Republic of Palau

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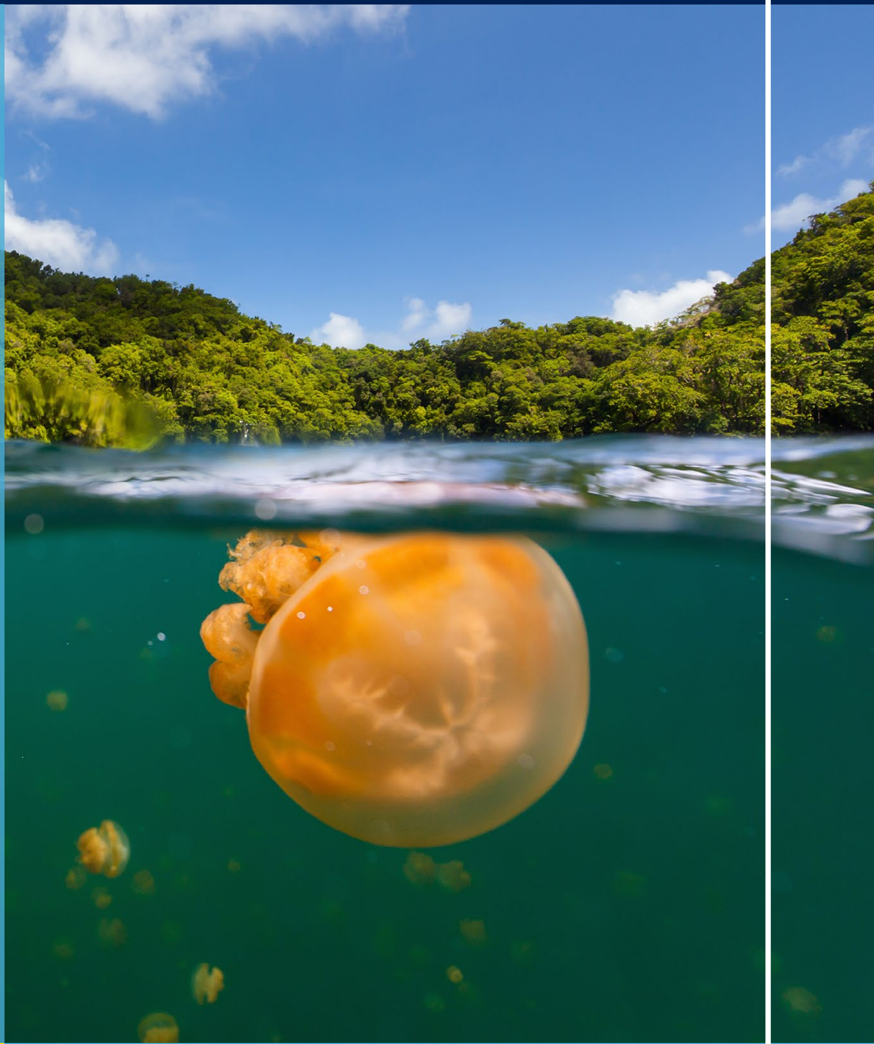

The Road to Recovery:

Further Updating the Economic Impact of COVID-19 and Strategies for Mitigation in the Republic of Palau

Economic Monitoring and Analysis Program (EconMAP) Technical Notes are intended to provide concise and timely analysis of important issues for decision-makers in Palau. Technical notes utilize currently available data sets and macroeconomic tools developed in close collaboration with the Palau government. The EconMAP program is managed by the Graduate School USA's Pacific and Virgin Islands Training Initiatives (PITI-VITI) with funding support from the Department of the Interior's Office of Insular Affairs. This publication was made possible with supplemental funding support from the Asian Development Bank through RETA-9719. Comments, questions or requests for further detail may be directed to info@econmap.org.

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Introduction

In the early months of 2020, the onset of the COVID-19 global pandemic ravaged the global economy with unprecedented reductions in GDP and rapidly rising unemployment. To reduce the spread of the virus, global travel restrictions were implemented which led to a collapse of international travel and tourism. In response to the pandemic Palau effectively closed its borders at the beginning of April and established a 14-day quarantine period for limited approved arrivals. Those arrivals included limited charter flights arranged to repatriate stranded Palauan residents living abroad, medical referrals and essential workers. Visitor arrivals to Palau effectively ended in April 2020.

As a result of these policies Palau has remained COVID-free with no recorded cases either in quarantine or in the community. The restrictive travel policies and the priority placed on health, at a time of highly limited demand for international travel, has served Palau well. As of the start of 2021, Palau is rolling out a nationwide immunization program. With a small population, Palau should be able to complete the program in a short period of time, subject to vaccine supply. Notwithstanding the threat of emerging virus mutations against which existing vaccines may provide reduced protection, the nation will be able to reopen its borders and commence economic recovery without a severe threat to the population and the national health system. This projected recovery will also be affected by the demand for travel from Palau's traditional markets.

This review and update on earlier Graduate School USA (GSUSA) economic impact assessments[1] starts with a review of the impact of the COVID-19 global pandemic on the economy of Palau in FY20. The second section analyzes the various mitigation programs initiated by Palau with support from the Asian Development Bank and the and United States, together with their impact on household incomes with a gender analysis. In the third section a projection is made for the economy in FY21, when the full impact of the pandemic is realized from the outset, and over the medium-term as economic recovery begins, following the implementation of the COVID-19 vaccination program. Special emphasis is made on financing needs and the impact of the pandemic on external debt and debt service. In the fourth section two scenarios, relevant at the time of writing, are examined: (i) the impact of opening a sealed corridor with Taiwan, and (ii) impact of the termination of the unemployment benefits under CROSS act. In the fifth and final section attention is devoted to policy options that the administration might wish to pursue to reduce costs and thereby reduce the debt burden on future generations.

[1] See Assessing the Impact of COVID-19 on the Palauan Economy, Graduate School USA, April 2020; and Where Do We Go from Here? Updating the Economic Impact of COVID-19 and Strategies for Mitigation in the Republic of Palau, Graduate School USA, August 2020

Economic and Fiscal Impact of the COVID-19 Global Pandemic during FY20

The Palau Economy contracted by 9.7 percent in FY20. FY20 was set to be a good year for Palau's economy as construction activity picked up pace, and through February 2020, the tourism industry was on pace to grow by 30 percent for the fiscal year. Then the SARS-CoV-2 virus descended on the world and international travel dried up; no further visitors arrived in Palau after the end of March. Initial projections for GDP estimated an 11.5 percent decline in FY20 but were later revised to project an even greater decline of 13.8 percent as further information came to light. However, both projections were overly pessimistic, and current estimates indicate a reduction of 9.7 percent, which reflects the positive impact of the mitigation programs.

Visitor numbers dropped to 42,000 in FY20. Figure 1 indicates the trends in visitor arrivals and GDP since FY10. The number of visitors rose rapidly in the FY10-FY15 period from 81,000 to 169,000, largely reflective of expansion of the low-end Chinese market. From FY15 through FY19 visitor numbers dropped to 90,000 as both the Chinese market and Palau's more traditional markets contracted. FY20 was set to be a better year with 120,000 visitors anticipated, but with the advent of the COVID-19 global pandemic that number dropped to zero by the end of March, even as 42,000 visitors were recorded for the fiscal period that began in October 2019.

The economy contracts by 9.7 percent in FY20, less severe than expected, although the private sector contracts by a large 20 percent.

Figure 1 - GDP and visitor arrivals

GDP rises during the expansion phase FY10-FY15 but is sustained through FY19 and then contracts due to COVID

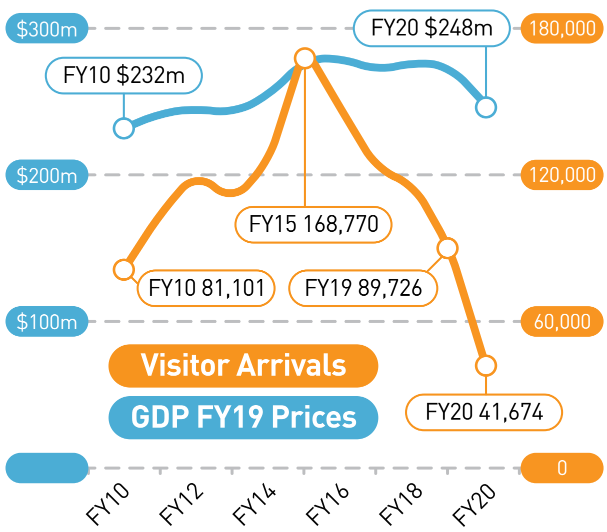


Figure 1 also indicates the pattern of GDP growth: in the early period GDP strengthened reflecting the growth in tourism. However, on the downside the contraction in visitors was not accompanied by a similar contraction in GDP. While visitors fell by a large 47 percent over the FY15-FY19 period GDP only contracted by 2 percent. The impact of the reduction in tourism was offset to a degree by growth in new IT services, finance, and public administration. The economy performed with unexpected resilience.

Private sector contracted by 20 percent in FY20. Figure 2 indicates the contraction in GDP in FY20 by major industrial components. The overall contraction in GDP was large although the full impact would not be felt until FY21. The Figure indicates the positive impact of construction activity during the period which offset 1.7 percent of the overall reduction. Figure 3 indicates the economic performance of the private and public sectors. The public sector—including the national, state and government agencies–has been remarkedly stable showing little variation through FY20. The volatility of the economy, however, is reflected in the private sector, which grew rapidly with the acceleration

Figure 2 - Contribution to GDP change in FY2020

GDP falls by 9.7% in FY2020 driven by collapse in tourism industry but with some offset from construction

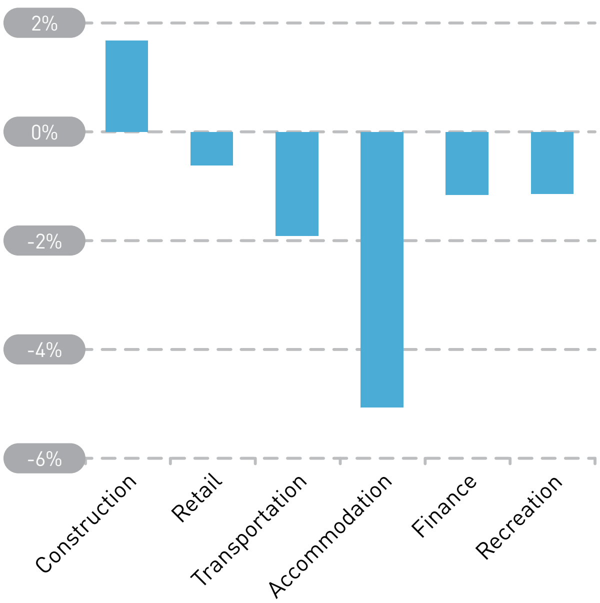
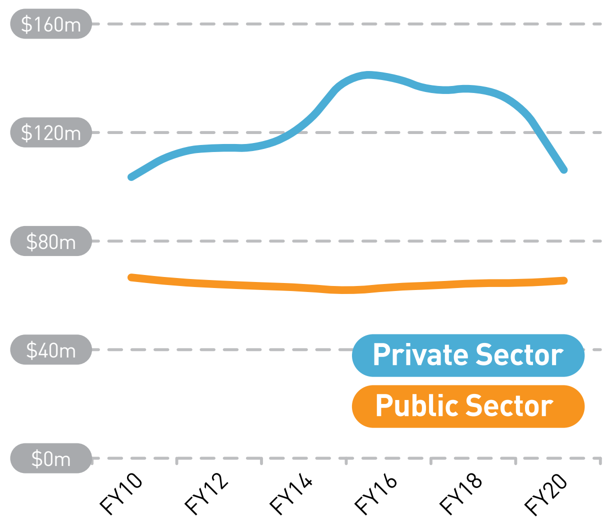


Figure 3 - Private and public sector contribution to GDP

Public sector GDP remains stable while private sector GDP falls by 20% in FY20



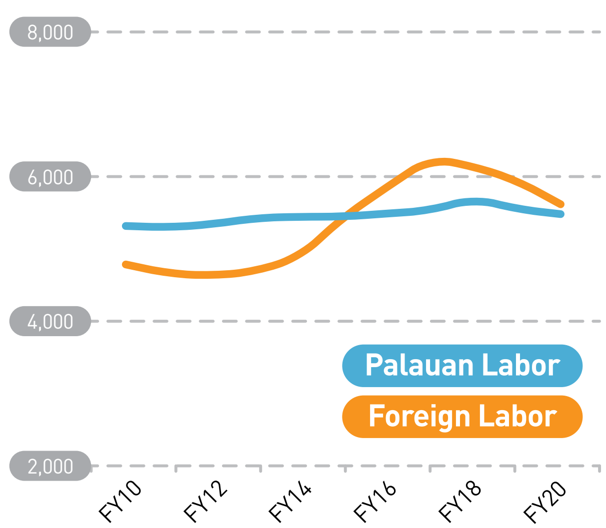
of the tourism industry through FY15, declined through FY15-FY19, and then contracted by 20 percent at the onset of the COVID-19 global pandemic. The contraction in private sector GDP was twice the overall rate of contraction of the overall economy.

