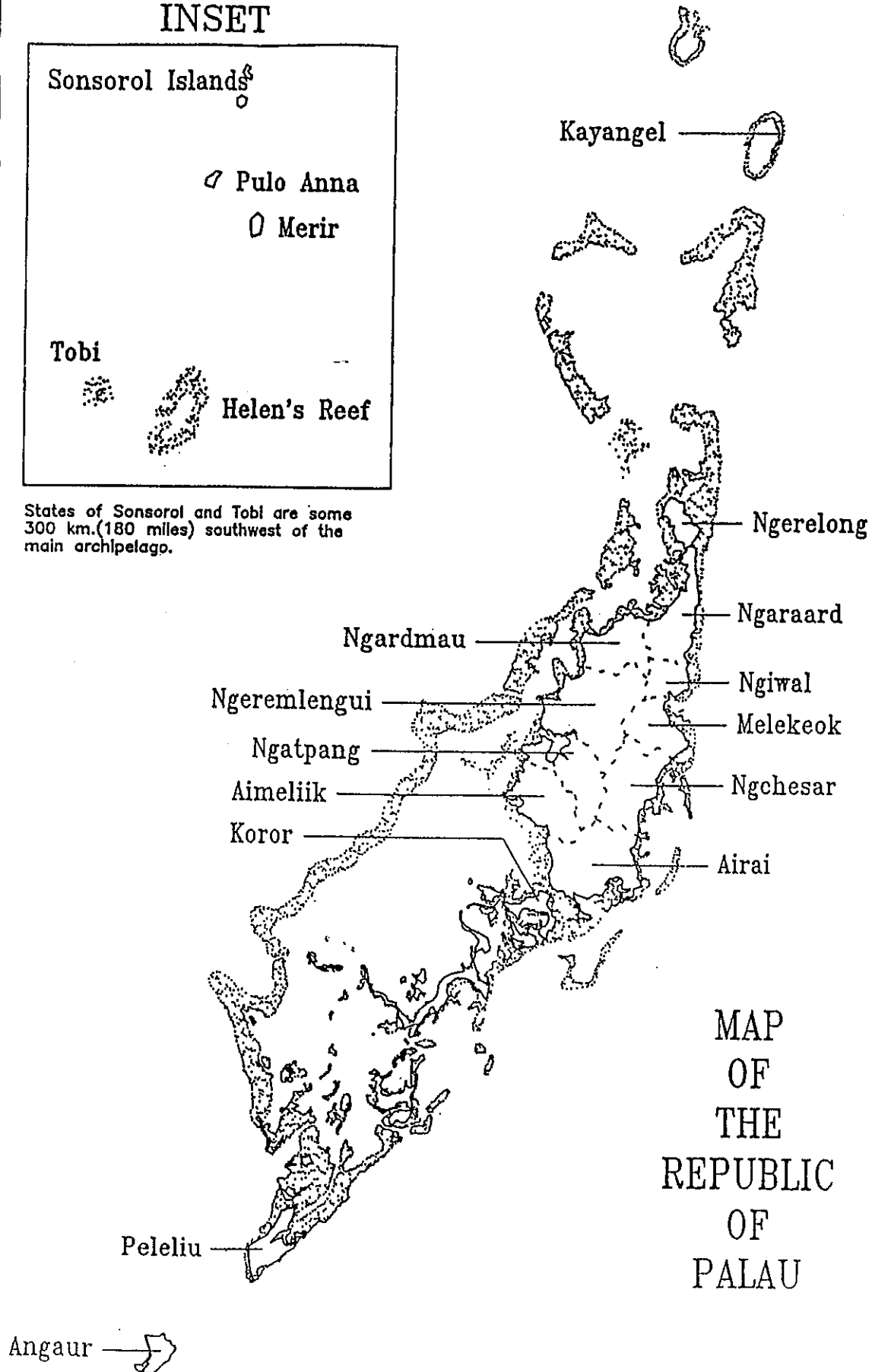
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INSET



States of Sonsorol and Tobi are some 300 km. (180 miles) southwest of the main archipelago.





ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
AES	Agricultural Experiment Station
AESOP	Australian Executive Services Overseas Program
AGEM	Agency for Government Enterprise Monitoring
AIDAB	Australian International Development Assistance Bureau
AISP	Agency for Investment Screening and Promotion
BCM	Bureau of Contracts Management
BLS	Bureau of Land and Surveys
BNRD	Bureau of Natural Resources and Development
BOT	"Build-Operate-Transfer"
BPW	Bureau of Public Works
BTA	Belau Tourism Association
BTIC	Belau Transfer and Terminal Company
C/ED	Conservation/Entomology Division
CAT	Civic Action Team
CBI	Caribbean Basin Initiative
CCS	Comprehensive Conservation Strategy
CES	Cooperative Extension Service
CIF	Cost Insurance Freight
CIP	Capital Improvement Program
CITES	Convention of International Trade in Endangered Species
CNMI	Commonwealth of the Northern Marianas
COM	College Of Micronesia
CPI	Consumer Price Index
CSIRO	Commonwealth Scientific and Industrial Research Organization
CSO	Community Service Obligation
CTSA	Center for Tropical and Subtropical Aquaculture
DAMR	Division of Agriculture and Mineral Resources
DCE	Division of Conservation and Entomology
DESS	Division of Environment and Sanitation Services
DoI	US Department of Interior
E/D	Entry Departure
EDP	Economic Development Plan
EEZ	Exclusive Economic Zone
EIA	Environmental Impact Assessment
EIS	Environmental Impact Statement
EIU	Economist Intelligence Unit
EO	Executive Officer
EPA	Environmental Protection Authority
EQPB	Environmental Quality Protection Board

FAA	Federal Airports Authority
FAD	Fish Aggregation Device
FD	Forestry Department
FDIC	Federal Deposit Insurance Corporation
FEMA	Federal Emergency Management Agency
FFA	Forum Fisheries Agency
FFPN	Family Food and Nutrition Project
FIAC	Foreign Investment Approval Certificate
FIAS	Foreign Investment Advisory Service
FIB	Foreign Investment Board
FOB	Free On Board
FSM	Federated States of Micronesia
GBE	Government Business Enterprises
GDP	Gross Domestic Product
GEF	Global Environmental Facility
GIS	Geographic Information System
GNP	Gross National Product
GRT	Gross Revenue Tax
GSP	Generalized System of Preferences
HRD	Human Resources Development
IAB	Industry Advisory Board
ICLARM	International Centre for Living Aquatic Resources Management
IPD	Implicit Price Deflator
JAC	Japan Airport Consultant Inc.
JTB	Japan Tourist Bureau
JTPA	Job Training Partnership Act
LCHO	Land Claims Hearing Office
LGP	Land Grant Program
MCT	Minister of the Commerce and Trade
MFN	Most Favoured Nation
MMDC	Micronesian Mariculture Demonstration Center
MOC	Micronesian Occupational College
MRD	Marine Resources Division
MWWTP	Malakal Waste Water Treatment Plan
NAFTA	North America Free Trade Agreement
NDBP	National Development Bank of Palau
NDP	National Development Bank
NEB	National Education Board
NETC	National Education and Training Council
NGOs	Non Government Organizations
NHA	Natural Heritage Areas
NMDP	National Master Development Plan
NMFS	National Marine Fisheries Service
NOAA	National Oceanic Atmospheric Administration
NPDES	National Pollutant Discharge Elimination System

NTO	National Tourism Organization
OEK	Olbiil Era Kelulau
OFCF	Overseas Fisheries Cooperation Foundation
OGRE	Office of Government Reform and Efficiency
OISCA	Organization for Industrial Spiritual and Cultural Advancement
OMIP	Operations and Maintenance Improvement Program
OSS	One Stop Shop
OTIA	Office of the Territorial and International Affairs
PAC	Palau Airport Corporation
PATA	Pacific Asia Travel Association
PCAA	Palau Community Action Agency
PCC	Palau Community College
PFA	Palau Fishing Authority
PFPA	Palau Federation of Fishing Association
PIC	Palau Investment Corporation
PITI	Palau International Traders Incorporation
PLA	Public Land Authority
PMA	Palau Maritime Authority
PMCI	Palau Modekngai Corporation Incorporation
PMIC	Palau Maritime Industries Corporation
PNA	Party to the Nauru Agreement
PNBC	Palau National Building Corporation
PNC	Palau National Code
PNCC	Palau National Communication Corporation
PNG	Papua New Guinea
PoA	Plan of Action
PPLA	Palau Public Land Authority
PPR	Palau Pacific Resort
PRI	Palau Resource Institute
PRPC	Palau Road and Port Corporation
PSIP	Public Sector Investment Program
PUC	Public Utilities Corporation
PVA	Palau Visitors Authority
PWWC	Palau Water and Waste Corporation
REA	Rapid Ecological Assessment
ROP	Republic of Palau
SBA	Small Business Association
SFS	School for Field Studies
SMA	Special Management Area
SPBCP	South Pacific Biodiversity Conservation Programme
SPC	South Pacific Commission
SPREP	South Pacific Regional Environment Program
STOL	Short Take Off and Landing
TNC	The Nature Conservancy
TTPI	Trust Territory of the Pacific Islands

UN ESCAP	United Nations Economic Social Commission for Asia and the Pacific
UNCED	United Nations Conference Environment and Development
UNDP	United Nations Development Programme
US DOE	US Department of Energy
USDA	United States Department of Agriculture
USFmHA	US Farmers Home Administration
USGS	US Geological Survey
VAT	Value Added Tax
VEMS	Visitor Expenditures and Motivation Survey
WAG	Wage Advisory Group
WHO	World Health Organization
WTO	World Tourism Organization
WWF	World Wide Fund
WWII	World War II

EXECUTIVE SUMMARY

CHAPTER 1: INTRODUCTION

This chapter examines the Palau National Master Development Plan preparation process and its interface with the Government of Palau's Economic Development Plan. The consultative processes as required under the contract for the preparation of the Master Plan are outlined.

The critical provision for the Master Plan is the necessity to put into place the institutions and policies for Palau which will guide it towards achieving economic sustainability and enable it to pay for the maintenance of its environment and culture. In this chapter, the focus of the Master Plan strategies are described as recommending:

- a substantial shift in economic activity from the public sector to the private sector aimed at increasing productivity, and efficiency of resource use. This is achieved through policies which minimize government intervention, and which provide a predictable framework for foreign investment and increase human resource training and development.
- strengthening government institutions to improve coordination of decision making processes, and focusing on greater accountability for performance, and approaches to improve selection and evaluation of projects, and effective resource allocation.
- identification of financing strategies to offset the decline in US assistance over time.

The chapter also outlines the format and introduces the logical framework matrix at the conclusion of each of the major sectoral chapters to assist in summarizing the programs and projects which will flow from the Master Plan recommendations. These programs and projects should be prioritized for the implementation of the Master Plan in the medium term and during the annual budget process.

CHAPTER 2: ASSESSMENT OF SITUATION AND PERFORMANCE OF THE PALAU SOCIO-ECONOMY

This chapter emphasizes the main factors relating to the performance of economic and social conditions. Key constraints which face Palau as they do other Pacific island economies include:

- a small domestic market spread across a number of islands;
- high unit costs for infrastructure and industry services;
- narrow resource bases;
- heavy dependence on external trade and foreign assistance; and
- price of exports lower than the price of imports.

Tables 2.1 and 2.2 compare some of Palau's economic indicators with its Pacific neighbors which show that Palau has performed better than most of its Pacific island neighbors, but does not match Guam and the Caribbean and Indian Ocean islands which have similar economies. Table 2.3 summarizes performance of the different economic sectors over a 10-year period showing that fisheries and tourism play a major role in the economy.

There is a high dependency on Government employment which constrains public policy decisions such as wages, restructuring and productivity changes. Indicators of foreign trade, prices, population, employment and wages, education, health and law and order are also summarized in this chapter. The overriding conclusion is that rarely do countries have such advantages and opportunities, but given these, economic performance could have been better.

CHAPTER 3: CONSTRAINTS, OPPORTUNITIES, VISION AND STRATEGIES

This chapter examines the constraints on development in Palau and the opportunities for advancement. From this analysis, through the community consultative processes that took place, a national vision and goals statement was developed and is outlined. The strategies are then outlined which will guide Palau towards achieving its **vision** which is:

To substantially enhance the quality of life of Palauans and future generations of Palauans

The key **development goals** which are necessary to achieve this vision are to:

- increase real economic growth per capita on a sustained basis;
- share the benefits of economic growth on an equitable basis; and
- enrich and enhance confidence in the Palauan culture, raise national consciousness, and protect the natural environment of Palau.

An important element is the development of a partnership approach with the private sector, one in which the Government establishes a policy framework that helps and encourages private sector initiatives.

CHAPTER 4: MACRO ECONOMIC FRAMEWORK

This chapter examines the basic macro economic framework that will underpin the strategies for economic growth, including fiscal management, particularly related to Compact funds, and policies related to the monetary system, labor market and foreign investment. The key approach is to develop fiscal and financing policies that smooth the adjustments that the economy will need to make as recurrent grants from the US decline and the flow of Compact funds ceases. The policy response to this should be to accumulate budget surpluses over the coming years to enable the financing of budget deficits in latter years. This can be achieved by increasing revenue together with restraining public expenditure.

The impact of the dependence of Palau on the US dollar as its currency, and the implications for its continued use are outlined. The labor market issues that affect Palau's economy include:

- around 4,000 Palauans work offshore;
- substantial US recurrent funding that has supported relatively high civil service wages and employment levels; and
- importation of low wage foreign workers.

Four areas of reform to the labor market which are recommended are:

- entry of unskilled and semi-skilled workers to the public sector made less attractive;
- attractiveness of the private sector for unskilled workers enhanced;
- recruitment of foreign workers made less attractive; and
- facilitation of industries which contribute a higher *value added*.

