



Report and Recommendation of the President to the Board of Directors

INTERNAL

Project Number: 54284-002
August 2022

Proposed Policy-Based Loan for Subprogram 2 Republic of Palau: Recovery through Improved Systems and Expenditure Support Program

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Asian Development Bank

CURRENCY EQUIVALENTS

The currency unit of Palau is the United States dollar.

ABBREVIATIONS

ADB	–	Asian Development Bank
COVID-19	–	coronavirus disease
FRA	–	Fiscal Responsibility Act
GDP	–	gross domestic product
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
MTFS	–	medium-term fiscal strategy
NIIP	–	National Infrastructure Investment Plan
OEK	–	Olbiil Era Kelulau (Palau’s national congress)
PFM	–	public financial management
PFTAC	–	Pacific Financial Technical Assistance Centre
PPP	–	public–private partnership
PPUC	–	Palau Public Utilities Corporation
SOE	–	state-owned enterprise
TA	–	technical assistance

NOTES

- (i) The fiscal year (FY) of the Government of Palau and its agencies ends on 30 September. “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY2022 ends on 30 September 2022.
- (ii) In this report, “\$” refers to United States dollars.

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PROGRAM AT A GLANCE

1. Basic Data		Project Number: 54284-002	
Project Name	Recovery through Improved Systems and Expenditure Support Program (Subprogram 2)	Department/Division	PARD/PASP
Country	Palau, Republic of	Executing Agency	Ministry of Finance
Borrower	Republic of Palau		
Country Economic Indicators	https://www.adb.org/Documents/LinkedDocs/?id=54284-002-CEI		
Portfolio at a Glance	https://www.adb.org/Documents/LinkedDocs/?id=54284-002-PortAtaGlance		
2. Sector		Subsector(s)	
✓ Public sector management	Economic affairs management	ADB Financing (\$ million)	
	Public expenditure and fiscal management	15.00	
		15.00	
		Total	30.00
3. Operational Priorities		Climate Change Information	
✓ OP2: Accelerating progress in gender equality		GHG reductions (tons per annum)	0
✓ OP6: Strengthening governance and institutional capacity		Climate Change impact on the Project	Low
		ADB Financing	
		Adaptation (\$ million)	0.00
		Mitigation (\$ million)	0.00
		Cofinancing	
		Adaptation (\$ million)	0.00
		Mitigation (\$ million)	0.00
Sustainable Development Goals		Gender Equity and Mainstreaming	
SDG 1.a, 1.b		Effective gender mainstreaming (EGM)	✓
SDG 5.c			
SDG 8.3		Poverty Targeting	
SDG 9.1		General Intervention on Poverty	✓
SDG 16.6			
SDG 17.1, 17.4			
4. Risk Categorization:	Low		
5. Safeguard Categorization	Environment: C	Involuntary Resettlement: C	Indigenous Peoples: C
6. Financing			
Modality and Sources		Amount (\$ million)	
ADB		30.00	
Sovereign Program (Regular Loan): Ordinary capital resources		30.00	
Cofinancing		0.00	
None		0.00	
Counterpart		0.00	
None		0.00	
Total		30.00	
Currency of ADB Financing: US Dollar			

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan to the Republic of Palau for subprogram 2 of the Recovery through Improved Systems and Expenditure Support Program.¹

2. The programmatic approach comprises two subprograms in support of public sector management reforms to bolster Palau's recovery from the coronavirus disease (COVID-19) crisis. Subprogram 2 is the final subprogram, deepening and implementing the reforms initiated under subprogram 1, which was approved and disbursed in 2021.² All policy actions completed under subprogram 1 remain in effect. Subprogram 2 builds on the achievements of subprogram 1 and further supports the government to strengthen public financial management (PFM), reduce fiscal risks, and promote private sector development to restore sustained and equitable economic growth. The program is aligned with Strategy 2030 of the Asian Development Bank (ADB) and its operational priorities of strengthening governance and institutional capacity—including a differentiated approach to institutional strengthening and private sector development in small island developing states—and accelerating progress in gender equality.³ It is consistent with the Pacific Approach 2021–2025, which prioritizes PFM improvements to achieve the strategic objective of preparing for and responding to shocks, and the broader goal of building resilience.⁴

II. PROGRAM AND RATIONALE

A. Background and Development Constraints

3. **Development context.** As a small island developing state with limited resources—a population of only about 18,200 as of 2022 and a land area of 458 square kilometers—Palau has few economic drivers, primarily tourism and public sector activity. It is among the most tourism-driven economies globally, with annual tourism receipts averaging about 46% of gross domestic product (GDP) during FY2010–FY2019. Through its Compact of Free Association with the United States, Palau receives grants equivalent to nearly 10% of annual GDP, which helps finance government expenditure. Official transfers contribute to a relatively high per capita gross national income of \$14,786 as of 2020, leading to a high-income economy classification, but elevated cost structures because of remoteness and a small domestic market erode the purchasing power.⁵ Palau is highly vulnerable to disasters caused by natural hazards and to external shocks.