Employment also contracted, but not to the same degree as the economy. Figure 4 indicates recent trends in employment for Palauans and foreign workers. The pattern for Palauan workers remained largely static during the period reflecting the predominance of Palauan workers in the civil service, but with some response to the downturn in the tourism economy. For foreign workers, the level of employment has been very responsive to the growth in tourism and the private sector rising on the upside and declining on the downside. Of particular interest is the small size of the reduction in employment during FY20 as employment among Palauans fell by 1.3 percent and foreign workers by 5.5 percent. This is far smaller than the reduction in either the economy as a whole or private sector GDP.

In part the data reflects yearly averages, but this also indicates that employers maintained staffing levels—even if at lower wages and reduced hours. It should be noted that this data does not capture any temporary jobs created

Figure 4 - Employment of Palauan and foreign labor

Brunt of reduction in economic activity experienced by foreign workers



through the mitigation programs discussed in the next section.

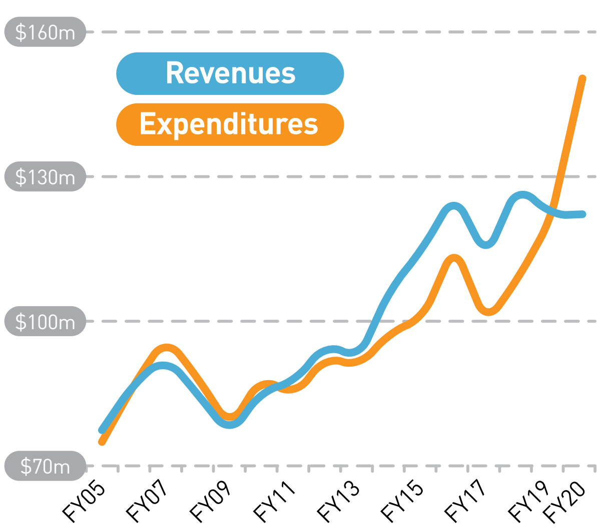
The fiscal outturn recorded a deficit equivalent to 12 percent of GDP. Figure 5 reveals the fiscal outturn since FY10. With the advent of significant growth in the tourism economy a sizeable fiscal surplus was generated, which was to fortuitously provide a source of funds to mitigate the impact of the COVID-19 global pandemic in FY20. Surprisingly, the figure indicates that revenues held firm in FY20 and only one category of taxation, the Gross Receipts Tax, exhibited a decline. This reflects the significant impact of a supportive fiscal policy and the various mitigation programs enacted to address the pandemic. Wage tax collections and import taxes all held firm.

Expenses grew rapidly reflecting the need not only to finance the operations of government, but also to implement various mitigation programs. By the end of FY20, the initial appropriation for the CROSS Act of $20 million was only about 18 percent utilized, thus reducing at the margin the government's funding needs. However, a variety of additional expenditures not directly related to the pandemic response were also budgeted in areas such as support to the SOE sector, social insurance and pension funds, which led to considerable additional spending not previously budgeted. These additional expenses are a particular area of policy concern and are discussed in the final section. The resulting fiscal deficit of $28 million—equivalent to 12 percent of GDP—was close to the original projections of the impact of the pandemic of $32 million or 13 percent of GDP. However, the forces generating the deficit were not fully pandemic-related as mitigation costs came in under budget while transfers to SOEs and government bodies rose.

A fiscal deficit of $28 million or 12 percent of GDP resulted as the government maintains operations and implemented a large mitigation effort.

Figure 5 - Revenues and expenditures of the national government

Signficant savings generated since FY2013 but large deficit in FY2020



Mitigation: CROSS, CARES, and impact on household incomes

This section examines the various mitigation efforts enacted by Palau through the CROSS Act and benefits that were available to the citizens of Palau through the U.S. CARES Act. Detailed analysis of the different programs is undertaken coupled with an impact study of the combined support on household incomes.

THE CROSS ACT

On April 27, 2020, the President of Palau signed into law the Coronavirus One Stop Shop Relief

Act known as the CROSS Act. A total of $20 million was appropriated for a nine-month period through the end of January 2021. The law provided a variety of programs to mitigate the impact of the COVID-19 global pandemic:

- **Unemployment benefits**: Qualified individuals in priority affected sectors may receive $100: (i) per week, if they are unemployed and generating no income; (ii) per fortnight, if their monthly working hours and earnings have been reduced by at least 50%; or (iii) per month, if monthly work hours and earnings are cut by more than 25% but less than 50%. The program is available to both Palauan and foreign nationals. The original program was designed to support 1,600 persons at a cost of $6.9 million.

- **Temporary jobs program**: Those unemployed because of the pandemic may apply for work in the temporary jobs program at the minimum wage of $3.50 an hour. Non-resident workers, particularly those in the tourism sector, may apply for transfer of employment visas to the temporary jobs, with an understanding that their original employers will either re-hire them once businesses re-open, or arrange for their repatriation when outbound travel becomes possible. The program budgeted for the creation of 700 jobs at a cost of $4.3 million.

- **Private sector relief**: Loans administered by the National Development Bank of Palau have been made available to an estimated 112 businesses in affected industries. The loans may cover businesses' fixed costs and possibly finance improvements in tourism facilities. Loans will be provided with 10-year terms, with no payment obligations during the first two years; annual interest payments of 2% to start by the third year; and principal repayments are due from the fourth year until maturity. Priority funding is for loans that cover businesses' fixed costs, capped at $30,000 every 3 months per employer. The CROSS act budgeted $8 million for this component.

The CROSS Act adopted by government was rapidly put together and a huge success mitigating the adverse impact on employment and avoidance of widespread poverty adding to Palau's international reputation.

- **Lifeline utility services**: This program enables a lifeline electric, water, and sewer subsidy program for low- or fixed-income households to include those affected by the COVID-19 global pandemic. PPUC's lifeline subsidy covers 150 kilowatt hours of electricity and 5,000 gallons each of water supply and wastewater services, per household. A sum of $0.8 million was budgeted for this program.

The unemployment benefit program has been widely utilized but average payments have been running at about half of the budgeted amount. Table 1 indicates the number and benefits received under the CROSS Act unemployment benefit program. In the early stages several payments were made in May, but this was regularized thereafter. At the start of the program both Palauans and foreign workers were included in the program, but after Palau became eligible for benefits under the U.S. CARES act, most Palauans were transferred to CARES funding. The numbers thus fell from around 2,000 at the start of the program, to 1,600 by year end. While the program allowed for a maximum benefit of $400 per month, after taking into account those persons on reduced benefits, the average current benefit fell to about $200 per month. After initial payments were made, benefit levels were locked, implying that individuals who subsequently became

Table 1 - CROSS Act unemployment benefits

Number of beneficiaries of CROSS unemployment program, by nationality and gender

	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Average Aug-Dec
Nationality									
Palauan - Female	222	174	131	52	58	31	31	31	**41**
- Male	407	242	150	62	82	40	41	38	**53**
Foreign - Female	1,024	647	723	682	712	652	642	620	**662**
- Male	1,275	807	979	858	960	924	913	889	**909**
Unidentified	849	609	339	167	193	120	120	116	**143**
Total	**3,148**	**2,063**	**2,041**	**1,707**	**1,865**	**1,696**	**1,675**	**1,625**	**1,714**
Value of benefits of CROSS unemployment program, by nationality and gender, $'000									
Nationality									Total
Palauan - Female	32.6	35.7	29.8	12.1	12.5	6.1	6.1	6.1	**141**
- Male	62.1	56.6	34.6	13.4	17.4	8.4	8.6	7.6	**209**
Foreign - Female	151.1	142.3	170.1	151.1	151.2	138.3	136.3	131.6	**1,172**
- Male	192.5	181.9	232.1	191.2	204.8	193.7	191.1	186.8	**1,574**
Unidentified	142.4	197.8	79.2	60.2	48.4	27.5	28.1	26.3	**609.9**
Total	**485.9**	**522.0**	**481.4**	**402.5**	**404.4**	**359.4**	**355.4**	**344.6**	**3,355.8**
Average benefits of CROSS unemployment program, by nationality and gender, $									
Nationality									
Palauan - Female	147	205	228	233	216	197	197	197	
- Male	152	234	230	216	212	210	210	200	
Foreign - Female	148	220	235	222	212	212	212	212	
- Male	151	225	237	223	213	210	209	210	
Unidentified	168	325	234	361	251	229	234	227	
Average	**154**	**253**	**236**	**236**	**217**	**212**	**212**	**212**	

fully unemployed received no adjustment. The proportion of females in the program averaged 43 percent in the final quarter of the year with just 4 percent of Palauans participating.

Temporary jobs program has unintended consequence of providing 80 percent of jobs to Palauans. Table 2 describes the temporary jobs program originally intended to fund 700 dislocated foreign workers. After a slow start the program gradually gained momentum, and by the end of October had largely achieved its objective, employing 650 people. However, while the program was initially intended to provide jobs for those made unemployed by the pandemic and not eligible for the U.S. CARES act, this was not deployed until several months into the program. As a result, over 500 Palauans or 80 percent of the total jobs provided were placed under the scheme by the end of October. Returning Palauan students and graduates from the Community College made up a significant number and were placed despite not having been laid off as a result of the pandemic. This unintended consequence made a favorable contribution to the broader economic impact of the program. Female participation was 50 percent and over 50 percent of the total placed was employment of those under 26 years of age.

Funds disbursed to support the private sector of $2 million by the end 2020 were

Table 2 - CROSS Act temporary jobs program

Month	May	June	July	August	Sept	October	Total
Number of workers							
Palauan	3	40	85	340	495	514	**542**
Philippines	1	27	55	102	115	121	**130**
Bangladesh	-	2	5	11	13	14	**14**
Female	4	45	81	246	346	357	**372**
Age<26	-	32	62	228	289	291	**310**
Total	**4**	**69**	**145**	**453**	**623**	**649**	**737**
Gross Payment ($'000)							
Palauan	1	8	34	199	228	258	**728**
Philippines	0	6	23	61	55	59	**205**
Bangladesh	-	0	3	7	7	7	**24**
Female	1	9	31	145	157	174	**518**
Age<26	-	6	27	139	133	143	**449**
Total	**2**	**30**	**118**	**552**	**580**	**642**	**1,923**
Average Payment ($)							
Palauan	195	211	399	586	460	502	**1,343**
Philippines	200	220	422	603	479	485	**1,574**
Bangladesh	-	84	554	624	522	509	**1,693**
Female	196	205	388	590	455	488	**1,392**
Age<26	-	195	439	610	461	493	**1,449**
Total	**195**	**211**	**399**	**586**	**460**	**502**	**1,343**

significantly below target. The disbursement of funds to support the private sector through the National Development Bank of Palau has not been widely subscribed. While the scheme was not designed for large establishments, the impact of the pandemic and uncertainties of its duration resulted in significant apprehension on the part of small and medium sized enterprises to avail themselves of loan funding that might lead to their insolvency. However, as the pandemic lengthens, and existing cash flow tightens, it is anticipated the need for finance will became more critical. Further, once recovery becomes more evident as vaccination programs are implemented, the need for funding and confidence concerning debt service capacity will likely strengthen.

The Lifeline utility facility has not been widely adopted. The application for funding for the utility program as a result of the pandemic has only amounted to small drawdowns of the $0.8 million allocated.

THE U.S. CARES ACT

Under the U.S. CARES Act 2020, the citizens of the Freely Associated States are eligible for certain unemployment benefits under two facilities:

- **The Pandemic Unemployment Assistant (PUA) program**. The PUA program provides a temporary benefit to individuals whose employment or self-employment has been interrupted or was lost as a direct result of the COVID-19 Pandemic. PUA provided $397 per week for up to 39 weeks through December 31, 2020 of unemployment assistance or benefits.

- **The Federal Pandemic Unemployment Compensation (FPUC) program**. The FPUC program provided an additional amount of benefits to qualified individuals receiving assistance under the Pandemic Unemployment Assistance. Under the FPUC, individuals were eligible for $600 per week for periods beginning on or after April 1, 2020 through July 31.