A foreign investment framework is recommended that builds on the experiences of other countries which have been successful and incorporates the following features:

- active promotion of foreign investment opportunities that recognizes the benefits of increased competition;
- administrative simplicity;
- clear environmental and cultural guidelines involving inter-agency coordination;
- professional and fast assessment; and
- non-discriminatory.

CHAPTER 5: FINANCING DEVELOPMENT

The two major areas that will be of crucial importance to the Government and private sector in financing investment and development are examined. Taxation and charging systems, and the domestic financial sector. The four likely sources of finance and funding likely to be tapped by the public and private sectors are:

- revenue from taxes and charges;
- domestic financial sector;
- foreign investment financed from outside Palau; and
- offshore commercial borrowings.

Taxation criteria, that is, efficiency and equity are outlined and principles enumerated. Major recommendations include the formation of a Tax Reform Unit within the Ministry of Administration to manage the reform of a number of taxes and charges, and the creation of a streamlined business licensing system within the Ministry of Commerce and Trade.

The importance of encouraging the domestic financial sector is the way in which it helps to mobilize and increase domestic savings. It is fundamental to sustained economic growth. Palau's two pension funds could be major investors in the economy, providing confidence of potential foreign investors by setting an example. Banking supervision and regulation also helps to build confidence in the domestic financial sector.

Support for Palauan entrepreneurs through a partnership between the Palau National Development Bank, and the business sector that provides an advisory service is recommended. The aim of this program would be to increase the participation of small businesses across all sectors of the Palauan economy, by providing entrepreneurs with the skills to access PNDB loans.

CHAPTER 6: INFRASTRUCTURE

One of the important areas of government activity is the provision of infrastructure to underpin private sector endeavor and to provide those services to citizens that are essential for improving living standards. It is particularly important at this stage of Palau's development because of the attainment of substantial Compact funds for infrastructure spending. This chapter focuses on both the institutional and policy environment to enable the performance of infrastructure spending to be enhanced, and on feasible project outputs. Issues and problems that have impacted on project selection, evaluation and allocation are examined. The importance of pricing policies and performance, the development of a process to support the preparation of a Public Sector Investment Program is stressed and a model for sustainable funding of projects is proposed.

The model incorporates the concept of achieving, where possible, a return on public sector investment which aims for sustainability past the decline in Compact funding. It therefore focuses not just on the management of offshore funds but also on the evaluation of those projects over which Palau has discretionary spending. This integrates social capital projects as well as infrastructure projects which are fed into in the budget cycle under the Public Sector Investment Program.

CHAPTER 7: LAND USE

Clear property rights are a fundamental requirement for a modern capitalist economy. If Palau seeks to pursue a path towards such an economy, issues related to land tenure and effective land use planning will need to be resolved as expeditiously as possible. This chapter examines a number of essential tasks that need to be implemented by the relevant Palauan authorities to facilitate and hasten the resolution of these land-related issues. Guidelines should be formulated to provide the context and parameters within which public and private sector developers must operate, these could include:

- guidelines for screening development proposals;
- site specific performance standards;
- uniform building code;
- appropriate land management practices;
- management plans for environmentally sensitive locations; and
- guidelines on land-related matters for foreign investors.

CHAPTER 8: TOURISM

Palau has few resources to offer the rest of the world in order to support its desired lifestyle and enhance its culture and environment. However those which it has - a unique and fascinating array of reefs, waters and islands are in diminishing supply. They are also located adjacent to the world's fastest growing areas of demand. Necessity and proximity now combine to possibly threaten the fragile culture and ecosystem of Palau. The challenge to decision makers is to open up good quality tourism facilities to an increasing number of investors and visitors without causing the intolerable damage to the attractions and Palau social system. This chapter assesses the current situation and trends, the main issues, strategies and options for assisting growth in this sector. A key element is the active participation of the private sector in tourism promotion working in partnership with the Palau Visitors Authority. The chapter also recommends creating a function within the Ministry of Commerce and Trade to take responsibility for tourism policy, which should involve inter-agency coordination with Ministries whose activities impact on tourism in Palau.

CHAPTER 9: AGRICULTURE AND FORESTRY

Agriculture and forestry development in Palau has grown modestly in the past decade, but it has declined significantly relative to other sectors. Strong growth in domestic demand for food and forestry products has been largely met via imports. Motivation for involvement in the sector is generally low, and the range of agricultural commodities produced is relatively narrow, despite relatively high domestic prices. Key constraints to agricultural production are outlined. The strategy for agriculture and forestry must take account of:

- efficiency in use of natural resources;
- equity of development opportunities; and
- biological, economic and social sustainability of resource use.

Increased domestic market opportunities will be enhanced with the improvement of transportation infrastructure. Market analysis and development programs could support import substitution and some exports, providing the Division of Agriculture and Mineral Resources can improve its research and extension capability.

CHAPTER 10: INDUSTRY AND SERVICES

As Palau moves ahead with the development of a self-reliant and market-oriented economy, Government policies and institutions should provide a framework such that the focus of activity is directed towards Palau's comparative advantages. These advantages lie in tourism, fisheries, small scale manufacturing and facilitating service industries. This chapter analyzes the growth of the industry and service sectors which will contribute to economic growth and employment, and support the economy's lead sectors. The strategic approach outlined seeks to provide an environment which encourages private sector development through provision of supporting infrastructure, competitive economic and regulatory policies, adequate consumer and worker protection, and facilitative policies towards promoting development and employment.

CHAPTER 11: MARINE RESOURCES

Marine resources are a fundamental underpinning of the traditional system. This chapter examines the issues that impact on marine resources and recommends policies that enhance development and returns, while balancing any environmental impact. To ensure sustainable development of marine resources, adequate systems for research, extension, monitoring and regulation of inshore and offshore fisheries are essential. The responsibility for marine resources which rests with a number of different agencies is detailed. Regional cooperation options for offshore fisheries are outlined, and alternative policies listed in the absence of regional cooperation agreements. A key element is the need for National and State governments to share responsibility for surveillance and enforcement of inshore fisheries.

CHAPTER 12: ENVIRONMENTAL PLANNING AND MANAGEMENT

The choice between the standard of living to which Palauans aspire, and the potential for damage to the environment is a conscious decision for Palauans to make. It is of crucial importance that Palauans know beforehand in the development process exactly what the environmental consequences of any major development project will be. Decisions are then made with knowledge of the issues, or more importantly people know that decision have been made with their consultation. Environmental concerns need to be incorporated into legislative and administrative processes. This chapter addresses the physical and institutional framework for environmental planning and management in Palau. A key element is the framing of a comprehensive legislation on natural resource conservation and management.

CHAPTER 13: PUBLIC ADMINISTRATION

This chapter describes the Constitution of the Republic of Palau which is the fundamental law of the land, putting emphasis on the various elements and levels of government and public administration, taking into account the Executive, Legislative and Judicial Branches of the national government, the state governments and the role of the traditional leadership. The major roles of each of the branches of the national government as they coexist and work in a check and balance system of a democratic type government are outlined. The organizational structure and functions of the Execution Branch are also described. Issues of public sector reform are raised for consideration as Palau undertakes a process of economic social and physical development.

CHAPTER 14: HUMAN RESOURCE DEVELOPMENT

This chapter examines the population and labor market trends. Table 14.4 provides population and labor market projections based on a number of assumptions about expected economic growth rates and demographic factors namely:

- Palauan and foreign population growth will be influenced by the economic cycle;
- Palauan employment opportunities will depend on education and training policies;
- median age of the population will continue to increase;

- labor force will continue to increase;
- labor force will continue to expand with the decline of subsistence activities; and
- some areas of foreign labor demand will decline.

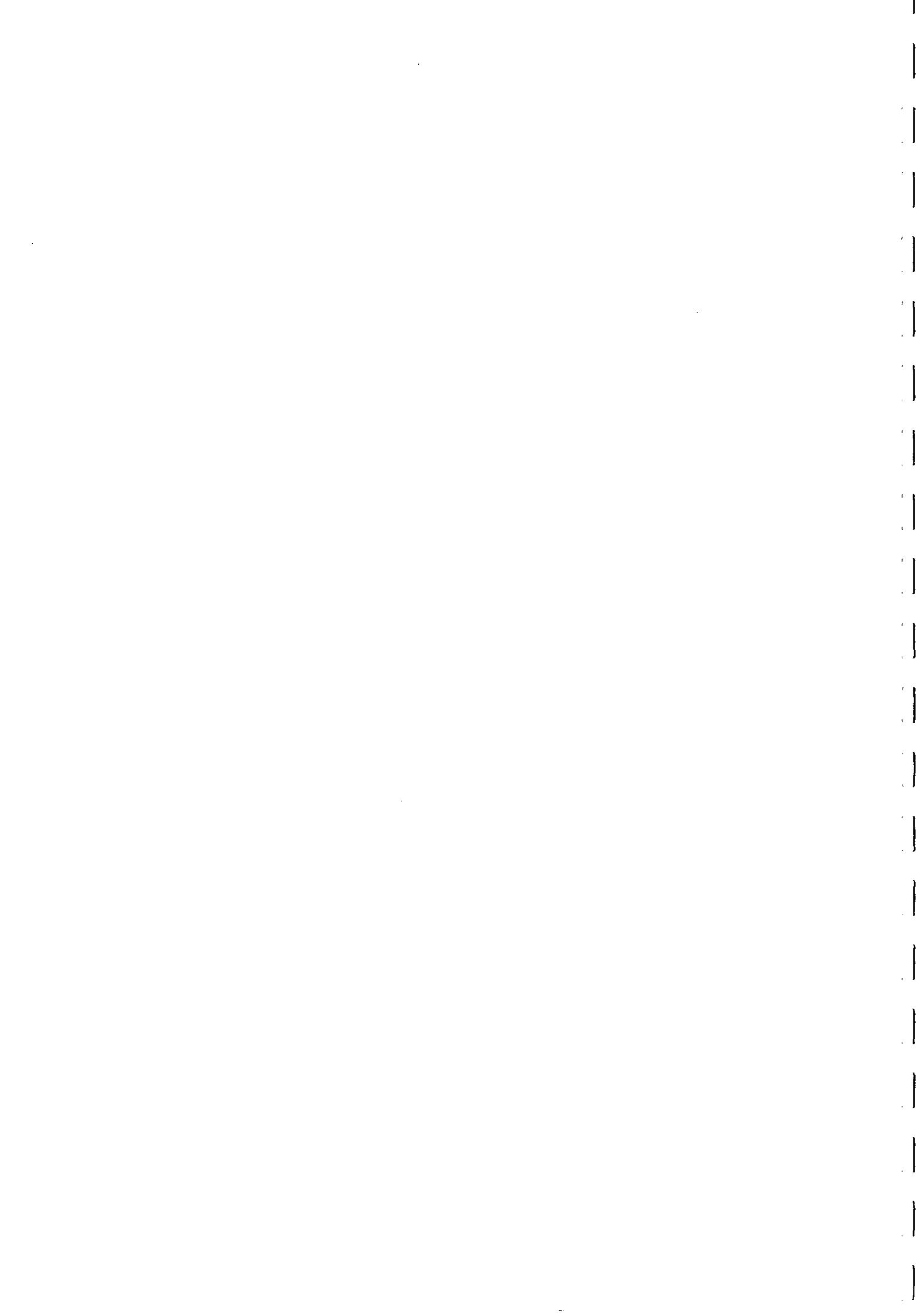
Education and training situation and institutions are described, and the key issues and recommendations raised in the Education Master Plan discussed.

CHAPTER 15: HEALTH

Improvement of the health status of Palauans is essential to the country's economic and social development. The changes in US funding of health services which have occurred since Palau's independence are likely to place increased burdens on both the Government and citizens. The impact of changing lifestyle on the health of Palauans and foreign residents are an important element in developing preventative programs. This chapter recommends a focusing of budgetary appropriations towards preventive and primary health care, and a more effective system for charging for health services which takes account of equity considerations.