U.S. CARES Act provides sizeable level of funding for Palau. Under the original CARES act the U.S. indicated that approximately $19 million would be available to Palau under the program. As of the end of November $14.6 million had been received by the local office of the Workforce Initiative and Opportunity Act with an application for a further $1.3 million to fund the program through the expiration date. The program was restricted to Palauan citizens and citizens of the other two Freely Associated States, as well as citizens of the U.S. During its life span the program has funded 437 self-employed people who were eligible for the FPUC component and a further 829 under both FPUA and the PUA. Table 3 provides further details, although the irregularity of payments and uneven periodicity of those payments has made analysis difficult. The program has largely benefited Palauan citizens and female participation recorded 45 percent. The average payments received during the first four months of the program were twice that of the average Palauan wage for the same period.

Household incomes showed sustained real increases FY10-FY16 as Social Security Benefits rise. Figure 6 provides a projection of the level of real household incomes since FY10. Between FY10 and FY16 there was a significant increase of average household incomes of an average 4.4 percent per annum, but after the height of the tourism boom real incomes stagnated. This large increase was due to a variety of forces, the most notable being the increase in Social Security benefits which rose by an average of 11.2 percent per annum during the period. Compensation of employees also grew strongly by an average of 5.3 percent per annum.

U.S. CARES Act provided large financial support for Palauan workers and led to an increase in household incomes in FY20.

Household incomes rose in FY20 despite the anticipation of a significant loss. The impact of the COVID-19 global pandemic on household incomes is also indicated in the figure, showing that real household incomes rose by 7.6 percent in FY20 despite the anticipation of a significant loss. A key element of this outcome was that wage payments or compensation of employees only fell by 2.4 percent. Employers held onto labor during the months following the pandemic, albeit with reduced hours to enable eventual recovery. The impact of the mitigation programs therefore was to provide a strong stimulus to the economy, bearing in mind that the figures represent full-year averages. Simulations indicate that without the CARES and CROSS programs household incomes would have fallen by 2.1 percent. This result attests to the highly successful and timely beneficial impact of the combined mitigation efforts. At the end of FY20, the U.S. Congress passed a further stimulus bill with unemployment benefits of $300 a week for FAS citizens through the end of March 2021. The Palau OEK has now passed a similar law to extend the CROSS benefits through March 2021. Estimates suggest that the original resources appropriated of $20 million should last through that extended period, though likely requiring some re-allocation at the sub-program level.

Table 3 - CARES Act PUA and FPCU benefits

	June	July	August	Sept	Total to date
No of Recipients					
Total	**294**	**443**	**520**	**284**	**1,165**
Palauan	259	407	479	252	1,049
Non-Palauan	35	36	41	32	116
Female	99	257	185	143	527
Male	195	186	335	141	638
Female Palauan	92	243	176	131	493
Male Palauan	167	164	303	121	556
Amount Paid ($ million)					
Total	**2.361**	**3.340**	**3.646**	**1.478**	**10.826**
Palauan	2.067	3.059	3.359	1.326	9.810
Non-Palauan	0.294	0.282	0.288	0.152	1.015
Female	0.777	1.595	1.171	0.714	4.257
Male	1.584	1.746	2.475	0.764	6.569
Female Palauan	0.719	1.516	1.103	0.650	3.988
Male Palauan	1.348	1.543	2.255	0.676	5.822
Average payment					
Total	**8,031**	**7,540**	**7,012**	**5,203**	**9,292**
Palauan	7,982	7,515	7,012	5,260	9,352
Non-Palauan	8,400	7,825	7,015	4,754	8,754
Female	7,848	6,205	6,332	4,990	8,077
Male	8,124	9,386	7,388	5,419	10,296
Female Palauan	7,814	6,238	6,270	4,960	8,089
Male Palauan	8,074	9,408	7,443	5,585	10,472

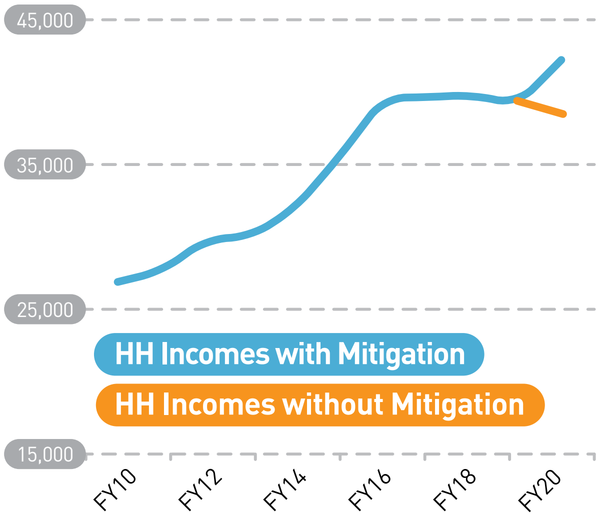
REPATRIATION

Repatriation of foreign workers has been modest with 460 workers returning home (including end of contract work permit holders) compared with direct foreign workers in the tourism industry of 1,770: At the start of the COVID-19 global pandemic, it was debated whether there would need to be widespread repatriation of foreign workers. Repatriation of foreign workers is the responsibility of employers and not the government. Most employers preferred to keep their workforce ready to restart the industry once the recovery took hold, rather than bear the cost of repatriation and subsequent recruitment of replacement employees at a later stage. To save cost, remaining foreign workers were in many cases placed on part-time work and coupled with the mitigation programs sufficient safety nets were put in place. However, some foreign workers were repatriated as flights became available, and Table 4 indicates numbers by gender and nationality by month.

Mitigation programs including the CROSS Act and U.S. CARES Act proved highly effective with the CROSS Act receiving a very favorable international reaction. At the start of the pandemic as the realization of the rapid collapse of Palau's tourism industry became apparent the outlook was dire with the prospect of a large pool of unemployed labor and rising poverty. Palau reacted quickly with the passage of the CROSS Act by the end of April and the first benefits paid in May. The combination of the use of Palau's internal savings, donor support through the Asian Development Bank, and

Figure 6 - Household real incomes, FY2015 prices

Household incomes are estimated to be 9.7 percent higher than without the CROSS and CARES programs



eligibility under the U.S. CARES Act, enabled Palau to maintain momentum in the domestic economy, actually increase household incomes, avoid widespread poverty, and suppress any threat to the social fabric. Palau's performance to support not only its own citizens but also foreign workers was widely recognized by the international community and has generated good will and a favorable reputation.

Impact of the Pandemic on the FY20 budget

Fiscal policy actions were designed to support the domestic economy. In March of 2020, as the consequences of the COVID-19 global pandemic were becoming understood, the government designed a set of policy actions to support the economy and mitigate the negative consequences. The first objective was to limit the economic consequences of the crisis emanating from the tourism sector, through maintaining the level of government operations to support demand for the local economy. The policy to support the domestic economy through an accommodating fiscal policy can be considered successful. Original projections of the impact of the pandemic made in April 2020 indicated a reduction in GDP of 13.8 percent. This projection turned out to be more adverse than the 9.7 percent provisionally estimated

Table 4 - Departures of Non-Palauan residents (workers, dependents, and other non-visitors)

	April	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Sum April-Dec
Total	3	80	17	47	119	140	20	129	80	635
Female	1	37	11	24	32	40	11	39	31	226
Male	2	43	6	23	87	100	9	90	49	409
Work permit	1	50	5	28	86	112	9	99	70	460
Dependent or other	2	30	12	19	33	28	11	30	10	175
Nationality										
Philippines	1	-	2	1	100	52	-	100	66	322
Bangladesh	-	-	-	-	-	-	-	-	-	-
China	-	2	-	15	-	67	-	-	-	84
United States of America	-	6	9	9	-	5	3	2	4	38
Japan	-	36	5	10	-	2	4	5	4	66
Korea, Republic of	-	29	-	-	-	-	1	1	-	31
Taiwan, Republic of China	2	-	-	1	13	2	1	7	4	30
Other	-	7	1	11	6	12	11	14	2	64

for the FY20 outturn. Of the actual 9.7 percent contraction in the economy the domestic non-tourism sectors grew by 1.2 percent, implying the impact on the economy was contained within the tourism industry. Greater construction activity played a key role in this regard.

The second objective to mitigate the impact legislated through the CROSS act was designed to provide funds in the four areas discussed above: (i) unemployment benefits, (ii) a temporary jobs program, (iii) support to the private sector through the NDBP, and (iv) a utility lifeline. The original legislation provided $20 million of resources through the end of January 2021. Applying that allocation on a proportional basis implies a resourcing need of $11 million for FY20. By the end of FY20, only $5.1 million or 25 percent of the resource needs had been utilized. In part, the savings were due to the eligibility of Palau citizens for the benefits under the U.S. CARES act, which reduced domestic funding requirements. Further, the individual programs took time to build up momentum. As the earlier section indicated, support to the household sector resulted in real household incomes growing in FY20 despite a level of mitigation funding use that was lower than budgeted.

Private sector demand for finance turned out lower than anticipated due to the uncertain outlook. Support to the private sector through the NDBP was only $1.5 million out of a total funding envelope of $5 million programmed for FY20. Demand for resourcing through the NDBP also turned out to be lower than anticipated due to the reluctance of the private sector to take on loans in an uncertain environment. However, going forward this is likely to change as the private sector becomes more confident regarding economic recovery, as existing self-finance dries up, and as businesses require funds to resume operations.

Fiscal policy designed to support the domestic economy and mitigate the impact of COVID-19.

REVENUE EFFORT

Revenue effort was strong in FY20 despite economic slowdown. Overall revenues remained static when compared with FY19, with a 13 percent reduction in taxes being offset by a significant increase in grants. However, taxes on wages and imports grew in FY20 despite the downturn in the economy. Although payrolls fell by 3 percent during the year, additional taxes on U.S. CARES benefits resulted in wage tax collections rising by 5 percent. Import taxes were also buoyant, rising by 5 percent and reflecting increased consumer demand and growth in the construction industry. Revenues from the GRT, of which the tourism industry forms a significant part, fell by 12 percent—much in line with original projections. As anticipated taxes on the tourism industry fell proportional to the drop in visitors; the hotel room occupancy tax and taxes on departing visitors (PREF - Pristine Paradise Environmental Fee) had declined to zero collections by the end of March.

Large funding increases flowed in grants from the U.S. under the CARES Act. Offsetting the reductions in tax revenues has been a large increase in grants. The annual flows recorded for Compact grants ceased in FY19 as agreed under the Compact Review Agreement (CRA) of 2018. On the flip side annual drawdowns from the Compact Trust Fund increased from $5 million to $15 million. The most significant increase in grants was recorded under federal programs and includes revenues of $13.5 million under the U.S. CARES act. There was also a significant increase in capital funding from the U.S. under the Compact Review Agreement including the Koror-Airai road repavement and the Anguar dock. Increases in funds were also received from Taiwan for the national Gym rehabilitation. The remaining significant element under "other revenues" is the receipt of fishing fees, which was slightly down in FY20, but now represents an important source of non-tourism related funding. Under the marine sanctuary, commercial fishing has been reduced but Palau remains eligible as a PNA member to sell its allocation of fishing days under the VDS scheme.

Tax reform will play an important part in supporting fiscal policy objectives. Drawing out lessons from the structure and performance of Palau's revenue base, several conclusions can be drawn. Firstly, tax effort is not, as in many countries, the overriding element of Palau's revenue base. In FY19, before the onset of the COVID-19 global pandemic, taxes represented 52 percent of total revenues. In FY20, taxes fell to 45 percent, as non-tax revenues provided a cushion against adverse shock of the pandemic. Secondly, the core elements of Palau's tax regime dates back to Trust Territory days and is inefficient, inelastic, and provides little scope for resource mobilization. Tax reform provides a key component of the ADB's proposed RISES program (Recovery through Improved Systems and Expenditure Support program) to enable Palau fiscal policy to be more responsive to needs and to enable revenues to be more buoyant with economic expansion. Thirdly, grants are a large proportion of revenues and likely to remain so, assuming the ongoing Compact renewal negotiations with the U.S. are successful prior to the end of FY24. Relations with Taiwan have also played an important role to support Palau's funding needs. Lastly, fishing fees have grown to represent a significant source of funds without which the tourism downturn in FY16-FY19 would have required adjustment. This is an important source of revenues and Palau will look to maximize its yield from the VDS.

EXPENDITURE PERFORMANCE

Expenses grew by 22 percent in FY20. In response to the COVID-19 global pandemic, it would be expected that expenses would increase as greater outlays were required to fund the various mitigation efforts; however, while this was certainly true and expenses grew by 22 percent in FY20, large increases in expenses were also incurred in subsidies to SOEs, transfers to the social insurance and pension sector, and funding for housing.