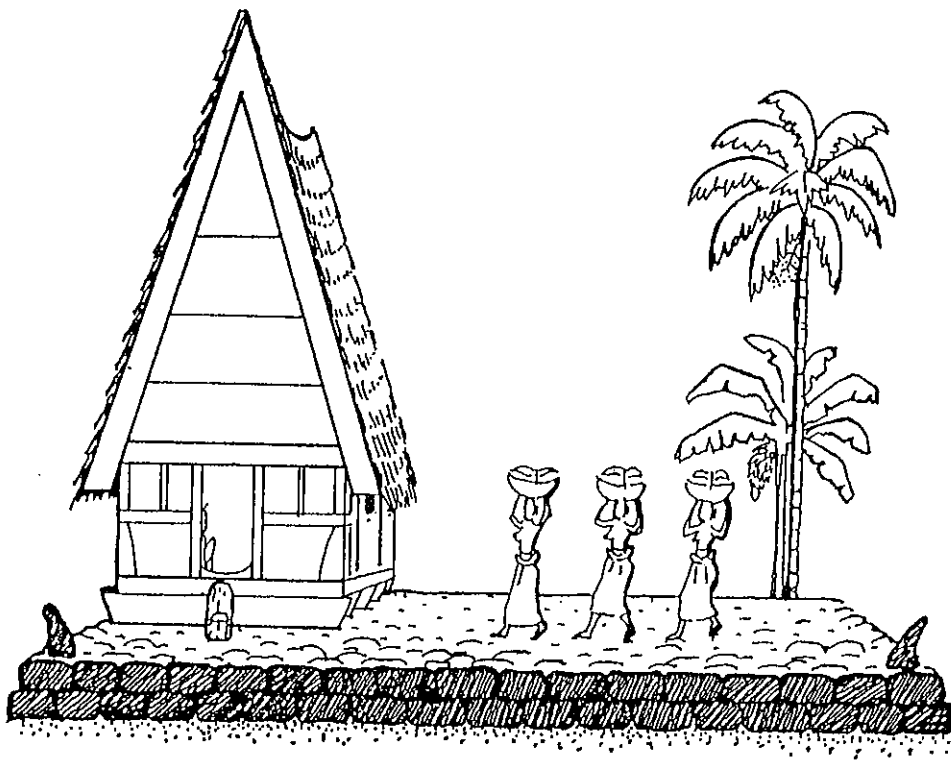
CHAPTER 16: LEGISLATIVE IMPLEMENTATION

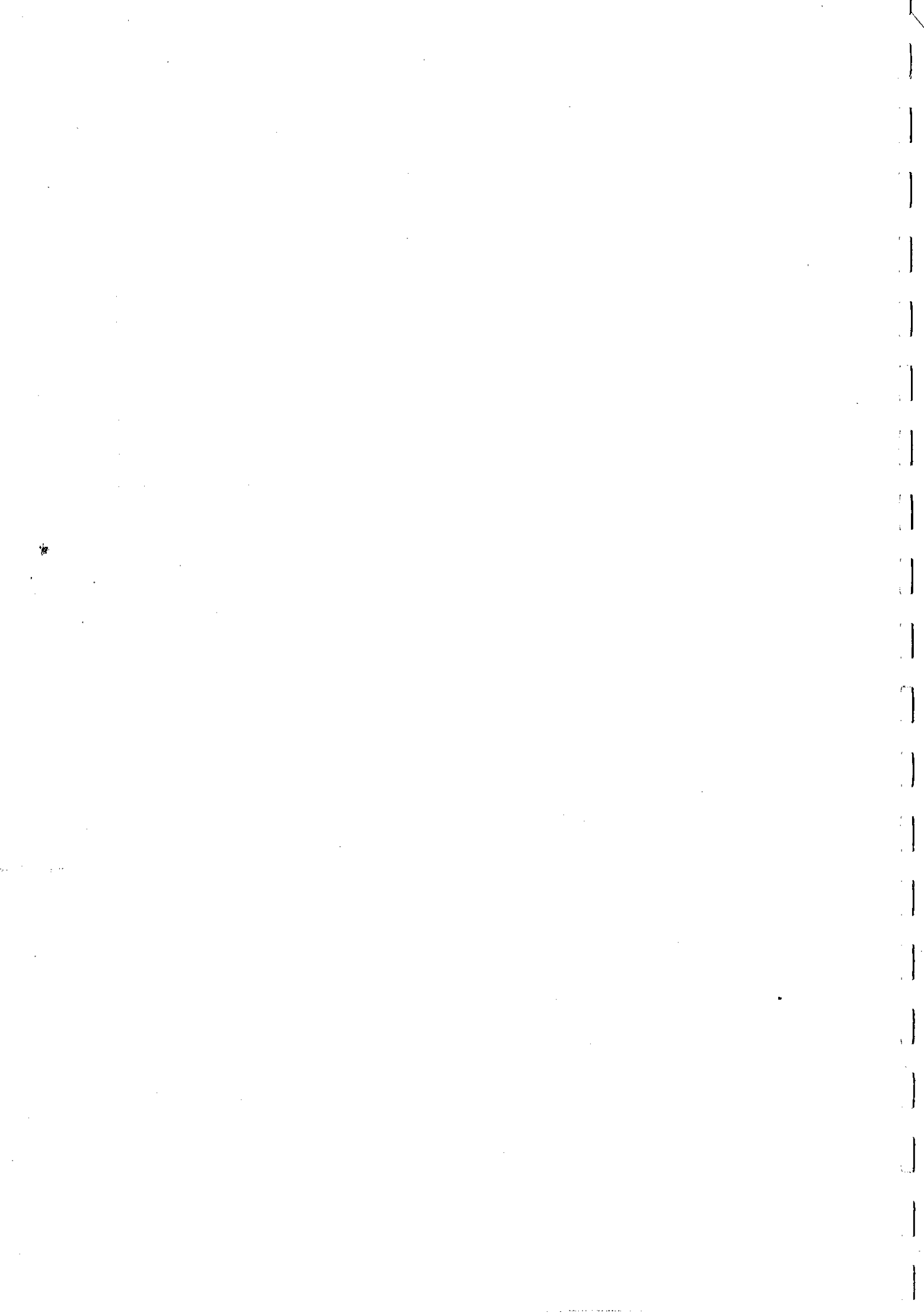
This chapter provides a background to the implementation process of the Master Plan and presents a draft of a Joint Resolution of the OEK.



CHAPTER 1

INTRODUCTION





CHAPTER 1

INTRODUCTION

This Chapter examines the Palau National Master Development Plan preparation process and its interface with the Government of Palau's Economic Development Plan. The consultative processes as required under the contract for the preparation of the Master Plan are outlined. The critical provision for the Master Plan is the necessity to put in place the institutions and policies for Palau which will guide it towards achieving economic sustainability and enable it to pay for the maintenance of its environment and culture. This Chapter describes the approach of the Master Plan and its emphasis on institutional building and policies rather than project selection and allocation.

1.1 BACKGROUND

The Palau National Master Development Plan was prepared by SAGRIC International Pty Ltd under a contract with the United Nations Development Programme Office for Project Services (Contract No. TTP/92/001). The drafting of the Master Plan and the strengthening of the planning process were undertaken at the request of the Government of Palau, with financial support from the UNDP and the United States Department of Interior.

The contractor (referred to in the contract as the "Master Planner") was required to assemble and analyze the data necessary for the planning effort, to review existing plans and studies, to become familiar with the needs and preferences of the people of Palau and the development constraints and opportunities which they face. With the guidance of the Palau Master Plan Task Force, the Master Planner was required to establish a consultative process based on public meetings, sectoral committees, and through close working relationships with counterparts and leaders at the National and State level. The major outputs of the project are:

- A Master Plan for the sustainable economic, physical, and social development of Palau, including identification of development potential for the 16 States. The First Draft of the Master Plan was presented to the Palau Master Plan Task Force, whose responsibility was to coordinate its review through a series of public meetings with comments being incorporated by the Master Planner into the Second Draft Master Plan. The Second Draft Master Plan and a designation of its critical provisions was submitted to the Office of the President of Palau and UNDP in December 1994, for comments which have been incorporated into this final report.
- Provision of assistance to the Office of the President in the preparation of a strategic plan for legislation necessary for the implementation of the Master Plan;
- Provision of assistance in building national planning capacity and mechanisms for policy analysis, review and decision making in line with the aims and strategy of the Master Plan.

1.2 APPROACH TO PREPARATION OF THE MASTER PLAN

The Master Plan has been developed using a bottom-up approach. It has attempted to set forth strategies in accordance with the desires of the Palau people based on their preferred development path. To achieve this, the Master Plan team has undertaken extensive consultations with representatives from all States, special interest groups, Government officials, elected representatives, traditional leaders, business owners and private individuals. While many discussions resulted in conflicting demands and aspirations, nevertheless, the Master Plan has attempted to coalesce these divergent views into a number of consistent strategies.

On July 26-27 1993, the Project held an Inception Workshop which focused discussion on describing the Vision for Palau in 25 years' time, and on identifying constraints and opportunities. During the same workshop, sector consultative groups were formed. From August to November 1993, State, community group and sector consultative meetings were held to focus on issues which Palauans considered were important to be addressed by the Master Plan. On December 14, 1993 a Planning Workshop attended by over 60 community and Government leaders was held followed by a National Forum on the Development Agenda on January 26-27 1994.

Sector specialists conducted many interviews and discussions with Palauans and foreigners in the public and private sectors as well as visiting consultants who in many cases have been directed to the Master Plan office for information or guidance.

The collection and analysis of data and reports has been and continues to be an ongoing process. This proved to be a very difficult part of the preparation phase of the Master Plan because of the lack of a coordinated approach to data collection in Palau. The wealth of information which has been collected is reflected in the bibliography in Annex 2 of this volume. Not all of the material listed has been referred to in the Master Plan, however much of the material has provided background and appreciation of Palau's situation. Rather than produce a separate appendix of tables within the document, the Master Plan has incorporated relevant data into its Chapters to support recommendations.

The sector reports which comprised volumes 2 and 3 of the First Draft Master Plan reflect the situation as encountered and analyzed by the short term specialists who contributed to the Master Plan during the period September 1993 to June 1994. In some cases, recommendations made within sector reports may be different from those made in this volume, reflecting the refinements made to the macroeconomic and institutional frameworks developed during the final synthesis of the Master Plan. The sector reports should be regarded as supporting documents to the Master Plan.

After submission of the First Draft Master Plan on July 29 1994, a series of consultations were undertaken with a broad range of informants, including the leadership, community groups, private enterprise and sectoral interest groups. Six formal consultative meetings were required to be conducted under the Master Planner's Scope of Services, and these were undertaken under the sponsorship and guidance of the Palau National Master Development Plan Task Force, and with the participation of the Government's counterparts. The six meetings were held with:

- Council of Chiefs (September 19, 1994 at Council of Chiefs Office);
- Traditional Women Leaders and Womens Organizations (September 21, 1994 at Bai ra Metal);
- National Government Representatives (September 22, 1994 at Greenland Restaurant);
- State Government Representatives (September 26, 1994 at Greenland Restaurant);

- Private Sector & Industries (September 28, 1994 at Greenland Restaurant);
- General Public Meeting (September 29, 1994 at Greenland Restaurant).

Written submissions were invited from any interested individuals or groups, and the Office of the President coordinated submission of national government responses to the First Draft. The deadline for submissions was October 30 1994. Submissions were received from:

Office of the President
 Ngarchelong State
 Land Claims Hearing Office
 Ngchesar State Government
 Koror State Government (2 submissions)
 Hatohobei State Government
 Melekeok State Government
 Kayangel State Government
 Palau Chamber of Commerce
 Sonsorol State Government
 Palau Community Action Agency
 Foreign Investment Board
 Bilung Gloria G. Salii

Many other Palauans, and resident and visiting foreigners also provided valuable informal comments during the consultative phase, for which the Master Planner is very grateful. A response was made to the Comments provided by the Office of the President to enable the Office of the President to more easily locate changes in the Second Draft, or be directed to the answers to questions which were raised in the document.

In early 1995, the Government of Palau and UNDP, provided comments on the second draft, all of which have been incorporated into this volume. A significant change was the inclusion of the health and education sectors which had hitherto been omitted from the Scope of Works, but which underpin the growth of any economy. These were incorporated as Chapters 14 and 15.

In January 1996 in a response to the draft Final Report dated August 1995, the Government of Palau advised that a decision had been reached that the Executive Branch would not be expanded or restructured, necessitating a change to most chapters of the Master Plan where reference was made to proposed new structures.

1.3 ECONOMIC DEVELOPMENT PLAN

Under Section 231 (a) of the Compact of Free Association with the United States, there is a requirement for an official national development plan to be promulgated by the Government and concurred with by the Government of the United States prior to the effective date of Compact implementation. The implementation of the Compact on 1 October 1994, meant that it was necessary for the Government of Palau to develop a specific plan targeted at complying with Compact requirements for submission to the US Government. An Economic Development Plan 1995-99 (EDP) was released in June 1994 for this purpose.

In 1987, in anticipation of Compact implementation, the Government developed the First National Development Plan. In developing the EDP, this earlier plan was updated and revised. In particular, the EDP focuses on the 5 year period following Compact implementation and provides a prioritized program of capital infrastructure projects that are expected to be financed through Compact monies, as well as infrastructure projects that have existing obligations. The EDP also outlines additional projects in the event that there are any remaining funds after completion of the prioritized projects. The overall aim of the EDP is the rational allocation of scarce capital resources available to Palau to maximize sustainable social and economic development.

The commencement of the development of the Master Plan preceded that of the EDP. While the two plans have different purposes, they are consistent in objectives and broad strategies and, therefore, complement each other. Many of the spending priorities targeted in the EDP are tied to specific programs and/or projects. These priorities are also assumed by the Master Plan along with State priorities. The Master Plan has suggested additional priorities where there is discretion in capital spending from Compact allocations, such as the \$52 million capital improvements monies.

While the main focus of the EDP is on the development of a five year capital spending program, the focus of the Master Plan is much broader and encompassing. It is less concerned about the allocation of funds to specific capital projects than on the framework and policies for sustained economic and social development, of which project evaluation is but one part. In this respect, institutional building is a strong element of the Master Plan. The Plan is much longer term in focus and generally projects out to 2010 to take account of, and plan for, the cessation of US Compact assistance after 2009.

In the third and final draft, the Master Planner has, at the request of the Government of Palau, incorporated specific material contained in the EDP to facilitate integration of both plans.

1.4 MASTER PLAN CRITICAL PROVISION

1.4.1 ASSUMPTION

The Master Plan has made one very important assumption - that long-term sustainable social and economic development is preferable to more rapid short-term development at the cost of future generations in Palau. While this may not seem a contentious issue, fast rising lifestyle expectations, human nature, and the election system, combine to shorten the time horizon of most political leaders. In many developing nations the path of short-term rapid growth is frequently chosen because the euphoria of immediate benefits obscures the magnitude of future costs, and often those future costs will not be borne by the same social groups who receive the initial benefits. Compact funding provides Palau with a unique opportunity to plan with greater foresight. Such opportunity is not available to most other developing nations.

1.4.2 STRATEGIES

The scope of work for the Master Plan, which has been agreed to by the Government of Palau and the UNDP, also defines certain strategies around which the preferences of Palauans should be intertwined. Many of these strategies are long-term in nature and are in conflict with the more immediate desires and interests of some Palauans. However, these strategies are based on international experience, and there is increasingly widespread consensus in the international community as to the soundness of such strategies.

These strategies include:

- a substantial shift in economic activity from the public sector to the private sector aimed at increasing productivity and, in general, the efficiency of resource use. In this regard, policies should minimize government intervention, improve operations and management of infrastructure through, for instance, increased use of user fees and privatization, establish a coherent and predictable framework for foreign investment and increase human resource training and development;
- strengthening of government institutions through improved coordination of decision-making processes, greater accountability for performance while, at the same time, reducing the relative size of government through the rationalization of government activities, by commercialization and privatization strategies; and
- the identification of financing strategies, including appropriate taxation arrangements and cost recovery measures, and improved fiscal management to offset the decline in US assistance over time.

1.4.3 IMPLEMENTATION

Many policies that emanate from these strategies are complex and difficult to comprehend. These policies can therefore be difficult for the political process to implement. Master Plan implementation rests on the ability of Palauan leadership and the will of the people to implement policies that improve the long-term prospects of the nation, but which may have considerable short-term costs for some members of society.

Expectations of large redistributive benefits from Compact implementation have been heightened to gain widespread acceptance by Palauans during the process of achieving independence. However, the financial benefits are likely to be substantially less than current expectations and the cost of independence will become more apparent as time passes. It is therefore very important that the Palauan economy not waste its scarce Compact resources.

To meet the vision stated in Figure 3.2 'To substantially enhance the quality of life of Palauans and future generations of Palauans', Palau needs to:

- improve its project selection and evaluation capabilities and all the decision-making processes concerned with capital expenditure allocation;
- implement structural adjustments which improve the efficiency of resource use throughout the entire economy.

This is the only way to ensure that the economy is placed on a sustainably higher economic growth path, such that it can meet the rising income expectations of the Palauan people, while at the same time providing sufficient resources to safeguard the natural environment and major elements of Palau's culture for future generations. The earlier the hard economic decisions are taken, the smoother the adjustment path, and the lower the level of economic instability and social conflict.

It is against these conflicting ends that the Master Plan has been drafted. It attempts to travel along that difficult path that tries to satisfy as many of the short-term desires of Palauans as possible, while, at the same time, develops strategies and institutions that will ensure long-term sustainable economic and social development.

1.5 FORMAT OF THE MASTER PLAN

The sixteen chapters of the Palau National Master Development Plan include sectoral chapters (chapters 4 to 15) at the end of which a summary of programs and projects have been presented in the form of a logical framework analysis. The logframe is a tool used by a number of multilateral and bilateral donor agencies to help strengthen project design, implementation and evaluation. In this report the logframe has been used as a method of summarizing the way in which the program outputs of each sectoral chapter are linked to the strategies leading to the vision for Palau (refer chapter 3).

In each logframe, indicators have been identified which show that an output has been achieved, and where possible the means by which these indicators can be verified.

Another important element of the logical framework is the column in which assumptions are listed that relate to the outputs. These assumptions are essential to the success of the program outputs. Where possible, an indication of the program's duration and the costs of implementation are provided, and possible sources of funds are identified.

The detailed implementation of any one of these programs will require further analysis of each of the program outputs, to identify the activities which will need to be undertaken to achieve those outputs along with their related indicators and assumptions.

These sectoral logframes were presented at a series of workshops conducted in June 1995 attended by staff invited from all Ministries. Feedback was received on a number of the outputs and assumptions and incorporated into the final report. They have also been used to summarize the Master Plan in the Executive Summary which has been presented as a separate document, designed to assist decision-makers in gaining an understanding of the scope of the Master Plan.

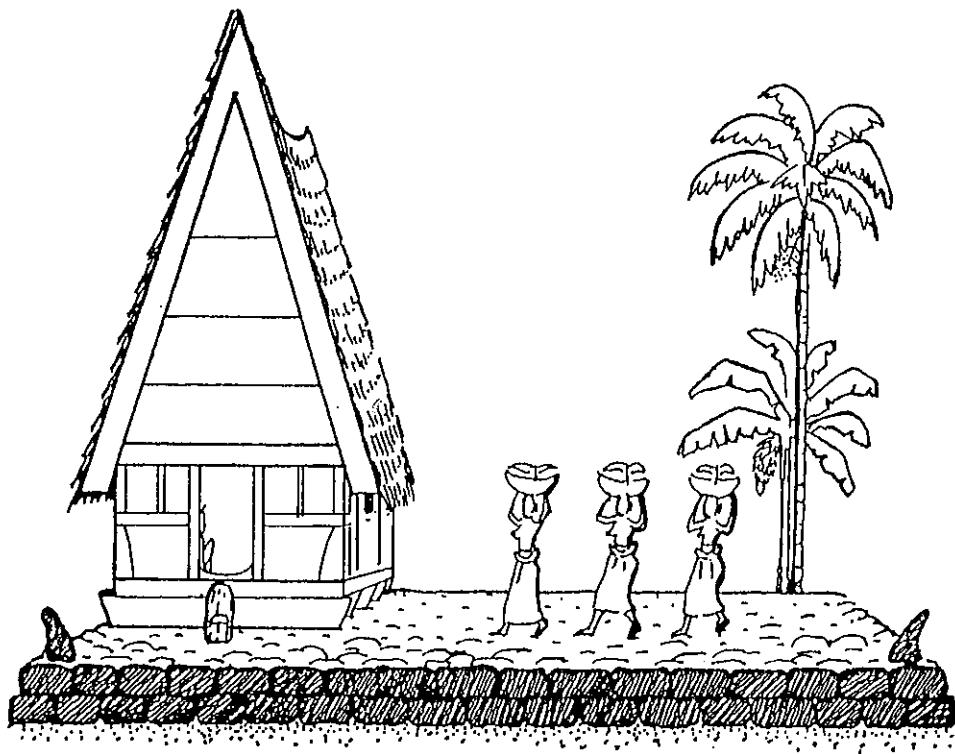
1.6 SECTORAL REPORTS

The reports prepared by each sectoral specialist were published with the first draft of the Master Plan as volumes 2 and 3. At the request of the Government of Palau, this final report includes more detail from these sectoral specialist reports in each of the chapters, as it was decided that more effective use could be made of the Master Plan if it was contained in one volume. Nevertheless, the sectoral reports contain a great deal more detail than was possible to include in this one volume, and should be consulted by anyone wishing to obtain more background or data on a particular sector.



CHAPTER 2

ASSESSMENT OF THE SITUATION AND PERFORMANCE OF THE PALAU SOCIO - ECONOMY





CHAPTER 2

ASSESSMENT OF SITUATION AND PERFORMANCE OF THE PALAU SOCIO-ECONOMY

This Chapter provides a situation assessment of Palau, emphasizing the main factors relating to the performance of social and economic conditions.

2.1 THE SETTING ..

Palau is small, beautiful, fragile and complicated.

The Republic of Palau is the most western group of the Caroline Islands in Micronesia, about 500 miles equidistant from the Philippines to the west and from Papua New Guinea to the south. There are 340 islands in Palau, but a total land area of only 188 square miles, of which Babeldaob, the largest island, comprises 129 square miles. To the north of Babeldaob lie the atolls of Ngaruangel and Kayangel. To its immediate south lies the island complex of Koror, Meyuns and Malakal which are connected by causeways. The modern capital of the Republic, also called Koror, is located on these islands. Babeldaob is of volcanic origin, as is Meyuns, Malakal and part of Koror island.

The capital is the gateway to 300-odd limestone islands to its south, collectively known as the Rock Islands, the beauty and uniqueness of which are world renowned. Further south again lie the islands of Peleliu and Angaur. These are essentially low coralline platforms, with some high limestone ridges. Some 200-300 miles further south of the main archipelago lie the six Southwest Islands of Sonsorol, Hatohobei (Tobi), Pula Anna, Merir, and Helen, a combination of low platform islands and atolls.

A barrier reef some 70 miles long and up to 20 miles wide surrounds much of the main archipelago forming an extensive lagoon. A small number of natural passes through the barrier reef and one man-made channel (German Channel) permit access to the lagoon. The lagoon is approximately 560 square miles in area.

The Exclusive Economic Zone (EEZ) extends over about 237,850 square miles and has substantial marine resources, particularly tuna stocks.

The climate is described as 'maritime tropical rainy'. The mean daily temperature throughout the year is 81 degrees fahrenheit with an average relative humidity of 82 per cent. Rainfall averages 150 inches annually with a July maximum. There is no dry season as such, but extensive periods of drought are by no means unknown, during which surface water on Babeldaob Island can become quite scarce. Palau is off the route of regular typhoons, but nevertheless suffers from periodic occurrences which can cause considerable damage to infrastructure and vegetation.

Palau was the last UN Trust Territory to seek its independence. It is a republic affiliated with the United States of America under a Compact of Free Association. As part of the Compact, the US provides substantial financial and technical assistance to Palau.

Governance is patterned on the American model with the National Government comprising three branches: judiciary, legislative and executive. The head of government is the President. There are 16 States which form a second tier of government. These States evolved from the municipalities formed under the American administration and reflect existing traditional power groupings. In addition, a representative body of paramount traditional chiefs is drawn from the States to form a Council of Chiefs.

There are 13,000 Palauans and 4,000 foreigners resident; another 7,000 Palauans, generally the more highly skilled, live in Saipan, Guam, Hawaii and the United States of America (US). A map of population distribution by State for 1990 appears in an annex at the end of this report (Map 1). Almost 70 per cent of the resident population lives in Koror State. Around thirty percent of the population is under 15 years of age. The real population growth rate is low, primarily due to declining birth rates and continued emigration of Palauans seeking employment and education.

There were around 50,000 people in Palau in 1800, organized in a hierarchical society of titles, privileges, rights and obligations, with harmony and stability as the social imperatives. By 1900, there were 5,000 people. After the Pacific War, there were 5,000. Many Palauans see the coming independence as an opportunity to restore certain aspects of a damaged, interrupted culture.

Palauans, like most other Pacific island populations, are in the center of a turbulent cultural struggle between individualism, propagated by Western cultural influences over the past 50 years, and the waning communalism which is an essential part of the Palauan self-image, way of thinking and social-economic milieu. Palau struggled for 15 years to solve its political status, and disengage from the US (UN Trust). This was achieved on October 1, 1994.

In terms of historical developments, the recently published Economic Development Plan 1995-99 has a detailed account which, to avoid repetition, will not be repeated in the Master Plan.

2.2 ISSUES IN A REGIONAL CONTEXT

While each Pacific island economy has its own unique culture and historical circumstance, there is much in common with respect to the structures, constraints and economic development paths of the island countries. In this regard there is much to be learned from the experiences of island economies. Pacific island economies, in general, are constrained by a number of common factors. These include:

- a small domestic market which is exacerbated by the geographical dispersion of islands within countries;
- high unit costs for infrastructure and industry services;
- narrow resource bases;
- heavy dependence on external trade and foreign assistance;
- adverse terms of trade (that is, the price of exports relative to the price of imports); and
- vulnerability to external shocks and natural disasters.

These constraints clearly exist in the Palauan economy.

Despite these constraints, Pacific island countries have achieved a relatively high standard of living. This has been, in most part, due to generous foreign aid, large worker remittances and favorable natural resources for subsistence living. Social indicators compare favorably with developing countries at the same level of income. Palau's GDP per capita was over US\$5,000 in 1992 which places it in the top bracket of per capita income earning countries in the Pacific islands.

The role of the private sector in Palau and in Pacific island countries generally has been a limited one. Development has been led by public sector activity financed by donor assistance in all Pacific island countries. Large concessional aid flows have permitted Pacific island countries to run large fiscal and current account deficits, maintain large public sector bureaucracies and undertake large public sector investment programs. While this strategy has achieved some notable gains with respect to welfare indicators, economic growth has been disappointing. In most Pacific island countries, real per capita growth in national income has stagnated over the 1980s and early 1990s. Palau is no exception, in that substantial US grant funds and high public sector investment levels have not produced the expected rate of economic growth.

There is general agreement that the cause of this poor growth performance of Pacific island economies can be attributed not only to exogenous factors listed above, but to discretionary factors such as inward-oriented development strategies, limited success in encouraging productive private investment, political instability, politicization of economic policy making and implementation, and low returns on public investment (World Bank, 1993).

In Palau over time and after adjustment for expected inflation, the substantial Compact grants in conjunction with declining grants from other US sources will amount to less than the previous level of US funding. Recurrent funding will cease altogether after 2009. This will result in a severe and widening budgetary contraction commencing around FY 2000. If those investments resulting from Compact funds do not perform and if the private sector cannot expand sufficiently to provide adequate growth in Government revenue, there could easily be a financial crisis, necessitating a drastic reduction in national income. This is the situation now confronting the Federated States of Micronesia. If economic performance is not lifted substantially, then these Compact funds will be wasted and Palauans will have to accept a lower quality of life and lower income levels. There will be significant costs for Palau in meeting its objectives of preserving its culture and natural environment. If these costs are to be met, while, at the same time, incomes are to be raised, the economy must perform extremely well - or put another way, the economy cannot afford to be inefficient.

To date, the performance of the public sector and, in particular, public authorities has been far less than optimal, as has been the case in most other Pacific island economies. The response from policy makers to this problem around the world has been to shift the allocation of resources to the private sector. Most Pacific island economies have this shift built into their policy goals but few have been able to realize such a shift in practice and, as such, have continued to stagnate - both culturally and economically. It is essential that this shift be the focus of Government policy in Palau. This is the goal of the Master Plan in its attempt to achieve the vision of rising incomes accompanied by enhancement of culture and protection of the natural environment.