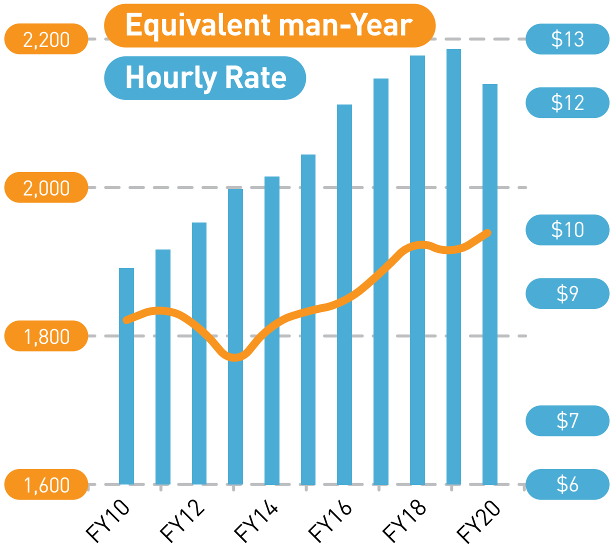
Payroll expense grew by 7 percent per annum during FY20, although introduction of a new financial management system made interpretation problematic. Payroll represents 40 percent of expenses in FY19. Figure 7 indicates recent trends in equivalent man-years[2] and average hourly pay rates. While the number of equivalent man-years has grown modestly at 0.6 percent between FY10 and FY19 before the pandemic, per annum average pay rates rose by 3.5 percent and at a greater rate than the cost of living which grew by 2.1 percent. That said, in FY20 while man-years rose by 1.3 percent pay rates fell by 4.2 percent. However, the payroll figures which are based on the former DILOG payroll system for the first 9 months of FY20 are not in accord with the preliminary fiscal data which shows a near 7 percent increase in compensation of employees. In FY20, the Financial Management Information system formerly based on DILOG software was replaced by the new Tyler-Munis system six months into the fiscal period. There are thus possible discontinuities arising from the changeover and differences in classification of items of expense. This is a matter for further study and confirmation.

Use of Goods and Services was contained during FY20. The second most important item of expense has been outlays on goods and services, which grew by 2.4 percent in FY20. Most items were generally in line with prior year figures with some exceptions. Purchases of medical supplies declined, perhaps reflecting in-kind provisions from donor partners. Medical referral expenses also declined, reflecting the inability to travel due to pandemic-related restrictions during the final 8 months of the fiscal year. Transportation expense was also down due to travel restrictions, but other items offset the decline in the above items.

[2] Total hours worked in a year divided by 2,080 hours (52 weeks times 40 hours).

Figure 7 - Public sector payroll: hourly rates (US$), and equivalent man-years

Use of manpower increases in FY2020 while hourly rates fall



Failure to adopt full-cost recovery in Palau's SOE sector poses a significant fiscal risk. Subsidies are a small component of Palau's expenses but the underlying failure to charge full cost-recovery poses a significant fiscal risk. Subsidies to Palau's small SOE sector have generally been small. The main component requiring explicit subsidy has been water and wastewater management, which required a $2.1 million subsidy in FY20. However, recorded subsidies are deceptive. Both electricity production and water and wastewater management operate significantly below full cost-recovery and thus the level of implicit subsidy is much greater. While the PPUC may operate after subsidy on a cash flow positive basis, assets are depreciating, and insufficient reserves are being set aside to allow for replacement and scheduled maintenance. The PPUC without tariff reform thus poses a significant fiscal risk.

Transfers to government entities were large in FY20, with increases to social insurance and pensions a particular concern. Transfers to government entities includes three major categories: government agencies, state governments and national insurance. Transfers to government agencies including the Community College recorded a significant reduction on the FY19 level. However, transfers to state governments grew to support operations as other sources of state revenues fell due to the pandemic. Transfers to state governments have grown significantly over the last few years and need to be carefully monitored. A major item of increase in cost has been transfers to the Social Security Administration and the Civil Service Pension Plan. Both entities are under significant financial distress due to payment of legislated benefits at increased levels without parallel increases in contributions. The financial position of the CSPP is particularly dire and without government support it is projected to collapse in the near-term. Required reforms to SS are less severe and form a part of the ADB's proposed RISES program. Reform of the CSPP will require a major initiative and was considered beyond the scope of RISES at present.

Social benefits payments through the CROSS and CARES acts recorded $18 million in FY20 or 8 percent of GDP. Payments to households under the CROSS and CARES acts are recorded under Social Benefits and on a fiscal year basis are estimated to be $3.6 million and $13 million, respectively. The rapid disbursement of funds under both programs provided significant support to Palauan and foreign workers and must be considered a notable success. It is of course anticipated that upon economic recovery these benefits will decline and then terminate.

FY20 saw major capital transfers to the NDBP and PHA. The final major item warranting note is capital transfers to the two public financial institutions for land subdivision and housing. While $1.5 million was provided to the NDBP under the CROSS act for private sector loans, the majority of the funds were provided through a loan from Taiwan of $15 million under the Housing Development and Loan Program (HLDP). In FY20 $7 million was recorded in the accounts with the remaining $8 million due to be transferred in FY21.

Transfers to SOEs, social insurance and pension funds pose the greatest risk to fiscal stability. The overall level of government expense in FY20 saw a significant increase over the prior year. However, once allowance is made for both the CROSS and CARES Act payments and the HLDP, government expense recorded a structurally adjusted level of $107 million; a reduction of 1.3 percent on FY19. The major areas of fiscal concern are (i) the apparent rise in payroll cost, which needs careful examination, (ii) transfers to the SOE sector and (iii) burgeoning payments of unfunded benefits to CSPP pensioners.

CAPITAL EXPENSE AND FINANCING

Infrastructure projects grew significantly in FY20. Capital expense in fixed assets and infrastructure funded through grants from the U.S. under the Compact Review Agreement and Taiwan saw a large increase in FY20 growing from $6 million in FY19 to $16 million in in FY20. This increase could not have come at a better time to support the struggling economy as the impact of the COVID-19 global pandemic hit.

Palau borrowed a record $50 million in FY20. On the finance account the major component was the large external borrowing of $50 million including $15 million from the ADB under the Disaster Resilience Program (DRP), $20 million from the ADB under the COVID-19 Pandemic Relief Option (CPRO), and $15 million under the Housing Development and Loan Program (HLDP) sourced from Taiwan. By the end of the year, cash balances had risen to over $60 million, an increase of nearly $20 million on FY19. Original fiscal planning under the CROSS Act had anticipated ADB loans would provide additional funding going into FY21 through the end of the calendar year. As it turns out Palau now has a significant fiscal reserve to support fiscal operations through much of FY21.

While expenditures were held in check the large increases in non-COVID-19 related subsidies to SOEs, and transfers to social insurance and pensions are an area of concern.

Fiscal deficit reached a record $28 million or 12 percent of GDP in FY20. While the FY20 deficit is largely in line with the original projections the shape of the deficit is different. It had been anticipated that the funding needs for the mitigation efforts under the CROSS Act would be responsible for a larger portion of the deficit. The reduction in use of the mitigation funding was however offset by increases in SOE, social insurance and pension needs. The important issue of external debt is raised in the following section.

Economic Recovery and Financing Needs

Analysis to this point has investigated the performance of the economy and fiscal outturn in FY20 reflecting the impact of the COVID-19 global pandemic. In this section a baseline projection or scenario is made for FY21 and onwards as the economy recovers. The focus of the analysis is to provide a conservative but realistic projection of the economy, fiscal outturn, and financing needs. Special attention is devoted to external debt sustainability. The next section of this review investigates a set of scenarios or variations on the baseline, while the final section focuses on the consequences of the projections and important policy issues that emerge.

ASSUMPTIONS OF THE PROJECTIONS

Palau's borders remain closed. Palau has adopted an extremely cautious approach to the

COVID-19 global pandemic and from April 2020 borders were effectively closed. Travel has been limited to returning residents, medical referrals, and a small number of essential workers, with all of these travelers subject to a 14-day mandatory quarantine period. Apart from periodic charter flights transporting these passengers, air services have been limited to a weekly air freight service from Guam. Shipping services have been mostly unaffected but are required to follow pandemic-related regulations.

Palau benefitted from CDC Operation Warp Speed (OWS). While these restrictions will remain in force for the near future, the emergence of effective vaccines in late 2020 provides a glimpse of a possible recovery timeline. Palau is fortunate to participate in the U.S. CDC OWS and due to its small population size has the potential for a rapid and broad-based vaccination program. While Palau could be one the first nations in the world to fully vaccinate its adult population, it will take time for the rest of the world to achieve the same status. However, this period will enable the private sector to be well-positioned once international travel resumes and people gain confidence to travel once again. It is assumed in the following projections that once Palau has attained full vaccination status, subject to adverse virus mutations, borders will be reopened to visitors provided they in turn can show both negative COVID-19 test results and proof of vaccination.

Recovery of the tourism industry is not anticipated until FY22. In FY19 visitor numbers attained the below trend level of 89,726 visitors. This fell to 41,674 in FY20 and is projected to largely disappear throughout FY21 with a projected level of 1,200 for the year. While the projection for FY21 is conservative, it is possible with a proactive vaccination program completed during the first half of 2021, that some visitors might return in the final quarter of the fiscal period. It is also possible that once Palau has achieved full vaccinated status, a "sealed corridor" might be created with Taiwan that would accelerate the revival of Palau's tourism industry. Following projections of international travel made by the International Air Transport Association (IATA), this paper assumes that in FY22 visitor numbers will attain a level of 45 percent of the pre-COVID-19 projected FY20 level (i.e. 45% of 116,000), 90 percent in FY23, and full recovery in FY24. Thereafter visitor arrivals are projected based on achieving a room occupancy of 55 percent and a long-run growth of 2 percent (Figure 8).

Construction demand is projected to remain above trend but down on FY20. Construction has traditionally had a large impact on the economy and the assumptions about major projects have a significant impact on the projections. In FY20 construction grew by 32 percent--a large acceleration on the prior year—that helped maintain the domestic economy as the COVID-19 global pandemic hit. In FY21 construction is expected to contract by 8 percent, but to remain above trend. It is assumed that major projects will continue, including finalization of the airport Public-Private Partnership, remaining elements of the Koror-Airai Sanitation Project (KASP), One-Stop Shop building in Koror, Anguar dock, and the Surangel Superstore shopping mall in Airai, to name the major projects. Other major public sector investments include a new power purchase agreement for the supply of electricity to PPUC, the second fiber optic connection to the internet, and continued installation of a U.S. radar surveillance system.

Fiscal policy stance assumed to remain accommodative. The projections assume there is no change in fiscal policy during FY21, and that the government adopts an accommodating fiscal position to support the private sector maintaining expenditures at current levels. While savings will continue to be made on travel-related items and other initiatives implemented in FY20, additional expenditures will be necessary resulting from the COVID-19 global pandemic. It is assumed that the government continues to finance the CROSS program at the current rate. The projections indicate that the original $20 million appropriation should finance the program through the end of FY21. However, there is likely

Palau benefits from CDC Operations Ward Speed with rapid immunization of the public lays the ground for recovery in the tourism sector.

to be a continuing need for the program, albeit at reduced levels in FY22, as the economy recovers. The U.S. CARES program is assumed to continue throughout FY21 but thereafter to terminate.

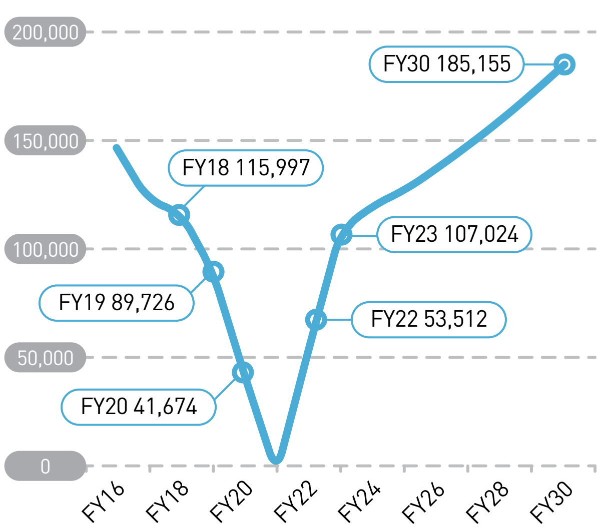
Tax reform is assumed to be implemented in FY23 and onwards. A major element of the ADB's proposed RISES program is the tax reform initiative. The major components of the tax reform will be:

- The introduction of Palau Goods and Services Tax (PGST).
- The introduction of Busines Profits Tax (BPT).
- Conversion of specific import taxes into excises applicable to both imports and domestic products.
- Abolition of general import duty rate and Business Gross Receipts Tax.