The fundamental requirement for strategies to meet the goal of shifting resources to the private sector lies in stimulating productive investment which takes account of social, cultural and environmental objectives. Policies must be aimed at reducing the risk premium for investment and providing an internationally competitive environment that is favorable to business. This will be a difficult process for Government because it invariably means a reduction in its authority and status now, so that future Governments will benefit from such current actions. This will require a major shift in attitude and a commitment to the Vision for Palau.

In pursuing economic growth, Palau, in common with all Pacific island countries, has little option but to follow the strategy of seeking an expansion of the private traded-goods and services sector (exports and import replacement). Its domestic market is simply too small to even consider an inward-looking strategy. However, as the goods and services offered by Palau can be readily obtained elsewhere, economic policies must be guided by the principle of enhancing international competitiveness. This will require a stable political and economic environment, smaller government, supportive economic infrastructure, productive workforce and a business environment conducive to trade and investment, including foreign investment.

The strategy of reliance on smaller, but more efficient government, coupled with an expansion of the private sector is best achieved by the focus in the Master Plan on the development of strategic economic policies, rather than sectoral targets and plans which are unfunded and have failed elsewhere in the world. The Master Plan, therefore, is a strategic policy document.

In summary, the Palauan Government will face a critical challenge over the medium term. It will need to reallocate resources and implement strategies to enhance the development of the private sector. This will be necessary in order to maintain the growth in national income and employment in the face of the Government's inevitable medium term budget constraint which will reduce its ability to employ, remunerate and provide essential services to Palau's growing population. If this reallocation of resources is not achieved, then the unemployment rate of Palauans will increase and their standard of living and quality of life will decline, particularly amongst those who are unskilled and have difficulty emigrating. Reliance on foreign workers will increase given the structure of the labor market and productivity of the Palauan workforce, and social conflict will be exacerbated.

2.3 MACROECONOMIC PERFORMANCE

2.3.1 ECONOMIC ACTIVITY

Palau does not regularly compile national accounts data and collects practically no regular statistical data. What data series are available tend to be inconsistent. This has meant that policies recommended in this plan have, in part, been based on experience elsewhere, adjusted for local circumstances, rather than empirical testing of Palauan data. Collection and compilation of standard statistical data is essential for planning and evaluation of economic performance and should be given high priority. Nevertheless, the available data do show some discernible trends that provide a basis for economic policy analysis. Also, to compensate for the weakness in data, there has been a reliance on:

- wide and impartial consultation with Palauans, resident foreigners and concerned visitors;
- clarity and strength of argument drawn from principles of development economics; and
- comparisons drawn from appropriate situations in other countries.

Table 2.1 shows comparative data on a number of Pacific island countries, together with the Maldives, Philippines and Taiwan. In particular, the data on Palau shows:

- GDP per capita 3 to 6 times higher than other Pacific island countries;
- imports per capita 3 to 8 times higher (with the exception of Fiji and Cook Islands, whose tourists greatly lift national imports);
- high hourly wages but with a low tax regime for persons and business;
- high Government spending per person;
- very high foreign assistance per person (currently \$2,000 per capita per annum);
- highly urbanized population with above average access to basic services and employment; and
- very small share of economic wealth coming from agriculture and inshore fishing.

TABLE 2.1:

COMPARATIVE ESTIMATES FROM RELEVANT ISLAND COUNTRIES

Country	Pop'n x 1000 1992	Pop'n growth 1980's %	Crude birth rate	Pop'n density sq.mile	Urban pop'n %	EAP female % (a)	Formal employ / pop'n %	Jobs in public sector %	GDP/ person US\$ 1991	GDP growth 1980's %	GDP forecast 1990's %	Agric share GDP %	Govt expend / GDP %	Taxes / GDP %	Local revenue/ person \$	Govt expend / person \$	O.D.A / person (b) \$	Debt / person 1990 \$	Exports / person 1990 \$	Imports / person 1990 \$	Imports / GDP 1990 %	Tourists/ pop'n 1992	Base wage/ hour \$	Annual inflation 1980's %
Palau	15.5	2.3	22	100	70		32	35	4600	2.5	3.6	3	31	13	645	2258	2000	1613	1613	2266	50	1.9	1.2	7
Cook Islands	18.4	0.8	24	76	25	40	43	14	1200	5		18	31	31	478	465	666	543	669	987	51	0.4	0.6	7
Fiji	753	2	26	40	40	23	14	37	1700	1.7	5	5	21	26	329	395	216	52	52	355	60	0.1	0.5	5.5
Kiribati	76	2.1	29	101	36	14	14	35	500	1	2	29	62	25			94			553		1.1		
Maldives	233	3.3	41	715	26	20	17	14	430	9	24	24												
Marshall Is.	50	3.8	49	255	65	30	14	34	1600	3.2	2.5		90	19	400	1720		46	46	880	49	0.1	0.6	6
FSM	106	4.6	38	21	26	18	26	25	1500	3.1	2.4		110	20	377	1179		51	51	350	50		0.6	
P.N. Guinea	3700	2	36	8	17		6	37	860	2.8	7	7	20	18	189	245	112	698	324	322	42		0.9	5
Solomon Is.	340	3.5	44	11	11	14	8	33	430	3.6	4	45	70	20	221	294	132	356	221	270	70		0.5	12
Tonga	89	0.5	30	139	21	18	25	25	600	2.5	3	40	100	19	315	674	287	685	90	590	110		0.6	10
Tuvalu	9	1.7	17	700	17		17	65		7	2.4		60	60	1111	667		56	56		50		0.6	10
Vanuatu	155	2.4	38	12	18	45			820	2		22	35	20			322	258		593			0.6	
W. Samoa	165	0.6	33	58	23	18			670	1.5	3	3	14	25	303	303	290	558	79	454	60		0.5	11
Philippines	63400	2.4	29	202	44	48			700	3.5	4	23	8	14			20	477		203			0.4	
Taiwan	57800	2.5	17	562	49	40			8000	8	7	4	16	15			0.6	321		945				

NOTES:

(a) EAP: Participation rate of the economically active

(b) ODA: overseas development assistance

Sources:

East West Center, Pacific Islands Development Program (R L Lucas) 1991: Performance and Growth Prospects: Republic of Marshall Islands, Federated States of Micronesia and Republic of Palau
 Government of FSM, 1992: Second National Development Plan 1992-1996
 Australian International Development Assistance Bureau (AIDAB), 1992: The Kiribati Economy, Development Options and Prospects for Growth
 AIDAB, 1993: Tuvalu, Economic Situation and Development Prospects
 AIDAB, 1991: The Western Samoan Economy, Prospects for Recovery and Long-term Growth
 AIDAB, 1991: The Solomon Islands Economy of Fiji, Performance, Management and Prospects
 AIDAB, 1992: The Economy of Fiji, Performance, Management and Prospects
 AIDAB, 1993: The Papua New Guinea Economy, Prospects for Sectoral Development and Broad Based Growth
 AIDAB, 1991: The Tongan Economy, Setting the Stage for Accelerated Growth
 Asian Development Bank, 1993: Key Indicators of Developing Asia Pacific Countries

The general picture is of a high consumption economy heavily dependent on foreign assistance and foreign labor, offshore fishing by foreigners and tourism.

In particular, growth in real income per capita in Palau has not been significant over the past two decades. It has been estimated that such growth was close to zero between 1975-80, just under two per cent between 1983-90 and around one per cent in 1991-92 (Palau National Accounts and NMDP estimates). The performance of the economy is better than that of most other Pacific island economies (see table 2.2). However, it is poor compared with the Caribbean and Indian Ocean island countries that have achieved average annual per capita GDP growth rates of 2.4 per cent and 3.6 per cent, respectively, over the past decade (World Bank, 1993). It is also less than the average real per capita GDP growth rate in Guam of 2.3 per cent in the 1980s. These figures take account of subsistence production but do not take account of shadow and unrecorded market activities which may be significant in Palau.

Table 2.2: Average Growth Performance 1980-90 (% p.a.)

	Palau --	Pacific Is	Caribbean	Africa & Ind
Population	2.2	2.1	1.2	2.1
Real GDP	4.1	2.1	3.6	5.8
Per Cap Real GDP	1.9	0.1	2.4	3.7

Source: World Bank 1993, Palau National Accounts and NMDP Estimates

The relatively low real per capita GDP growth rates cannot be attributable to strong population growth. External migration, coupled with a low natural birth rate, resulted in little growth in population between 1973-80. Population growth increased to 2.2 per cent per annum between 1980-90, but this has been predominantly due to the inflow of foreign workers (EDP, 1994). The population of Palauans actually declined over this period (UCLA, 1992). However, the low wages and higher productivity of foreign workers may have resulted in higher relative GDP per capita for Palauans. Foreign workers have increased from around 500 in 1984 to an estimated 4,300 in 1992, just below the number of Palauan workers (4,400). An analysis of population trends, projections and the labor force is shown in Chapter 14.

The recorded GDP growth rates may be an underestimation. General business indicators such as telephone calls, vehicle registrations, international business visitors, building approvals, merchandise imports, and electricity consumed show high real growth rates of 8 per cent or more. These partial indicators suggest higher levels of economic activity than that recorded. This discrepancy could result from a number of sources, including shadow market and black market transactions, compliance and collection difficulties in the payment of taxes and fees, and deficiencies in statistical measurement of the relevant indices.

As a measure of living standards, GDP may also not be particularly appropriate for Palau, given the relatively high income and transfer payments received and repatriated from/to other countries. GDP is a measure of domestic production. As such, GDP excludes income earned from overseas property or productive activity (less income paid to overseas residents). That is, remittances and the value of output from foreign fishing fleets (not based in Palau) are excluded from GDP. However, the 1992 accounts have included foreign fishing fleet output which will tend to over estimate GDP. Gross National Product (GNP) may be a more appropriate measure. It equates to GDP plus net income received from overseas. This is expected to be considerably higher than GDP (if a downward adjustment is made to GDP for foreign fishing boat output). That is, the income of Palauans is likely to be higher than that indicated by

the value of domestic final production. However, there is no data available on personal income payments and no data is collected from the domestic banking system or elsewhere that could provide a solid estimate of these flows.

External income inflows involves inward remittances from Palauans working abroad and investment income derived from various offshore deposits and trust accounts associated with pension funds. From census data and numbers registered to vote in the Compact plebiscite, it has been estimated that around 4,000 Palauan workers reside offshore and, therefore, remittances to Palau are probably significant. External income outflows result from repatriation of foreign workers' income (which is likely to be significant and may not all pass through the banking system) and foreign company operating surpluses (which could be higher than expected due to transfer pricing arrangements). Foreign workers' income has been estimated at \$9 million in 1992 (Wages Advisory Group Report, 1993), of which it is estimated that around 75 per cent is repatriated. Repatriations of income by foreign businesses is also likely to be substantial and increasing. An indication of these income movements can be gained from the consolidated balance sheet of the domestic banking system. Modest growth over recent years in the money supply (defined currency circulation plus bank deposits) could indicate that the overall net flows may not be significant and, therefore, the deviation of national income data from GDP data may not be substantial. However, account would need to be taken of other balance of payments transactions, including capital account transactions such as net equity and debt flows. For instance, large capital inflows associated with the Aimeliik power plant (\$32 million) would have expanded liquidity in the domestic banking sector, although much of this would have been drawn down via expenditure on imports.

2.3.2 PRODUCTION

Despite the relatively low per capita GDP growth rates, significant growth in the private sector has occurred, which has been fueled by moderate growth in the tourism sector and tuna exports. The strength of private sector development is reflected in (volatile) growth in direct foreign investment (particularly in tourism, tuna and garments factories), robust levels of construction (mainly apartments and hotels) and a strong increase in the number of foreign workers.

The growth in fisheries has depended on exporting fresh fish (tuna) to Japan and Guam and supplying an expanding local market due to tourism growth. Total fisheries' exports recorded by PITI and PMIC were \$27.6 million in 1992 (Division of Marine Resources, Annual Report, 1992). However, the flow-on effects of tuna transshipment to Palau are considerably less than indicated by these amounts.

The high levels of US grant funds, channeled through wages of the relatively large public sector, have increased incomes generally. With little domestic production and with relatively low import duties and taxes, the increase in incomes has stimulated imports and fueled growth in the wholesale and retail sectors, and the transport sector. The number of retail/wholesale establishments has grown significantly over the past decade.

In contrast, the agricultural sector has declined substantially in relative terms (as a proportion of GDP) with food imports replacing domestic agricultural production, although estimates of subsistence production remain uncertain. Manufacturing has shown modest growth, both in nominal terms and as a proportion of GDP (estimated at around one per cent in 1992). Growth has centered on building construction materials and, in recent times, garment manufactures aimed at accessing the US market

under the favorable trade arrangements. The establishment of an additional large clothing factory in 1994 is likely to increase further the contribution to GDP of manufacturing output.