The base scenario assumes the tax reform package will be implemented in FY23 over a phased period and in a revenue neutral fashion. The impact of the tax reform on the economy is investigated as a special scenario in Section 5.

Figure 8 - Projected tourism arrivals

Trourism arrivals collpase in FY21 but commence recovery in FY22



ECONOMIC AND FISCAL OUTLOOK

Outlook for the Economy

In FY21 the economy experienced the full force of the collapse in the tourism industry. The outlook for the Palau economy is projected in Figure 9. After a reduction of 9.7 percent in FY20, the economy is again projected to fall further by an additional 17.4 percent in FY21 as the full force of the collapse in the tourism economy is felt without the benefit of 4-5 months of pre-pandemic economic activity that affected the FY20 results. The drop in FY21 reflects the virtual disappearance of visitors for the whole fiscal year, a reduction in the level of construction activity, but assumes the continuation of the mitigation programs including both the CROSS and CARES Acts provisions.

The economy is projected to start a slow recovery in FY22 and full recovery by FY24. In FY22 it is assumed that the process of a slow and gradual recovery commences and visitors to Palau achieve a level of 54,000 (40 percent of the projected level for FY20 before the pandemic). However, it is assumed that the stimulus provided through the U.S. CARES act and its subsequent acts are no longer available but that there remains a reduced need for the CROSS Act provisions. It is further assumed that the construction industry reverts to trend after the earlier projects close out and contracts by 23 percent. The partial recovery in the tourism industry leads to growth in the economy of 15 percent. By the end of FY23 the economy is close to full recovery and is again projected to grow by a large 17 percent. The recovery in the tourism industry over the FY22-FY23 period leaves the economy 1.8 percent above the depressed level of FY19. In the years after recovery from the pandemic, the hospitality industry is projected to achieve an occupancy level of 55 percent and visitors attain 185,000 by FY30.

Private sector received the brunt of the impact of the pandemic. Figure 10 indicates the impact of the pandemic on the private sector. While the public sector is projected to remain unchanged—due to donor financing to maintain basic services—the brunt of the COVID-19 impact is felt by the private sector. In FY20, a large reduction of 20percent was experienced, reflecting the collapse of the tourist economy after the end of March and indirect effects on secondary industries. In FY21, a further reduction of 24 percent is projected, reflecting the full impact of the reduction in tourism. Overall, a massive loss in output of 39 percent has been projected for the private sector.

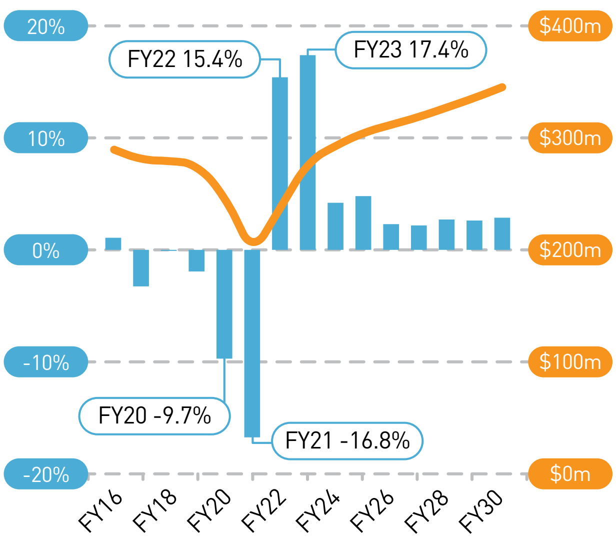
Accommodative fiscal policy designed to support the private sector. During the crisis, the public sector is projected to remain operating at prior levels, although the normal attrition of workers is not assumed to be replaced. This modestly restrictive policy reflects both the accommodative fiscal policy adopted but also the need for fiscal discipline.

Employment and Impact on Household Incomes

Early projections of job loss turn out to be unrealistic as employers placed people on part-time basis. Initial projections of the loss of jobs suggested that total job loss of up to 3,100 could be anticipated or 27 percent of the labor force. However, as the FY20 employment data became available it revealed that for the year as a whole employment had only fallen by 3 percent with a loss of just 400 jobs. Information from the CROSS and CARES acts suggests that about 2,650 people or 23 percent of the work force are claiming benefits. The apparent lack of consistency in the data is explained by three factors. Firstly, the Social Security-based

Figure 9 - GDP growth

Total two-year reduction in GDP is 26%



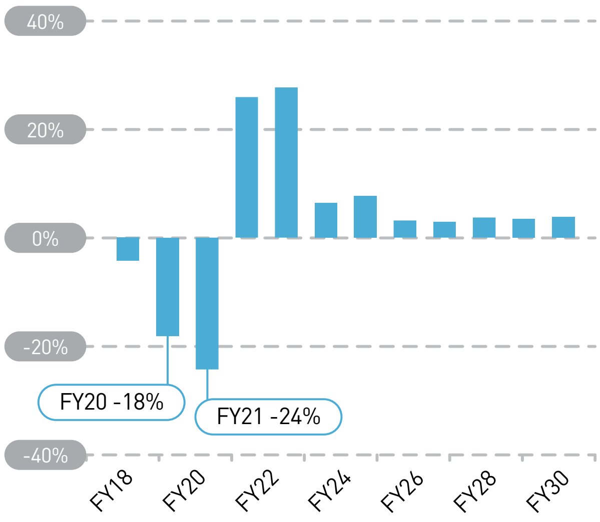
employment figures are averages for the whole of FY20. Secondly, many of the beneficiaries of the mitigation programs received benefits on a part time basis. Thus, employers held on to employees but on reduced hours. Thirdly, there was some repatriation of foreign workers in the early stages of the crisis.

Unemployment projections are revised downwards, but with a significant switch to employment on a part-time basis. During the last quarter of FY20 the SS data indicates a total loss of 1,143 jobs or 10 percent of the workforce. The projections in this review project a job loss in FY21 of 1,601 compared with FY19, i.e., a further 458 loss in jobs compared with

The medium and longer-term outlook for the Palau economy looks favorable as the tourism industry returns to a level of capacity (55 percent) higher than the existed in the min-90s.

Figure 10 - Private sector GDP growth

Total two-year reduction in private sector GDP is 39%



the 4th quarter FY20 outturn. These figures are shown in Figure 11 which is indicated for both Palauan and foreign workers. The early projections of job losses were based on a fixed ratio of jobs to output for the various sectors in the Palauan economy. This simplistic assumption is clearly not realistic and makes projection of job loss problematic. The revised projections are based on the 4th quarter FY20 data, and a return to normalcy once the recovery is complete by FY23. Thereafter additional demand for labor is filled by foreign workers reflecting the fully employed status in the Palauan segment of the market.

Design of the CROSS Act is expected to maintain labor force once recovery gets underway. Typically, unemployment of foreign workers has not been an issue for public policy as foreign workers leave Palau following cessation of employment. However, departure of released foreign workers has been constrained by travel restrictions and minimal flight availability. In response to this, the intent of the government's CROSS Act has been not only to mitigate the resulting hardship but also to maintain the foreign work force in-country, so that Palau will be in a position to rebound quickly once recovery is underway.

Palauan segment of market is less affected by the pandemic but impact remains large. Given the concentration of the Palauan segment of the labor force in the public sector, the brunt of the impact of unemployment has been felt by foreign workers. Nevertheless, about 800 Palauan workers have received benefits under the U.S. CARES Act, indicating the magnitude of the impact of the pandemic.

Mitigation programs have large beneficial impact on household incomes. Figure 12 indicates the impact on household incomes with the mitigating effect of the CROSS and CARES acts. In FY20 the combined impact of the CROSS and CARES acts led to a 6.7 percent increase in average household real incomes. This was a totally unanticipated result that helped support the private sector. However, in FY21 the full impact of the crisis is reflected in the figures and coupled with a reduced level of CARES support, household incomes are projected to fall by 3 percent compared with FY19. Simulating the impact of the crisis without the benefit of the mitigation programs and unemployment benefits, household incomes would have fallen by 15 percent in FY21 compared with FY19, resulting in rising levels of poverty in both the Palauan and foreign sectors of the workforce. The magnitude of the coordinated government and donor response has thus been both timely and significant.

Fiscal Impact

The accumulated fiscal deficit resulting from COVID-19 is likely to reach 36 percent of GDP. The fiscal outturn is shown in Figure 13. In FY20 a fiscal deficit of $28 million—11 percent of GDP—was attained. In FY21 the gap is projected to widen, and the deficit rises to $39 million, or 18 percent of GDP. Again, even in FY22 a significant deficit of $19 million, 8 percent of GDP, remains, which does not finally disappear until FY24. The emergence of a nascent recovery is not sufficient to eliminate the need for deficit financing. In total, an accumulated deficit of $86 million or 36

Figure 11 - Employment - Paualan and foreign workers

A total job loss of 1,654 or 14% of the labor force is projected

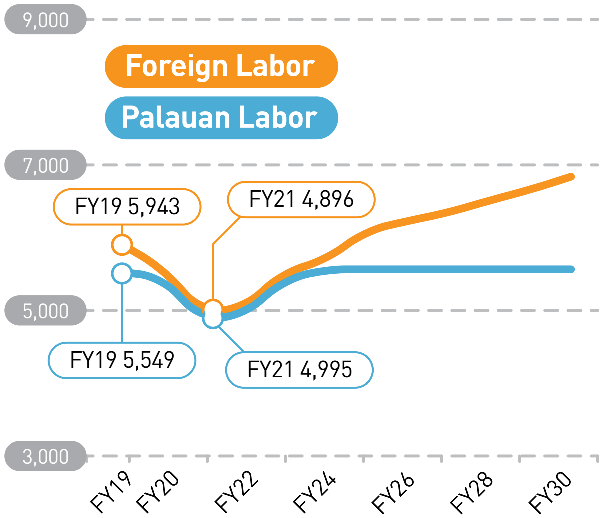
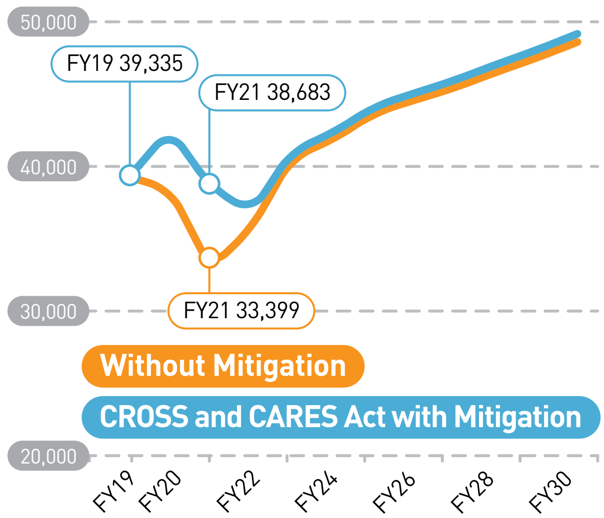


Figure 12 - Household real disposable income

Mitigation efforts reduces household income loss significantly by 14 percent



percent of GDP is likely to result during the FY20-FY22 period.

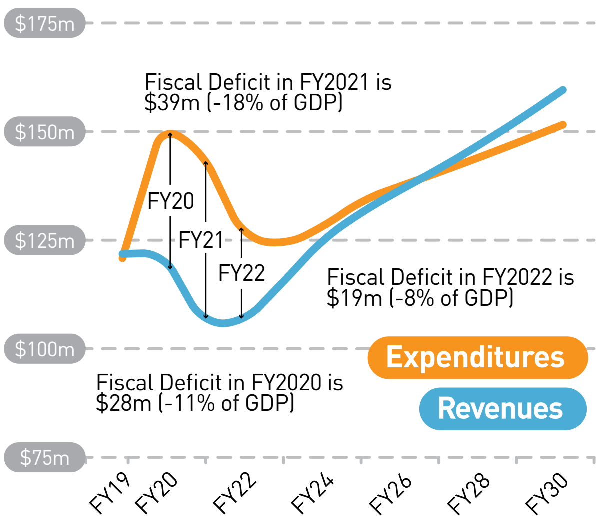
Analysis of the fiscal deficit is decomposed in three parts. The magnitude of the projected deficit reflects three major forces: (i) event driven costs of the health response and mitigation efforts, (ii) the cyclical impact of the loss of the tourism industry on government revenues, and (iii) an emerging structural deficit. Of a total projected deficit of $86 million over the three fiscal periods, FY20-FY22, the cost of implementing the CROSS Act is projected to be $25 million through the end of FY22. Additional costs of medical supplies and drugs were smaller than expected, while medical referral costs fell sharply reflecting travel restrictions. The size of the event driven part of the fiscal deficit item (i) above is thus largely limited to the implementation of the CROSS act.

Tax revenues are likely to fall short by $31 million during FY20-FY22. Notably, the unprecedented size of the fiscal deficit is mitigated by the structure of Palau's fiscal account. About half of revenues are non-tax revenues representing grants, drawdowns from the COFA trust fund, fishing fees, and other fees and charges. These are all assumed to be unaffected by the COVID-19 global pandemic. The principal components of the tax revenues are the payroll tax, gross revenues tax, hotel room tax, PPEF, and import taxes. Total tax revenue fell by $7 million in FY20—about half of the original projections--and further losses of $17 million and $7 million are projected for FY21 and FY22 compared with FY19, respectively. Over the three-year period, tax revenues are projected to fall by $31 million; this represents the size of the cyclical deficit.

Expenditures are projected to be tightly controlled and reduced in real terms until the recovery is well advanced. On the expenditure side, the projections are anchored on the FY20 outturn that has been analyzed in section 3 of this review. Payroll is projected to be constrained through careful monitoring of pay rates and rehiring of vacant positions until the recovery is well advanced. Similar use of goods and services are held in check and fall in real terms. Payments of grants to other layers of government including agencies and state governments are projected on a similar basis. However, the large recent increases in transfers to support financially stressed social insurance and pension funds to the

Figure 13 - Revenues and expenditures

Large fiscal deficits sustained through FY2022



SS and the CSPP are maintained, as are subsidies to PPUC for water and wastewater. Deduction of the event driven part of the fiscal deficit, as well as the cyclical tax shortfall, indicates a structural deficit of $30 million over the 3-year period or $10 million a year.

Financing

National government cash reserves, combined with the proposed ADB RISES program, should provide enough financing to support Palau through FY21 and FY22. Figure 13 indicates a total financing need of close to $60 million over the FY21-FY22 period. At the end of FY20, bank balances had risen to over $60 million reflecting savings from the two ADB loans: (i) The $15 million facility under the DRP (Disaster Resilience Program) and (ii) $20 million under the CPRO (COVID-19 Pandemic Relief Option). There were also savings from the Taiwan $15 million HLDP (Housing Development and Loan Program) which had not been fully spent by year end. A further $55 million Policy Based Loan (PBL) is under negotiation with the ADB to continue support for Palau through the pandemic, although up to $15 million of the program is earmarked to be on-lent to Koror state. Adding existing reserves to the resources under the proposed RISES program of $40 million suggests that, with careful management, Palau should have enough resources to finance the projected deficits of $39 million in FY21 and $19 million in FY22, respectively. This would leave Palau with funds for other purposes such as tax reform implementation and replenishment of cyclical and climate resilience reserve funds.

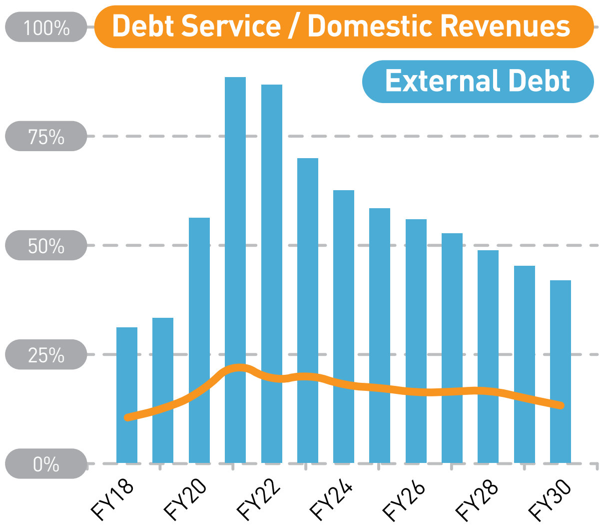
External debt

External debt/GDP ratio rose rapidly to nearly 90 percent of GDP to finance the impact of the COVID-19 global pandemic, but then declined as the economy recovered. As a result of the COVID-19 global pandemic the need for external borrowing is projected to rise rapidly in the short-term (see Figure 14). External debt rose from a level of 33 percent to GDP in FY19 to 56 percent in FY20, and then even higher to 88 percent in FY21. While the rise in the debt/GDP ratio attained record levels, much of the increase is due to the decline in the denominator. In FY21, revaluating the ratio based on the average level of nominal GDP in the FY16-FY18 period indicates the structural level of debt/GDP is about 20 percent lower. After peaking in FY21, the ratio declines rapidly to 62 percent by FY24 as the economy recovers. From this point forward debt/GDP is projected to fall steadily to 42 percent of GDP by FY30 on the assumption that Palau incurs no further external debt. While much of the rise in external debt, $90 million, is due to COVID-19, Palau is also borrowing heavily for other purposes: the Taiwan HLDP loan of $15 million, an additional ADB PBL for PPUC of $10 million, $15.4 million of the second internet fiber project, and a potential further loan from Taiwan of $10 million for a capital injection into the Civil Service Pension Plan. In all, recent additional non-COVID borrowing totals $50 million.

External debt service is projected to rise significantly but should not result in a high risk of debt stress, provided Palau implements offsetting fiscal measures. Debt service follows a similar but less extreme pattern. From representing 10 percent of government domestic revenues before the crisis in FY18, debt service, including SOE payments, rises to 20 percent in FY21 and then is projected to drop back to 13 percent by the end of FY30. Removing the SOE component from legacy borrowing, national government debt service is projected to stabilize at around 12 percent of domestic revenues in FY24. After a period where debt service has been a minor component of the national budget, it will end up consuming a significant but manageable proportion. While the level of debt Palau will incur is large by historical standards, it should not, given fixed low interest rates and the concessional nature of the debt, pose a high risk of debt stress. Rather, it will require careful monitoring and require offsetting adjustments in the national budget. This is the focus of the final section of this review.

Figure 14 - External debt and debt service

External debt rises to high levels in short term



Special Scenario Analysis

THE SEALED CORRIDOR

Sealed corridor may be achieved after Palau completes its vaccination program by the end of June, 2021. The sealed corridor scenario assumes that Taiwan and Palau enter into agreement and create a common travel area with agreed protocols allowing residents of each country to travel within the dual country "bubble" without a 14-day quarantine restriction. It is also assumed that Palau will complete its vaccination program before opening the bubble. By mid-February 2021 Palau had vaccinated 20 percent of its population over 18-years of age with an ultimate target of 80 percent of the entire population, or 100 percent over 18-years. It is projected Palau may achieve this target, including required second vaccine doses, by the end of June 2021. For modelling purposes, this Review thus assumes that the number of Taiwanese tourists visiting Palau in FY21 during the last quarter may reach 13,000, which on a quarterly basis is close to the record number of 41,000 visitors from Taiwan attained in FY12. It is also assumed that visitor numbers achieve 90,000 in FY2022, 35,000 above the baseline (see Figure 15).

Simulation results indicate that the economic impact of creating a sealed corridor in July of 2021 is relatively minor in FY21, but significant in FY22. GDP is 8 percent higher in FY22 under the sealed corridor scenario than under the baseline (see Figure 16). Jobs also improve and the level of full-time equivalent positions rises by 1,200 in FY22 as jobs are re-created and 1,200 people return to work (see Figure 17). Figure 18 indicates that household incomes also rise by 5 percent in FY22 above the baseline, as people go from reliance on unemployment benefits to normal wages. Finally, there is a significant impact on the fiscal deficit

Significant fiscal deficits are projected for FY21 and FY22 until recovery with a large but temporary increase in the debt/GDP ratio.

which improves by $15 million over the two year period FY21-FY22, compared to the baseline. This represents a total of $15 million less that Palau would need to borrow to fund the cyclical downturn and mitigation effort (see Figure 19). The debt-to-GDP ratio falls by 10 percent compared with the baseline.

Completion of the vaccination program is key to opening a travel bubble. The bubble scenario thus has a favorable outcome and clearly accelerates the economic recovery through re-creating jobs, supporting household incomes, reducing the fiscal deficit, and reducing the need for external financing. The concept of bubble tourism with Taiwan was first presented to the Palauan leadership in July of 2020 and was received with interest but without affirmative action. The new administration has greatly favored the project to advance the recovery of the economy and has indicated its desire to open the corridor by the end of March. While this is an ambitious target and reflects Palau's impatience to get the recovery going, Taiwan has so far been reluctant to open the bubble—although it has indicated interest. Once Palau has completed its vaccination program, achieved heard immunity, and thus protected against possible community spread of the virus within Palau, the willingness of Taiwan to implement the project should be greatly enhanced. This assumes, of course, that a new mutation does not emerge in the meantime.

PRE-RECOVERY TERMINATION OF CROSS UNEMPLOYMENT BENEFITS

Growing concerns arise over the costs of unemployment benefits under the CROSS Act. With the expiration of the CROSS act at the end of January and need for renewal, concern has been expressed over the affordability of the provisions. Extension of the program under revised conditions to improve the efficiency of the program is currently being proposed through the end of March of 2021. Any further continuation through the remainder of FY21 will be included in the budget act for the second half of FY21 under the new administration.

To help assess the economic impact of a termination of the CROSS act unemployment benefits for foreign workers before the end of the COVID-19 tourism sector crisis, a special scenario has been simulated.

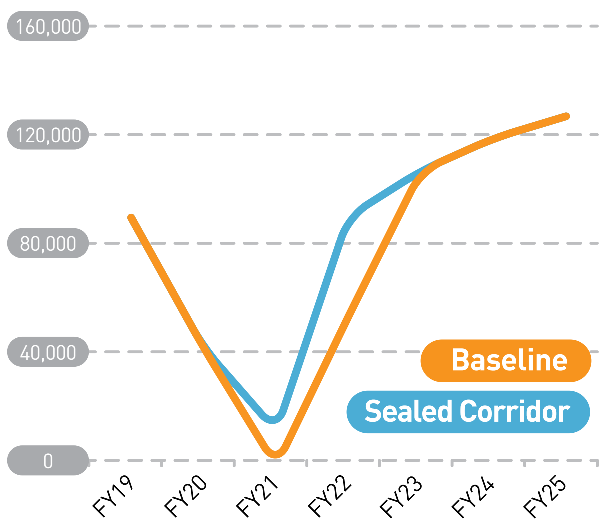
CROSS Act has an important reputational benefit. The original CROSS program was designed with two intentional benefits and one unintended consequence:

- To mitigate the impact of COVID-19 through providing social benefits and humanitarian assistance to adversely affected households and businesses.
- To provide macroeconomic support to the domestic economy through fiscal stimulus.
- To create a reputational benefit through a quickly enacted and disbursed program targeting both Palauan and non-Palauan households.

Earlier discussion has argued that the CROSS act was beneficial in achieving the first two objectives. The program was enacted rapidly and while improvements in delivery are to be developed in coming budget extensions, overall, the program was highly effective. What was not specifically envisioned was the reputational

Figure 15 - Visitor Arrivals

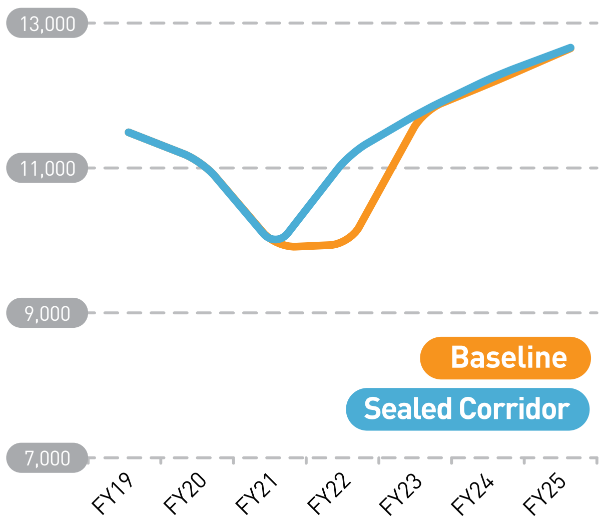
Sealed coridor accelearates recovery



The implementation of a sealed corridor with Taiwan has a significant beneficial impact on the economy.

Figure 17 - Employment

Over 1200 jobs are re-created in FY22 under sealed corridor



benefit Palau accrued as a result of the implementation of the program. This facilitated the rapid response from the donor community and can be assumed to create lasting benefits for Palau's recruitment of foreign labor to support a growing tourism sector.