Other sectors which have experienced solid growth and increased their contribution to GDP growth include the finance and insurance, and the business services' sectors. Table 2.3 shows GDP by economic activity as a share of total GDP:

Table 2.3 Gross Domestic Product (% shares)

Economic Sector	1983	1990	1991	1992
Agriculture	9.9	3.0	3.0	2.9
Fishery	7.2	23.0	25.2	25.9
Manufacturing	0.4	0.7	0.8	0.9
Constr Residential	0.9	0.9	1.3	0.8
Commercial	1.9	2.0	1.8	2.6
Government	10.1	8.2	5.3	4.0
Gov. Utilities	1.9	3.7	4.4	5.0
Whole/Retail Trade	16.9	15.6	16.5	15.7
Hotel & Restaur	1.7	8.1	8.1	9.7
Transport & Com	2.4	4.4	4.1	4.6
Finance & Insur	1.8	4.0	3.8	3.6
Real Est & Bus	0.8	4.3	4.5	4.1
Government Ser	37.6	18.5	17.9	16.0
Other Services	6.5	3.6	3.6	4.1
GDP	100	100	100	100

Source: Government of Palau: Economic Development Plan, 1994

In summary, from the production accounts, it is clear that:

- the agricultural sector has experienced a substantial decline as a proportion of GDP (although has increased modestly in nominal terms) with the contraction of subsistence farming, while fisheries has increased sharply to account now for around 26 per cent of GDP;
- manufacturing has remained small, although increasing modestly with the establishment of a number of garment factories exporting to the US under the preferential trade access policy;
- construction has eased in relative importance, although residential and commercial construction have maintained steady growth, while the relative importance of government construction has declined;
- retail and wholesale trade remain an important sector at around 16 per cent of GDP;
- increases in tourism expenditures have fueled strong growth in hotel and restaurant services; and
- government services, including utility services, have continued to increase, although as a proportion of GDP have declined significantly from around 40 per cent of GDP in 1983 to 21 per cent of GDP in 1992. Within government services, utility output has expanded at a rate in excess of GDP growth rates. This is predominantly due to the 12 per cent increase per year in electricity usage over the period shown.

2.3.3 EXPENDITURE

On an expenditure basis, GDP estimates are outlined in table 2.4. Unfortunately, no consistent earlier data is available.

Table 2.4 Gross Domestic Product (\$ 000 current prices)

	1990	% GDP	1991	% GDP	1992	% GDP
Private Cons	34,015	44.2	36,543	43.6	39,886	44.4
Govt. Cons	25,492	33.2	26,629	31.8	27,679	30.8
Gross Fixed Cap	29,457	38.3	28,335	33.8	28,905	32.2
Construction	21,306	27.7	17,537	20.9	16,722	18.6
Dur Equip	5,012	6.5	7,183	8.6	8,500	9.5
Increases in Stock	3,139		3,614		3,683	
Exports Gds&Ser	27,533	35.8	37,681	44.9	42,395	47.2
Imports Gds&Ser	-36,490	-47.5	-42,999	-51.3	-45,000	-50.1
Stat Discrep	-3,118		-2,333		-4,126	
Gross Dom Prod	76,888	100	83,855	100	89,739	100

Source: Republic of Palau, National Accounts, 1990-92 Economic and Social Commission for Asia and the Pacific.

While the unavailability of time series data limits analysis of trends, the expenditure shares provide information on the structure of expenditure. Expenditure on private consumption is around 44 per cent of GDP. Earlier fragmented evidence (Economic Development Plan, 1994) suggested that the share of private consumption was around 138 per cent in the mid 1980s. This would indicate that the economy was dependent on aid and offshore income inflows with little domestic production.

High consumption ratios are typical of earlier Pacific island economic structures. The reduction in the ratio of private consumption to GDP, however has been quite significant which indicates substantial growth in exports and investment levels. In this respect, Palau has performed much better than other Pacific island economies which generally have private consumption to GDP ratios around 70 per cent (AIDAB, International Development Issues reports, 1992). Palau compares favorably with South East Asian economies which have similar relative private consumption spending ratios.

However, government consumption to GDP ratios in Palau in the early 1990s (31 per cent) are higher than the average of Pacific island countries (20 per cent) and substantially higher than South East Asian economies (under 10 per cent) (Asian Development Bank, Key Economic Indicators, 1993). Government spending per person is around \$2300, equivalent to about half GDP per person. Foreign support, mainly from US grants, has contributed consistently about two-thirds of total public spending. In the last three years, government has improved its revenue collection with a view to a gradual transition to fiscal self-reliance, at least for recurrent purposes. However, in the FY 1995 Budget, recurrent spending increased substantially. Compliance, collection and accountability difficulties associated with tax and fee payment remains one of the major constraints to government effectiveness. In addition, the inefficiency of the existing taxation system also creates a major distortion which will increasingly impede economic development as the Government seeks to expand its revenue efforts in coming years.

There were 2,697 public employees who contributed to social security in 1993. The figure includes some casual employees, part-time employees and those who may have left and come back into public employment. The regular, full-time public sector employment is around 1800, suggesting a ratio of three Government employees for each four Palauan households. Such a high dependency on Government employment almost certainly constrains public policy choices, particularly in matters of wages, taxation conditions, restructuring, staffing and productivity changes.

Investment levels have been high in Palau (over 30 per cent of GDP in the early 1990s) as have such levels in most Pacific island countries and South East Asian countries. However, the difference between Pacific island countries and South East Asian countries is the much higher share of public sector investment in the former countries. In this respect, Palau is very much in the same category as other Pacific island countries.

Public investment in Palau has focused on infrastructure, with major capital expenditures in recent years being on a large hospital in Koror, rural water supplies and five local fishing bases. Foreign government funds have been the predominant source of public investment, estimated at around \$10 million per year. With a backlog of investments in airport, waste water, water supply, energy and roads, it is likely that government investment will continue to be predominant over the next decade.

The performance of public infrastructure appears to have been far less than optimal with low technical efficiencies, little demand management, low rates of return on investment, service delivery that could be improved, and a declining financial reputation due to loan servicing difficulties.

Private investment has focused on the purchase of fishing boats and equipment, the construction of residential houses, apartments, tourist accommodation and facilities (especially for diving) and, in recent times, the construction of garment factories. The value of approved investment in residential and commercial buildings in Koror State, from foreign and domestic sources (excluding the hospital), has been about \$5 million per year. Data on commercial returns of private businesses does not exist. This is exacerbated by the absence of taxation data based on income statements.

A significant amount of investment may be entering the economy as private loans to Palauan business partners. Such loans tend to support commercial and residential building in Koror and working capital for restaurants, trade and services, and business equipment. The absence of data on private sector debt sourced offshore prevents any conclusions on the level of debt servicing and the effect this will have on liquidity of the domestic banking industry. Estimates based on trends in imports, building approvals, wages and bank deposits indicate that such investments could total around \$1-2 million per year. It may also be possible that such loans are supporting some portion of the unrecorded economy which may explain the discrepancy between the official record in production and taxes, and the apparently high consumption trends.

According to anecdotal evidence, a significant proportion of private domestic investment funds are invested in the needs of relatives and friends (mainly new houses and extensions). The Household Income and Expenditure Survey (ROP, 1991) estimated that 20 per cent of household expenditure is for gifts and contributions. Customary obligations also attract remittances from some of the 4,000 Palauans employed offshore. From data on comparative per capita remittances in South Pacific countries, it is estimated that around \$2 million per year could be remitted to Palau.

2.3.4 FOREIGN TRADE

Where Palau has clearly outperformed other Pacific island economies is in the area of foreign trade. It was reported in the First Development Plan 1987-91 that in 1984 the value of imports was \$23 million and exports \$0.5 million, resulting in a merchandise trade deficit of \$22.5 million. By 1992 exports of goods and services had increased to \$42 million and imports to \$45 million (ROP, National Accounts, 1992). There has also been an improvement in the current account deficit which is attributable to significant increases in merchandise exports (mainly fresh fish to Japan and Guam) and tourism services receipts, as well as a substantial decline in the imports/GDP ratio (import penetration) from around 74 per cent in 1983 to around 50 per cent in 1992. The contribution of exports is likely to be overstated due to inappropriate inclusion of the output of foreign fishing fleets in the 1992 National Accounts.

Recent data on fish exports relies almost totally on the declared value of shipments by the tuna agencies, and these show substantial increases in 1990-93. However, shipments declined substantially in 1994-95 due to lower catch levels and the temporary closure of the large fishing company - PITI (refer Chapter 11). There is evidence from local sources that a significant volume of fish exports is being unrecorded because of:

- the direct transfer to offshore markets without landing in Palau;
- catch by boats based at Guam; and
- personal consignments of inshore products.

The increase in fish exports in the early 1990's was predominantly due to increased production from foreign fishing vessels. The tuna industry is, in many respects, an enclave economy with ill-defined contributions to the Palauan economy. Thorough evaluation and recording of exports would assist in a proper evaluation of the flow-on effects of tuna transshipment and the resulting contribution to ROP capacity to pay for imports. A large proportion of the earnings is repatriated offshore and in the balance of payments framework is up as a large offshore income payment. Therefore, apart from the income of the Palauan fishing agents, these exports will not inject substantial liquidity into the domestic banking system which would provide scope for the country's import and capital demands. Therefore, the multiplier effects of tuna exports would be expected to be low.

Imports per capita are relatively high, reflecting a dependency on oil products (about \$1200 f.o.b. per person per annum); food and drink (about \$600 per person per annum); and the manufactured products necessary for an urban lifestyle. Table 2.5 shows the value of imports (f.o.b.) in 1994 for various categories. In 1993-94, judging from public sector capital spending (CIP), building activity, business diversification and the investment in three hotels (Airai View, Sunrise Villa, Palau Pacific Resort), current imports include a greater share of building materials, capital equipment, furnishings and office equipment. Since import regulations do not levy tax on personally procured items, there may be significant non-recorded imports by people who buy direct from Guam, Hawaii and the West Coast of the US.

Table 2.5 Imports (fob) 1994

CATEGORY	\$'000	\$'000
Food and Live Animals		6,647
Of which Meat & Canned Meat	1,687	
Dairy Products & Eggs	581	
Rice	701	
Vegetables & Flour	699	
Canned Fish	141	
Beverages and Tobacco		3,816
Of which Beer	1,631	
Soft Drinks	1,152	
Liquor	440	
Tobacco	592	
Mineral Fuels		19,882
Chemicals and Related Products		1,147
Manufactured Goods		3,546
Of which Wood Products	1,074	
Paper	331	
Textiles	455	
Iron & Steel	669	
Machinery and Transport Equipment		5,936
Of which Industrial Machinery	3,047	
Road Vehicles	1,274	
Boat Engines	686	
Other		7,608
TOTAL:		48,582

Source: Ministry of Commerce and Trade

With increased public and private sector activity expected in the immediate future, it is imperative for Palau to strengthen its data collections and monitoring of trade flows. Similarly, with increasingly diverse business services, tourism and international transactions, it is necessary to monitor the flows of invisibles, such as for travel and freight, financial services, insurance, communications, commissions, etc. Only with such information can Government and business accurately form their economic responses and strategies.

2.3.5 PRICES

There are no indicators of prices and the cost of living in Palau. In recent years, US-sourced goods and services have risen by around 5 per cent. However, the depreciation of the US dollar in recent years has resulted in much higher prices for non-US sourced goods. With consumer prices in Guam increasing by 10 per cent per annum in recent years and CNMI by 8 per cent, it is likely that Palau's cost of living has been rising at similar rates. Also, the shift towards Western tastes is likely to have had compositional effects resulting in increases at the margin in higher valued imports which are likely to have lifted the cost of living further.

2.4 POPULATION, EMPLOYMENT AND WAGES

The population of Palau is estimated to be around 17,400 in 1995 (13,384 Palauan, 4,024 foreign). After remaining stagnant in the 1970's, the population grew by an average annual rate of 2.3 per cent in the 1980's and an estimated average annual rate of 2.9 per cent over the first half of the 1990's. Population data is collected every 5 years as part of the census conducted by the US Bureau of Census. The last census undertaken was in 1990. Partial data for the first half of the 1990's indicates that the growth in population in these years was predominantly due to the growth in foreign labor - three quarters of which came from the Philippines. The very low Palauan population growth rate reflects low birth rates and out-migration of Palauans, predominantly to US territories.

There are a number of difficulties with the collection of labor market data which argues for caution in interpretation of trends. Nevertheless, some discernible trends are apparent. The participation rate in the formal economy has grown significantly in recent decades. In 1980, 39 per cent of the potential Palauan work force were in the labor-force, with 61 per cent in subsistence activities. By 1990 participation in the formal economy had increased to 53 per cent. Over the same period the unemployment rate for Palauans has increased from 4.9 per cent to 10.8 per cent. There are marked sectoral differences in the distribution of foreign and Palauan workers. Palauan workers dominate the public sector, whereas foreign workers increasingly dominate the private sector. In 1990 non-resident foreign workers in the private sector numbered 2,242 compared to 964 Palauan born workers.

Labor costs in Palau are low relative to neighboring Guam and Saipan, but are high relative to other Pacific islands and Asia. In 1990 average hourly wage rates paid to public sector employees (\$4.62) were around twice that of private sector employees (\$2.59), and well in excess of that paid to Philippine workers (\$1.56). Access to the US labor market has placed an effective wage floor in Palau, at least for mobile skilled workers. There are no minimum wage laws in Palau.

Population and labor market trends and projections are shown in more detail in Chapter 14. The labor market is also discussed in a macro economic framework in Chapter 4.

2.5 HUMAN RESOURCE DEVELOPMENT

2.5.1 EDUCATION

The education system in Palau in terms of goals, curricula, technology and governance is distinctly Western/American. The Government provides free compulsory education to all Palauan children aged 6 - 14 years through an 8 year elementary program. There are 18 government-run elementary schools and 2 private elementary schools. Secondary education is not compulsory and is free of charge. Attendance ratios are high by regional standards. The Government runs one centrally located public high school which has around two thirds of total enrollments. There are 5 private high schools which account for the remaining one third of enrollments. Palauans have had access to post-secondary education in US colleges and universities, and have been supported by a Government scholarship scheme. A large proportion of graduates have not returned to Palau. Within Palau, post-secondary education and training is predominantly the responsibility of the Palau Community College.

Literacy rates are high compared with Pacific island standards, although independent testing has revealed much lower competency levels. Unit costs of education in Palau are very high, in part due to the very low student/teacher ratios of around 8 - 10 in elementary and secondary levels, and very low graduation rates at the College. In terms of fiscal resources, the Ministry of Education expenditure has amounted to around 12 per cent (\$4.3 million in FY 1994) of the total Government budget in recent years. The Ministry also receives around \$5 million per year in grants from the US.

An analysis of education and training policies, and a number of recommended program outputs are shown in Chapter 14.

2.5.2 HEALTH

In general, over the past three decades, Palauans have experienced continued improvements in health conditions. This reflects improvements in literacy, living conditions, income, and health care services - both preventive and curative. Indicators of health, such as infant mortality and death rates, compare very favorably within the region, although not as favorably as developed market economies. Despite these improvements, prevalent rates of diseases of developing nations are still high, and there is an increasing incidence and prevalence of chronic illness (cardiovascular disease, cancer and diabetes). The growth in non-communicable diseases is imposing a major burden on health care resources because they usually require expensive hospital-based curative treatment. Concerns over behavioral health illness and health problems exacerbated by drugs and alcohol have increased.

Expenditure on health is relatively high in Palau, accounting for around 13 per cent of total Government expenditure in the 1990s (\$5 million local contribution, and \$1.5 million in foreign grants). A large proportion of foreign grants are from the US and are focused on preventive and primary health care. A new 80 bed hospital was opened in Koror in late 1992 funded by US grants which allows relatively high quality secondary and tertiary care. Health services are heavily subsidized by the Government.

2.5.3 LAW AND ORDER

Communal property rights and communal sharing of material have probably obviated the recording of crimes related to property. Increasing disparity in incomes and expressions of individual accumulation can create an environment which leads to increased rates of crime. The cost (both financial and social) of security to business and households has become a major expense in some Pacific island economies. For instance, in Papua New Guinea, the cost of security is now estimated to be equivalent to the cost of capital expenditure. Good Government policies across a broad range of issues can minimize the allocation of Palau's resources to public safety by reducing the disparity in incomes and wealth accumulation.

Foreign investors are sensitive to issues of crime and property rights and will be expected to consider the costs of expenditure on security measures in financial analysis of any proposed investments. Government economic policies which foster a strong middle class and minimize polarization of incomes will assist in minimizing the cost to the community of crime and law enforcement.

2.6 CONCLUSIONS ON PERFORMANCE

Over the past decade, Palau's economy has advanced unevenly due to factors such as the downturn in fish exports in 1982 and their recovery in 1990-93, the recent stimulus from tourism, the emigration of a large number of Palauans and their replacement by a much greater number of foreigners, the shift away from subsistence and the greater rate of participation in the market/wage economy. The more constant forces affecting the economy appear to have been Government employment and services supported by US assistance. High levels of consumption persist while local private investment has stalled at low levels.

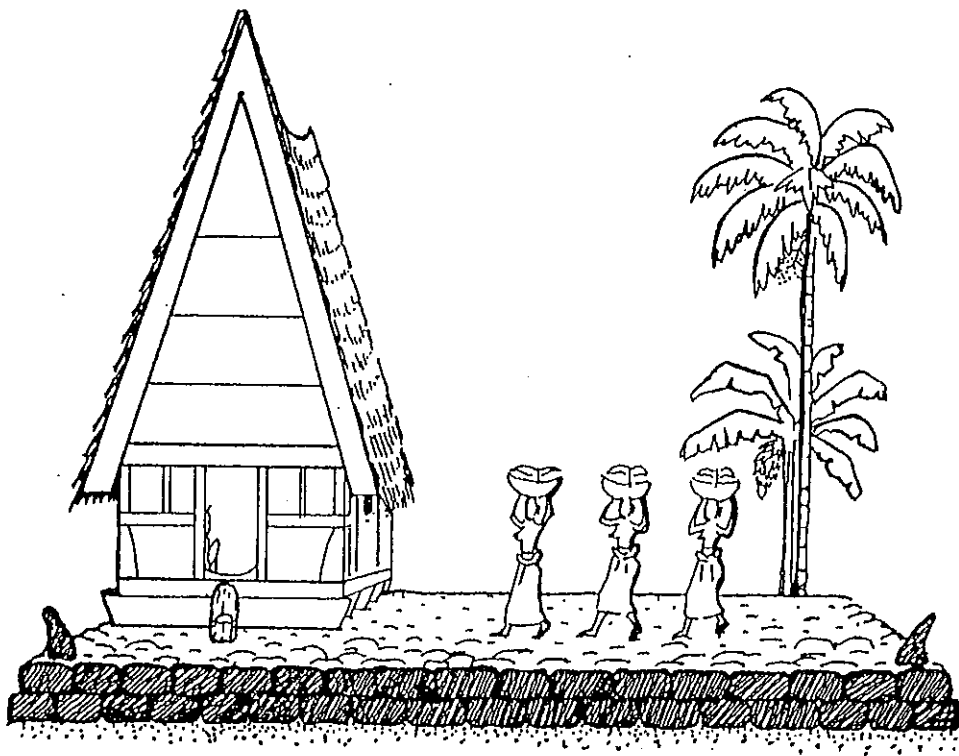
Although the performance of the Palau economy is better than that of other Pacific Island economies, it has not performed as well as it might have when compared with island economies in the Caribbean and Indian oceans. This is so despite the fact that:

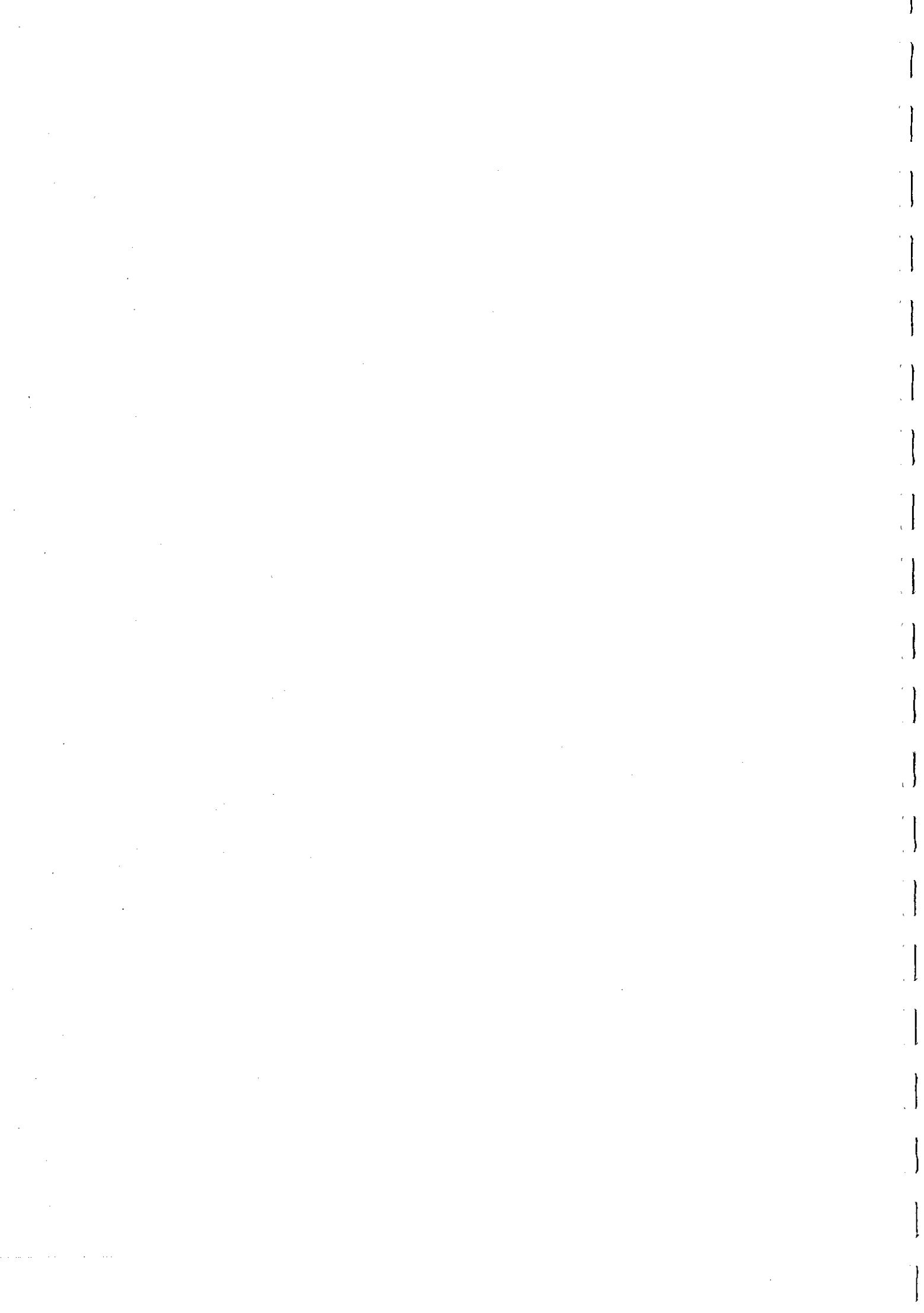
- Palau has not had tight capital or human resource development constraints, given the substantial US grant aid for projects and programs relating to infrastructure, education, health and technical skills training. As a consequence, Palau has had strong public investment rates;
- Without a natural resources constraint, Palau has substantial land available per capita, little pollution, abundant supply of fresh water, a large exclusive economic zone relatively rich in marine resources and some of the most attractive natural island/reef formations in the world;
- unlike many other Pacific island economies, Palau is not distant from major markets, being adjacent to the most rapidly growing and highly populated region in the world; and
- Palauans have unrestricted access to the United States, including access to preferential trade arrangements without extending reciprocal rights, and access to the US and regional labor markets.

In summary, few countries have such advantages and opportunities. Yet the economy has achieved little real economic growth per capita; considerable conflict and instability remains over cultural and political issues; concern is mounting over environmental degradation; and Palau has been unable to prevent large numbers of its citizens from emigrating.

CHAPTER 3

CONSTRAINTS, OPPORTUNITIES, VISION AND STRATEGIES





CHAPTER 3

CONSTRAINTS, OPPORTUNITIES, VISION AND STRATEGIES

This chapter examines the constraints on development in Palau and the opportunities for advancement and, from this analysis, develops a national vision and goals statement, and strategies that will guide the strategic approach of the Master Plan.

3.1 CONSTRAINTS ON DEVELOPMENT

3.1.1 HISTORICAL AND CULTURAL FORCES

(a) *Decision-Making Processes*

Reaching and maintaining agreement in Palauan society is very difficult and time consuming. The practice of long lasting policy consensus and firm long-term business agreements is not rooted in Palauan ways. Before western contact, inter village rivalries and a continual competition for power and prestige involved considerable diplomacy, patience, negotiation, intrigue and the frequent re-establishment of alliances. Agreement to act came through the Chiefs' instruction after a period of upward percolation of consent. These ways are still evident today. Despite the numerous changes in this century in Palau, most people still regard the need to co-exist peacefully as more important than settling matters in the western capitalist mode with its perceived win/lose outcomes of definitive transactions. These attitudes have strong similarities with those of many small, isolated communities worldwide where the costs of confrontation can be substantial.

In public affairs, decision by majority, as westerners know it, was not exercised. Withholding consent against the will of a numerical majority was and is a legitimate social practice employed by interested parties. The acceptance of such strategies has tended to preserve peaceful coexistence. Such emphasis on coexistence meant that inter-personal relationships dominate the social system and decision making is often protracted, compromised and cumbersome by western standards.

(b) *Redistribution versus Total Welfare Considerations*

The dominance of individual and minority interests over institutional practices has enabled personal, clan and State jealousy and rivalry to continue. Moreover, in times of crisis and change, even over apparently small matters, inter-personal, inter-clan and inter-State envy and rivalry appear to have influenced and frustrated decision-making. This type of competition does not translate into a vibrant private sector as has

occurred in larger countries because, in small countries, participants have market power to influence the rules. This has led to an overemphasis on distributional issues rather than on issues that may result in some inequities but which will increase the overall level of national welfare.

This is clearly seen by the almost total preoccupation of the debate between States and interest groups over the allocation of Compact funds, particularly the distribution of the \$52 million infrastructure fund. All the other very important issues, such as building the necessary institutions and policies for independent nationhood, appear to be of much less concern. Another example is the recent restrictions placed on foreign participation in tourism services to favor narrow, sectional interests, at the cost of growth in the tourism industry and consequent national benefits. It also manifests itself in a lack of concern for compliance with national policies such as taxation, debt repayment and user charges.

In this respect, it is important that political and business leaders focus the debate on longer term development issues, as opposed to shorter term opportunism or redistribution issues. If this shift is not achieved by Palauan leadership, the economy will continue to be dominated by non-productive, 'rent-seeking' behavior which will reduce the performance of the economy and, particularly, reduce the effectiveness of Compact-funded spending.

(c) *Incentives*

The focus on redistribution distorts incentive structures and, equally important, disincentive structures that are essential for economic and social enrichment. Currently there are few sanctions for low productivity. In the public sector, high relative wage levels, flat wage structures, lack of performance measurement and tenure arrangements mean that there is little incentive for performance and few sanctions for poor performance. The very high relative income and social support in the village system means that there is little incentive to perform in the private sector and few sanctions resulting from unemployment. Political support is based on regional patronage and, if distributions to the respective State can be obtained by politicians, there is little sanction for poor performance with respect to national policies.

Without a doubt, policies will fail if appropriate incentive and disincentive structures are not established. Policies, therefore, need to take account of the effects on incentives of traditional cultural forces, as well as those effects introduced by generous levels of US assistance and the importation of large numbers of low-paid foreign workers.

(d) *Institutional Development and Accountability*

This focus on regional redistribution also permeates the political process and prevents the evolution of strong political parties and the consequent discipline associated with a party platform and coherent set of policies. It also reduces the demands for accountability based on national welfare and performance criteria. The lack of concern for total welfare of Palau has led to hesitancy in implementation of public policy and projects, and non-compliance and non-enforcement of rules and expectations established in formal organizations. In response, public administration has been increasingly devolved to boards and authorities which decentralizes decision making for social stability reasons, at the cost of allowing private interests to distort public decisions away from national welfare considerations. There are also costs in terms of excessive administration.