The repatriation of workers risks labor shortages during recovery. In the pre-recovery termination scenario, it is assumed that Palau decides to save immediate costs and repatriate many of its foreign workers after March 2021, thus depriving itself of a significant part of its tourism workforce. Before the pandemic, the local labor force was largely fully employed with an unemployment rate of less than 2 percent at the time of the last census. While the Palauan segment of the COVID impacted work force will in time return to work, there would be significant labor shortages, especially if the nation at the same time successfully opens a sealed corridor with Taiwan. Recovery thus would be impacted if the supply of labor represented by repatriated

Figure 16 - GDP in constant prices, FY19

GDP improves in FY22 by 8 percent over baseline

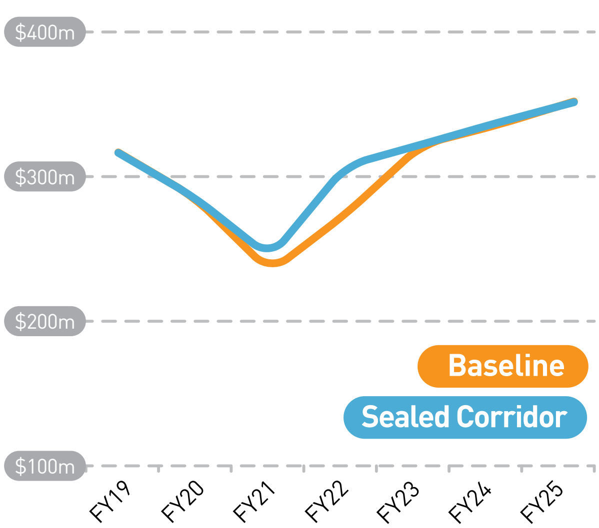


Figure 18 - Household incomes FY19 prices

Real household incomes are 5 percent higher in FY22 under sealed corridor

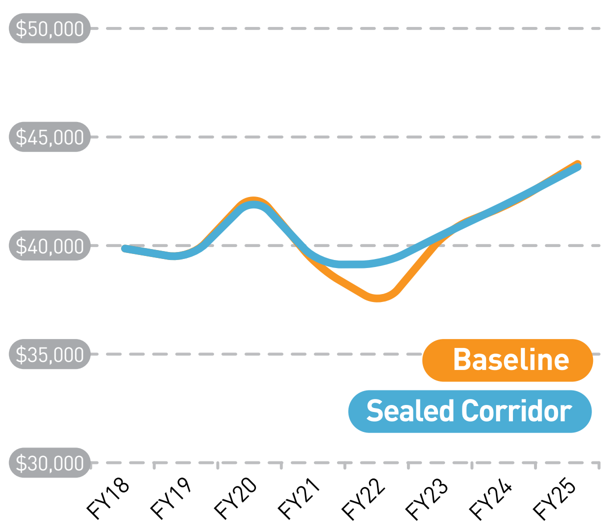
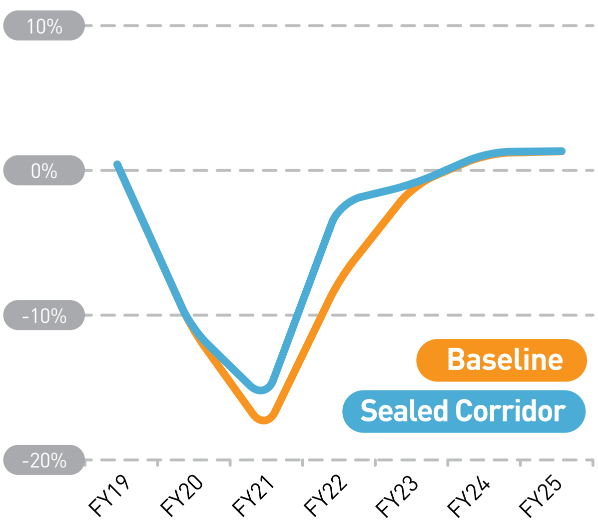


Figure 19 - Fiscal deficit, percent GDP

Under sealed corridor fiscal position improves by $16 million in FY21 and FY22



foreign workers requires both overseas recruitment and training to meet the labor supply needed by a recovering tourism sector.

Recovery is projected to be delayed. the assumed profile of visitor arrivals follows the trajectory shown in Figure 19. This assumes visitor arrivals grow in 25 percent increments until the industry attains a level of 125,000 visitors in FY25. The precise impact of the reduction in the workforce is, of course, hard to predict. The profile projected is thus conjectural and only intended as an indication of the possible order of magnitude of failure to extend the CROSS act unemployment provisions.

Pre-recovery termination of unemployment benefits has a negative impact on the economy. Figures 20-24 tell the story. The recovery is delayed significantly, and the GDP trajectory is 10 and 8 percent below the baseline in FY22 and FY23, respectively. Similarly, employment is significantly below the baseline by over 1,000 jobs in FY22 and over 950 jobs in FY23. Household incomes tell a similar story, falling by 7 and 5 percent below the baseline in FY22 and FY23, respectively. In terms of the fiscal impact the outturn is positive in FY21 by $2.4 million as savings accrue for reduced unemployment payments. Some of this cost reduction could prove illusory—repatriation costs are contractual obligations of individual employers; however, many of those employers may be illiquid if not insolvent at the very depth of the tourism crisis. In such cases, funding to repatriate some foreign workers may fall to the government.

In the following years through FY25 the negative impact of pre-recovery termination of the CROSS act unemployment benefits outweighs the short-term savings in FY21. Over the period an accumulated deficit of $12 million is projected. These figures do not account for the recruitment, mobilization and training costs to bring in replacement workers. These costs would fall entirely on tourism operators at a time when their cash reserves have presumably hit their lowest levels.

Policy Considerations

Government should adopt the proposed RISES program with ADB to support institutional reform and fiscal sustainability. The analysis in this review has examined the impact of the COVID-19 global pandemic on the economy and fiscal position of the government in FY20 and FY21. It has further examined a likely recovery path starting in FY22 and continuing over the following 3 years with projections through FY30 and a set of scenarios. These projections are based on conservative assumptions and are in line with forecasts of international travel. However, there is much uncertainty, and the projections will be subject to a significant degree of error, hopefully, but not assuredly on the upside through earlier and more rapid recovery.

The ADB's proposed RISES program incorporates a series of actions designed to support fiscal sustainability and private sector growth. Palau will incur significant external debt and will require adoption of supporting policies that ensure a sustainable fiscal position through the remainder of the decade. In this regard the RISES program (Recovery through Improved

Pre-recovery termination of CROSS unemployment benefits has a negative impact on recovery, generates labor shortages and adds to financing needs.

Systems and Expenditure Support Program), a Policy Based Loan that Palau has formulated in collaboration with the ADB, includes a series of reforms that will support fiscal stability. The main elements of the reform program include:

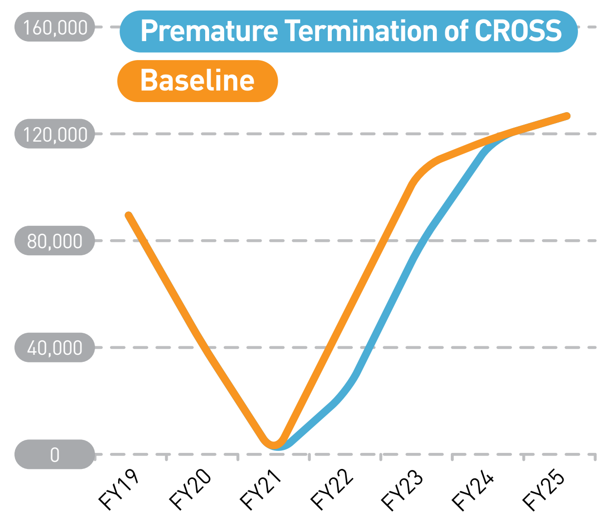
- Fiscal responsibility law
- National infrastructure plan
- External debt management law
- Tax reform
- Social Security reform
- Private public partnership framework
- Arbitration law
- Corporate law reform and registry

There remains a need for a comprehensive framework to address the reform challenge. In the analysis of the fiscal deficit in this review, three components were indicated: (i) an event driven component due to the additional costs of the health response and mitigation efforts, (ii) a cyclical component resulting in lost government revenues due to the economic downturn, and (iii) a structural deficit due to emerging imbalances. The policy response required will reflect the nature of the deficit.

The depth and magnitude of the impact of COVID-19 will require long-term reforms. Response to the event driven and cyclical components of the fiscal deficit are normally of short-term duration limited to the period of fiscal recovery. However, the depth and magnitude of

Figure 20 - Visitor Arrivals

Termination of the CROSS act results in reduced visitors



the impact of the COVID-19 global pandemic is such that reforms of a longer duration will be required to address the issue of the large increase in external indebtedness.

Palau may wish to undertake an in-depth Public Expenditure Review to rationalize delivery of public services. To provide a comprehensive and guiding framework for

Figure 21 - GDP in constant prices, FY19

Recovery delayed due to labor shortages

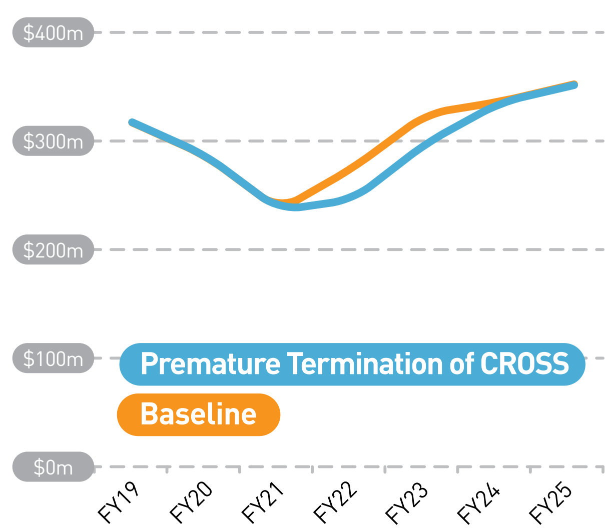
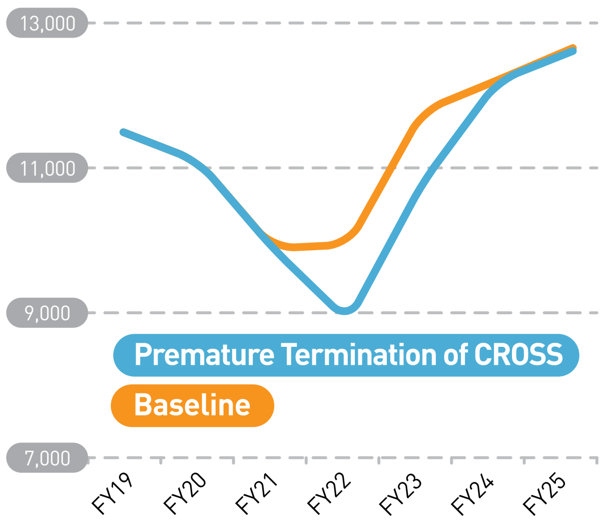


Figure 22 - Employment

Futher job losses are expereinced in FY22



reform, Palau may wish to consider undertaking a comprehensive review of its expenditure policies. Such a review process has been adopted by the World Bank in its series on Public Expenditure Reviews (PER) and has been undertaken in the FSM and is underway in the Marshall Islands. PERs provide an in-

Figure 23 - Household incomes FY19 prices

Household incomes projected to fall by 7 and 5 percent in FY22 and FY23

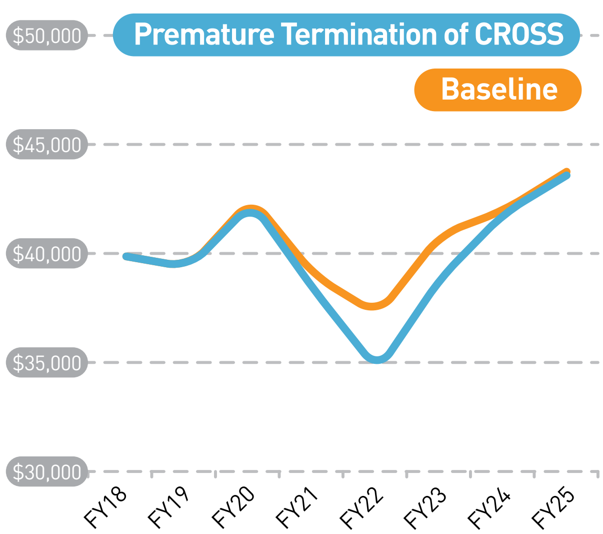
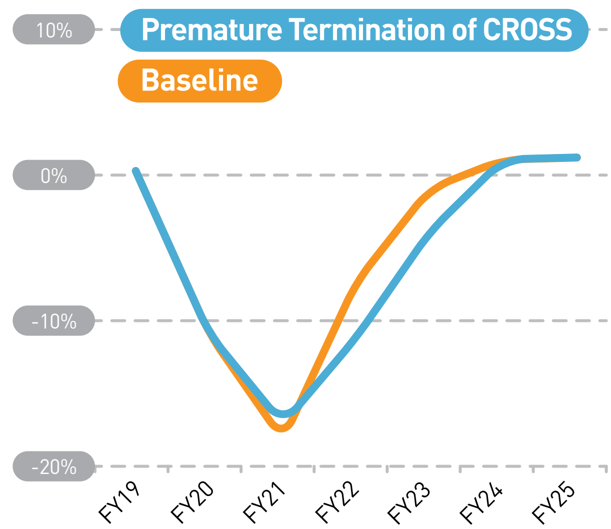


Figure 24 - Fiscal deficit, percent GDP

Overall fiscal cost of early termination is $12 million in additional funding needs



depth analysis of the structure of government expenditures and policies, and address such issues as civil service reform, health and education expenditure reform to improve efficiency and effectiveness, public financial management reforms, such as in procurement, etc. Executed properly, a PER would assist the national government in implementing a period of expenditure restraint without relying exclusively on across-the-board cuts which often result in missed opportunities to protect or even enhance highly efficient and effective components of government-wide expenditures.

REVENUE REFORMS

Tax reform will play a key role in fiscal adjustment during recovery. Reform of the outdated tax regime inherited from Trust Territory days will play a key role in assisting Palau in the reform effort. It will provide a means to raise revenue while at the same time supporting economic efficiency. In the first instance it is expected to be introduced in a revenue neutral fashion to avoid fiscal tightening during the recovery period. However, *The ADB funded RISES program provides the underpinning for sustained financial recovery of the economy.*

a reformed regime will also provide a powerful and efficient tool should additional resource mobilization be required. The recommended tax reform regime and process is well established in Palau and is not elaborated upon in this review.

EXPENDITURE POLICIES

The analysis of the Palau's fiscal expenditures reveals key areas for potential adjustment and a series of structural weaknesses.

Cyclical adjustment

Payroll Policies. Historical trends indicate that payroll cost has declined as a share of GDP. While a PER would indicate potential civil service reforms and possible efficiency gains, this is not an area requiring structural adjustment in the overall size of the civil service. While Palau's policy has been to maintain salaries as an element of fiscal support, adjustment in wage rates to reduce costs during the latter stages of the COVID-19 global pandemic might be considered as an element of burden-sharing. Not only would this distribute the burden between private and public sectors but also inter-generationally. Reductions in cost would reduce borrowing needs and thus reduce future debt service obligations and their negative impact on future generations.

Expenditure adjustments should avoid across-the-board cuts in the use of goods and services. Frequently across-the-board cuts in the purchases of goods and services is the first line of adjustment when the need for cost savings arises. However, government cannot function efficiently if complementary inputs to personnel are cut. Civil servants would potentially be left with insufficient supplies to maintain service levels. While careful examination of costs and greater efficiency in the use of inputs is necessary, across-the-board cuts in the use of goods and services should be avoided.

Structural adjustment

In August 2014, the President issued a policy statement for State Owned Enterprises with the primary objective that all SOEs should operate on a commercial basis covering full cost-recovery. The policy statement, prepared with the backing of the ADB, provided a framework for best practice for operations within the sector. However, in the power and water sector the adoption of full cost-recovery has not been achieved. Further, the full level of subsidy has been hidden by the depreciation of the capital base without provision for replacement or full implementation of scheduled maintenance.

PPUC will adopt a full cost recovery tariff with support from the ADB. To rectify the situation in the power sector Palau has undertaken a PBL of $10 million with the ADB to reform the sector and finance capital needs and maintenance costs. One of the conditions has been the adoption of a new tariff designed specifically to achieve full cost-recovery. In the water and wastewater sector a $28 million loan was incurred to rehabilitate the Koror-Airai system, but further funds are required to complete the program. As a result, revenues from the sale of water and wastewater are less than half of operating costs, implying the need for a substantial subsidy. Without reform and implementation of the full cost-recovery, the sector will pose a significant fiscal risk, requiring a continuing and increasing level of subsidy. The SOE policy announced by the President in 2014, once passed into law, will provide a sound basis for operation of the sector.

However, significant fiscal risk exists in the SOE, pension and state government sector that requires supportive policy to reduce fiscal threat.

Award of three supplemental benefits to pensioners without off setting measures has resulted in a lack of financial sustainability and distortions in the Social Security system. The Social Security system in Palau has been professionally managed and although the funded ratio is low at 19 percent[3], the ratio of contributions and investment earnings to benefits and administrative costs has generally been within sustainable limits. However, periodic adjustments have been required to bring the system into alignment. In FY17 a supplemental benefit of $50 per month was awarded to beneficiaries and the government transferred $2 million to support the payment. In 2018 the rate of contribution for both employers and employees was raised from 6 to 7 percent to cover the cost of the earlier transfer. Again, at the start of FY19 a further $50 per month was awarded to beneficiaries, but with no compensating increase in contribution rates. Yet again in April 2020 a third supplemental benefit of $50 was awarded. To cover the increasing cost for the two additional payments the government made payments in FY20 of $2.1 million and $650,000. The FY19 audit indicates SS ran a $0.5 million deficit before transfer of government funds. This will rise in FY20 and in FY21 when the full impact of the 3rd supplemental benefit increase is incurred.

The proposed RISES program will support SS reforms to rectify financial stability and structural distortions. As part of the policy conditions of the ADB's proposed RISES program, an actuarial study has been commissioned to review the financial position of SS and to recommend reforms, including governance reforms, to ensure financial stability. The relevant second sub-program condition is that reforms based on the actuarial review are transmitted to the OEK. SS was originally designed to operate independently without government support or reliance on transfers. To reduce fiscal risk the reforms to be identified in the actuarial assessment will require enactment into law.

Civil Service Pension Plan is in imminent threat of collapse. Unlike the Social Security system, the Civil Service Pension Plan has been less well-managed financially and suffers from serious design flaws that have been present from the outset of the plan. Thus, CSPP is currently in imminent threat of collapse. With contributions projected to remain stagnant and benefits rapidly growing, a recent actuarial evaluation of the system, known as the Milliman report, projected collapse by FY24. In FY19 total benefits and administrative costs were $10.4 million while contributions and investment earnings were $8.2 million; that is, expenses exceeded revenues by 27 percent. The gap without reform or infusion of funds from government is projected to widen considerably as benefits rise, requiring drawdown of investments until the projected collapse as early as FY24. In the FY20 budget a total of $4.4 million was transferred to the CSPP. A loan of $10 million has been arranged with Taiwan to finance the shortfall in the near term but that injection will only delay collapse by three years.

The CSPP is in dire need of reform and poses a high degree of fiscal risk. The Milliman report was originally intended to design reforms that would provide long-term solutions even if requiring difficult adjustments. However, the agreed scope of work between Milliman and the CSPP Board was limited to present only interim solutions until FY30 on the basis that Palau would in the meantime have an opportunity to

[3] Provisional estimates from the current and unpublished actuarial assessment.

consider what it wanted to do with the Plan. An actuarial assessment with serious reform proposals thus remains to be undertaken. Reform of the CSPP was considered too far reaching to be included in the RISES program but it arguably remains the most serious fiscal risk facing Palau.

Koror State government faces serious financial issues due to COIVD-19. Transfers to state governments have also grown strongly with a near doubling from an annual average of close to $5 million in the early 2010s to nearly $10 million in FY20. Such transfers thus also pose a significant fiscal risk. While most state governments have not been strongly impacted by the COVID-19 global pandemic, Koror state faces serious financial issues due to the pandemic. In FY19 the state operated a $10 million budget financed in large part from tourist-dependent fees from the Rock Islands and Jellyfish Lake; 60 percent of Koror state revenues were derived from this source. The second most important source of revenue is derived from commercial leases which are also dependent on tourist-based plant: hotels, dive and tour operators. Meanwhile, expenditures are heavily concentrated in payroll, which equates to 68 percent of FY19 total expense. Adjusting to the loss of all tourist-related revenues thus places the state in dire financial circumstances. Fortunately, the state had saved a significant part of prior year surpluses and at the end of FY19 had accumulated over $20 million in deposits.

Part of the proposed ADB RISES program funding is to be allocated to Koror State. Given the precarious state of the Koror state's financial position the state has requested a $25 million loan and an $8 million grant from the national government. In response, up to $15 million of the proposed RISES program funds of $55 million have been earmarked for Koror. Estimates of the state's financing needs based on the economic recovery made in this review suggest that $15 million would cover the budget shortfall through 2022. However, a possible financing schedule might be based on a matching program that for every dollar of financing shortfall the cost would be born equally by the state (to be drawn out of reserves) and national government. This would provide contingency funds that would be available if the duration of the recovery were longer than projected in this review. Koror state financial management is also seriously deficient, and the state needs support to build capacity and to also ensure the annual audits are available in a timely manner.

Conclusion

Beginning five months into FY2020 Palau began to suffer the negative impacts of the COVID-19 pandemic. The most immediate concern for Palau was to prepare for—and to guard against—the potential devastating impacts that might have arisen through community spread of the virus. This event posed an existential threat to the small island nation given the challenge that its health system might have had to face. Fortunately Palau remains completely COVID-free; however, Palau's heavily tourism-dependent economy has been deeply affected by the virtual cessation of global tourism and related costs from closing the nation to avoid COVID-19 exposure.

At the start of the COVID-19 pandemic Palau might have been considered one of the least desirable places to endure a pandemic. The nation was presented with a range of choices in the early frenetic days of whether (or how quickly) to close its borders, whether to repatriate many or most of the suddenly unemployed foreign workers, whether to provide widespread tax relief to the private sector, and how to manage Palau's air and sea ports of entry to enable necessary trade in goods—especially imports—with the rest of the world. After some delay for debate within the nation's leadership, inbound visitors were disallowed, the foreign workforce was largely retained in Palau to allow for eventual recovery without need for repatriation of foreign workers followed by recruitment and training of replacement workers, a humanitarian mitigation program provided unemployment benefits to

Palauan and foreign workers, financial support was targeted somewhat narrowly to those elements of the private sector directly affected, and Palau was able to keep a steady and essential flow of goods into the country at its air and sea ports. One year later, Palau can be seen to have responded favorably to the challenges it has faced, though not without pain and suffering, especially in key parts of the private sector.

With ADB support funding Palau's own CROSS Act, and with U.S. support provided through the CARES Act, Palau has navigated through stormy seas and is nearing safe landing with several likely lasting effects. One lasting effect—on the negative side—will be the external debt undertaken to mitigate impacts on the most directly affected individuals and sub-sectors of the economy and to support household incomes to avoid widespread poverty and social stress. Another lasting effect—on the positive side—will be the reputational recognition Palau merits from acting to avoid economic collapse and to provide a humanitarian response to its valuable, and even essential, foreign workers.

While the immediate risk of utter calamity has almost certainly passed, especially as Palau is now well on its way to vaccinating the vast majority of its adult population, significant challenges remain. Debate continues on when the nation should reopen its borders and whether it can sustain the costs of supporting the thus far retained foreign workers through a further and still uncertain period of time. Domestically, the temptation exists to remain within a cocoon and behind closed borders, effectively ignoring the large and growing financial cost even as evidence will likely begin to point towards a safe—if not entirely risk-free—reopening of the tourism sector. At the same time pre-recovery termination of the CROSS Act benefits targeted toward unemployed foreign workers may be financially unwise after Palau has invested significant resources to retain foreign workers ready to return to work once the recovery is underway. The costs imposed on private employers to repatriate foreign workers in the near term would be high and ill-timed; however, the costs to recruit, mobilize and train replacement workers would be even higher, and those costs would be borne by employers trying to rebuild their operations after a period of deep financial stress.

The financial burden imposed by the COVID-19 pandemic requires the nation to set in place a firm foundation to prudently manage fiscal policy to achieve a sound fiscal stance and to provide an effective enabling environment for the private sector to lead economic recovery and to achieve sustained growth of Palau's economy. Assistance from the ADB proposed through the RISES program has been designed to support just such achievements. Establishment of a fiscal responsibility framework, adoption of a sensible external debt management policy, adoption of a modernized and efficient tax regime, reform of the Social Security system to ensure independent sustainability, a framework to regulate private public partnerships to improve resource mobilization, and Corporations law reform to adopt international best practices are seven elements of the program designed to support Palau on its road to recovery and restoration of economic growth. Having been severely challenged by the COVID-19 pandemic, Palau now stands on solid ground to achieve that same recovery and restoration of economic growth for the benefit of all, including generations to come.

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The Economic Monitoring and Analysis Program (EconMAP) provides professional expertise to support statistical development and economic analysis in the three Freely Associated States (FAS) of the Republic of the Marshall Islands (RMI), the Federated States of Micronesia (FSM) and the Republic of Palau (ROP). Annual program outputs for each FAS include the development of economic statistics, the publication of Economic Reviews, and the delivery of economic presentations. Occasional topical reports and technical notes are also published occasionally.

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