Western consumption patterns generally are attractive to Palauans. The granting of substantial US assistance over time has supported these consumption patterns. However, work practices and productivity levels have not developed to support these levels of consumption on a sustainable basis. The distribution of US assistance, generally without performance requirements, has also meant that institutional structures have not been developed to the extent necessary for accountability. Nor has the anonymity of institutions, the objectivity of law and precedent, the primacy of private property and the permanence of contracts - all of which are essential to the encroaching international system - been embraced by the highly personalized and pragmatic practices of an essentially oral Palauan society.

In general, institutional development and governance issues will have a decisive effect on the performance of economic and social policies. The development of solid institutional structures and integrity in governance are prerequisites for sustained economic and social development. The development of appropriate incentive structures is a prerequisite to rising productivity growth. These basic structures are necessary to underpin the development of well-functioning markets with minimal distortions. Evidence from around the world has clearly shown that the development of well-functioning markets is the path to sustainable economic and social growth.

However, recognition of market failures (of which there are many in developing countries) should not be sufficient to immediately justify government intervention. There must be an assessment that government intervention and regulation will be more effective and less costly than the effects of the continuing existence of the market failure. Furthermore, a major cost of government regulation, particularly in developing countries, is that for every regulation that distorts the market, an incentive is created which provides scope for avoidance.

In many developing nations it is often the case that official corruption can be very financially rewarding to a few powerful individuals, and the costs are not readily appreciated by citizens, particularly if there are substantial, concurrent inflows of foreign government assistance with little requirements for accountability. The lack of action against corruption in these countries is often muted by traditional authority structures and the preoccupation of traditional societies with unproductive compensation and distribution issues, distinct from concerns about the national welfare or ethics. Palau is not immune from such forces, and the institutional building effort should follow a course which minimizes their expansion.

(e) Property Rights

One important way to ameliorate tendencies of individuals to seek private gain through public office or leadership status is to actively encourage the establishment of formalized private property rights. Individual ownership and security over title, particularly over land, limits the influence of the powerful few to enter into private commercial arrangements for land.

Individual ownership is a powerful force that has underpinned economic development in all the successful market economies. Cultures that have had the flexibility and pragmatism to facilitate such a change have developed at a much faster and sustainable pace than those that have resisted such forces. In Palau, the difficulties in acquiring clear title over land is a major constraint on investment and, therefore, economic development. The constraint is manifested in an increased risk premium on investment and difficulties in obtaining credit and capital without recognized security. This is an important issue in Palau, particularly with respect to the investment in large fixed capital assets such as tourism hotels and telecommunications networks.

(f) *Fragmentation of Authority and Leadership*

The Republic ties together 16 hereditary social organizations which the Constitution identifies as States. The concept of national welfare, and the force of national institutions, are still relatively weak. Authority in the States is now blended, to varying degrees, with a mixture of hereditary titles, elected offices and influence through business and employment. Control over resources is fragmented and inter-clan and inter-personal rivalry ensures that conflicts and disputes will retard at least some economic activities. The critical processes of decision making and commitment to implementation by government are being seriously impaired by the fragmentation of authority. This fragmentation is facilitated by the conduct of public policy through boards comprised of sectional interests.

The success of many developed countries has been due to the replacement of fragmented traditional authority structures with strong public sector institutions with clear objectives aligned to the general national interest. When traditional authority structures are not replaced by institutions with integrity and public interest goals, then sectional interests and opportunism lead to conditions which tend to retard private sector investment and economic growth.

(g) *Conclusion*

In general, the potential for economic growth is maximized in economies with the least distorted markets, the least government intervention, the least corruption, and in those economies that have instituted a strong, formal system of property rights for their citizens. However, in very small countries with strong traditional elements and conflicts, market failures are so great and the incentive structures so distorted that the government must take a leading role. But, in such situations, the government must appreciate the pitfalls in formulating and implementing policies in such an environment.

In terms of planning economic development, traditional aspects tend to restrict the development of social and economic strategic planning processes. These processes, if to be successful, need to be based on access to information, objectivity, integrity in institutions, the appeal of a national agenda, trust in the power of the executive government, the legitimacy of individual concerns and enterprise, the primacy of private ownership, the sanctity of agreements, the anonymity of authority, and cooperation amongst people who recognize their common needs.

In Palau, the lack and inconsistency of these processes coupled with the distortion of incentive structures from generous levels of US assistance, have resulted in:

- inappropriate discretionary policies such as inward-looking strategies (for instance, restrictive foreign investment criteria);
- lack of concern over the effectiveness of and compliance with national policies;
- political instability and politicization of economic policy making and implementation;
- low returns on public investment because of inefficient pricing structures, lack of concern for the opportunity cost of capital, poor incentives and lack of performance measurement;
- low levels of private sector investment, in part, because of land title restrictions.

Overall, achievement of the proposed economic growth path will necessitate a number of changes to cultural norms, particularly in allowing the development of a market in land, increased focus on national leadership and national objectives which will mean a diminution of village/clan leadership, and increased tourist development in the states which will change village lifestyles, particularly after the Compact road

is constructed. With the necessity for productivity increases, Palauans will be required to work much harder and for longer hours, placing strains on customary obligations which are very time consuming.

If Palau wants to hold onto its cultural heritage in the face of expected rapid change, it will need to take a more flexible approach to cultural aspects. Traditional leaders will need to involve themselves in the formal decision-making process. That is, they need to be participants and not just reactionary.

3.1.2 MARKET SIZE

With a resident population of around 17,000, the domestic market in Palau is very small. If this is coupled with the dispersed nature of the islands, the domestic market is likely to be high cost because of an inability to be able to reap technically efficient scale economies. In the provision of basic infrastructure, this will mean high unit costs and pressure for substantial subsidies to meet the basic needs of all citizens.

To overcome the disadvantages of a small market size, there is little option other than to seek an expansion of the private traded-goods sector and, particularly, exports where scale economies can be obtained. However, because the goods and services offered by Palau in this sector can be readily obtained elsewhere, production and prices must be internationally competitive. If additional costs are to be imposed on both private and public enterprises to safeguard the environment and cultural aspects, then the importance of being competitive is even more critical. Therefore, the over-riding strategy that must guide the economic planning process must be one that aims to significantly enhance international competitiveness. This will be the case whether policies are dealing with tourism exports, tuna exports or manufactures.

The necessary specialization in a narrow range of exports, however, has risks, particularly related to the potential for sharp shifts in Palau's terms of trade and vulnerability to external shocks. This underscores the necessity for appropriate fiscal measures focused on stabilizing sharp movements in the level of economic activity. It also provides a significant rationale for greater diversification.

3.1.3 POPULATION, LABOR MARKET AND MIGRATION

Currently, there is a high material standard of living in Palau and expectations are that it will continue to increase. However, the level of productivity needed to support these expectations on a sustained basis is not adequate, hence the recourse by an increasing number of businesses to more cost-effective foreign labor. The discipline and effort required of Palauans to lift productivity rates is generally constrained by:

- the relative affluence of a communal, subsistence life, even in the urbanized context, due to cultural redistribution particularly from public sector employees, foreign grants, plentiful natural endowments, and casual income from traditional activities - all of which have lifted the wage required to enter formal sector employment (reservation wage);
- relatively high wage rates in the public sector which have influenced wage benchmarks in the private sector;
- unrestricted access to higher wage rates in the other previous trust territories and the US which have raised expectations and allowed local employment decisions to be stalled;
- the restraint on private sector wages and conditions due to the ready availability of low-wage foreign labor; and

- the dominance of foreign labor in certain sectors, the development of cultural attitudes against participation in those sectors.

Without a doubt, dependency on foreign labor is increasing. Foreign workers are displacing Palauans in a growing number of occupations and levels, and this trend is expected to continue. Given this trend, the unemployment rate of Palauans is likely to increase significantly over coming years with the decline in Compact assistance and the consequent reduction in public sector employment which is predominantly Palauan. This could exacerbate social conflict. The reduction in use of foreign labor will not be able to be achieved easily given the dramatic decline of Palauans in certain skill categories in areas such as construction, hotel services, manufacturing, etc.

With the implementation of the Compact from October 1994, there are widespread expectations that an increased number of Palauans will take advantage of the provisions that allow unrestricted access to the US labor market. Migration may be beneficial to the development aspirations of a country. Off-island Palauans do send remittances, and many do acquire skills, attitudes, contacts and capital. It may be financially sensible in the short run to encourage Palauans to migrate, remit and develop their capacity, while, at the same time, utilizing foreign workers as a cost-effective substitute for the basic development work.

However, such a labor substitution strategy has a number of important risks which could be both economically and socially costly in the longer term. These risks include:

- loss of skilled resources with depressing effects on economic growth;
- adverse effects on the labor market as the more competitive and marketable Palauans migrate, resulting in an increase in the relative proportion of long-term unemployed with low skill levels (who are reluctant to accept the lower wages and conditions of the foreign workers); and
- an increase in foreign dependency for skilled resources which could become endemic.

It appears that unrestricted access to the US labor market, which distorts relative incentives and provides a safety net in the event of the failure of domestic decisions, may not correspond with the other longer term social, cultural and developmental objectives of Palau. The long-term aim, however, must be to attract and retain qualified Palauans to contribute to their own economy.

3.1.4 ATTITUDES OF DEPENDENCY AND RELATIONS WITH THE REST OF THE WORLD

Restructuring the Palauan socio-economy will be a difficult and long-term task. Failure to achieve the necessary restructuring will leave Palauans dependent on foreign assistance and subject to the interests of a narrow range of powerful domestic entrepreneurs and foreign interests. Nevertheless, it is quite possible that a significant portion of the population will tend towards the comfortable delusion of depending on foreign assistance and foreign labor. Furthermore, a century of foreign hegemony has induced in some Palauans attitudes of passivity and incapability in managing their own affairs. Some believe or expect that there will be other donors or an extension of Compact funding to prolong the assistance arrangements.

Such attitudes present a grave risk to the development path of Palau. They encourage the opportunism which opens the way to easy deals; they erode the determination to pursue difficult commitments and to seek performance; and they subvert the co-operation and cohesion amongst Palauans that is necessary to build an innovative, attractive quality of life.

Also, while Compact implementation will bring a much greater level of independence, the continuation of US monetary ties will reduce the scope for Palau to influence important domestic economic policy variables such as the domestic interest rate structure and the level of competitiveness through exchange rate alterations.

3.1.5 THE COSTS OF NATIONAL SOVEREIGNTY

The Trust relationship has covered the cost of many functions of the National Government, especially capital improvements, recurrent spending, representation and protection of national interests and certain social welfare programs. However, accession to full sovereignty will bring significant costs.

While the Compact includes substantial up-front capital payments, the continuing payments covering operational spending will decline significantly over the period 1995-2009 because of the low inflation adjustment factor, no allowance for population growth, and cessation from 2010. If these up-front monies are not invested or expended to maximize returns, whether on infrastructure or portfolio investments, then the Government will face severe budgetary problems in a matter of only a few years.

The consequence of this for development could mean a sharp reduction in public sector employment, decline in government services and maintenance, and a sharp increase in the taxation burden. From an investment viewpoint, recognition of the possibility of very tight fiscal conditions in the near future will increase the risk premium on investments because of the uncertainty of the Government's response. This will be of particular concern to foreign investors because, in the past, when Governments have faced financial constraints, they have responded by lifting the tax burden on foreign businesses more than on local businesses and persons.

Full sovereignty will mean a reduction in most Federal programs, which is particularly important in the areas of health and education. Independence will also redirect the responsibilities to Palau for marine surveillance, treaty obligations and full protection of citizens and visitors.

These costs will be relatively large for this small country. While there will be some offsetting gains to Palau, in terms of foreign assistance and involvement in international organizations, these gains will require investment in the preparation for and administration of such relationships.

Overall, the substantial costs involved in full sovereignty underscores the extremely important need to manage the Compact funds prudently and efficiently. The lessons of poor management of such funds elsewhere in Micronesia must be heeded.

3.1.6 UNFUNDED LIABILITIES AND EXISTING DEBT

A major constraint on the Government's budget over the near term will be the cost of debt service associated with the IPSECO debt rescheduling and the urgent requirement to substantially increase the Government's contributions to the Civil Service and Social Security pension funds.

The new agreement with the IPSECO creditors calls for repayments of around \$20 million over the next 5 years. The two pension funds would appear to be seriously underfunded. The Government will need to make substantial increases in its contributions to these funds.

3.1.7 SYNTHESIS OF PUBLIC CONSULTATIONS CONCERNING CONSTRAINTS AND UNCERTAINTIES

The following conditions were most commonly reported from consultations with the general public and specialist interest groups. They are presented in no special order:

- fragility of ecosystem;
- fragility of culture;
- small population;
- inadequate compliance and enforcement of laws;
- potential conflicts of public duty and private affairs;
- small number of public leaders and 'doers';
- land tenure disputation;
- persistence of State-National tensions and uncertainties;
- intensity of local rivalry and competition;
- risk to natural assets and advantages from development activities;
- low productivity in an intensely competitive region;
- need for foreign capital and technology;
- non-sustainable dependency on US programs;
- high dependency on imports;
- increasing dependency on foreign labor;
- low contribution of local revenue for government;
- high consumption of fuel and electricity;
- unsustainable preference for consumption and leisure; and
- narrow economic opportunities.

Though the list is long and of some concern, these conditions are not unique to Palau. A retreat to protectionism, out of pessimism or lack of confidence, would almost certainly exacerbate these listed conditions.