4. **Macroeconomic management.** Propelled by tourism, Palau's economy grew at an average annual rate of 3.2% during FY2011–FY2015, but the tourism industry has struggled ever since.⁶ This resulted in successive GDP contractions averaging 1.3% during FY2016–FY2019. Prior to COVID-19, Palau maintained an annual fiscal surplus averaging the equivalent of 3.0%

¹ The policy design and monitoring framework is in Appendix 1. The program concept paper was circulated to the Asian Development Bank (ADB) Board of Directors on 14 December 2020.

² ADB. [Palau: Recovery through Improved Systems and Expenditure Support Program \(Subprogram 1\)](#).

³ ADB. 2018. [Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific](#). Manila.

⁴ ADB. 2021. [Pacific Approach, 2021–2025](#). Manila. The approach serves as ADB's country partnership strategy for the 12 small Pacific developing member countries, including Palau.

⁵ Gross national income per capita in purchasing power parity terms in 2020 for Palau (\$16,610 in current international dollars) was below that of upper middle-income economies such as the People's Republic of China (\$17,080) and Thailand (\$17,710). Data are from the World Bank's [World Development Indicators](#) (accessed 7 July 2022).

⁶ From a peak of nearly 170,000 tourists in FY2015, arrivals fell to less than 90,000 in FY2019. Among the factors causing the decline were a drought that affected water supply in hotels and resorts, restrictions on tour groups from the People's Republic of China, and subsequent reductions in flight services because of weak demand.

of GDP during FY2011–FY2019, denoting solid fiscal management.⁷ This was facilitated by tax and revenue reforms, and control of the public sector wage bill.⁸ Fiscal prudence allowed for a buildup of buffers in the general fund reserve to 11.3% of GDP by FY2019, providing reserves to absorb short-term liquidity shocks, including the onset of the pandemic.⁹ Public debt, estimated at the equivalent of about 38.6% of GDP in FY2019, was considered sustainable.¹⁰

5. **Economic and fiscal impacts of COVID-19.** Palau avoided COVID-19 outbreaks until the first community transmission cases in January 2022.¹¹ However, travel restrictions reduced tourist arrivals from close to 90,000 in FY2019 to 41,753 in FY2020, and to 3,407 in FY2021.¹² Along with delays in capital projects, this caused the economy to contract by 9.7% in FY2020 and by 17.1% in FY2021. Declining tax collections because of subdued economic activity and additional spending authorized under the Coronavirus Relief One-Stop Shop Program to mitigate the impacts on the private sector led to fiscal deficits equivalent to 10.9% of GDP in FY2020 and 19.5% of GDP in FY2021 (Table 1).¹³ The ratio of public debt to GDP climbed to 85.7% in FY2021, although it remained sustainable, helped by a large share of concessional financing (footnote 10).

Table 1: Selected Fiscal and Economic Indicators
(% of GDP, unless otherwise stated)

Item	FY2018	FY2019	FY2020	FY2021e	FY2022p	FY2023p
Real GDP growth (% change)	(0.1)	(1.9)	(9.7)	(17.1)	9.4	18.3
Change in CPI (% annual average)	2.0	0.6	0.7	0.5	4.3	4.2
Central government budget						
Total revenue	44.5	44.5	47.4	46.3	41.2	38.0
Tax revenue	21.2	20.4	18.9	14.7	14.3	16.3
Nontax revenue	5.9	7.4	5.0	7.4	5.9	6.5
Grants	17.3	16.7	23.4	24.2	21.0	15.1
Total expenditure	38.2	44.1	58.3	65.8	53.9	41.1
Recurrent	35.9	39.6	52.3	61.3	48.9	36.7
of which: wages and salaries	15.7	16.1	17.2	20.7	19.0	16.0
Capital	2.3	4.5	6.1	4.5	5.0	4.4
Fiscal balance	6.3	0.4	(10.9)	(19.5)	(12.6)	(3.2)
Excluding external grants	(11.1)	(16.3)	(34.3)	(43.7)	(33.6)	(18.2)
Public debt	37.1	38.6	62.1	85.7	90.3	74.0
of which: external debt	32.2	33.9	58.1	80.9	86.0	70.5
Nominal GDP (\$ million)	284.7	274.2	257.7	216.2	242.7	294.9

() = negative, CPI = consumer price index, e = estimate, FY = fiscal year, GDP = gross domestic product, p = projection.
Note: Numbers may not sum precisely because of rounding.

Sources: *Asian Development Outlook* database and International Monetary Fund (IMF). 2021. Republic of Palau: 2021 Article IV Consultation—Press Release; staff report; and Statement by the Executive Director for the Republic of Palau. *IMF Country Report No. 21/263*. Washington, DC.

⁷ Sector Assessment (Summary): Public Sector Management (accessible from the list of linked documents in Appendix 2).

⁸ Reforms to raise tobacco taxes and departure taxes pushed the tax–GDP ratio up to an average of 20.2% in FY2015–FY2019, from 17.3% in FY2005–FY2014. Palau also successfully controlled the public sector wage bill, which declined as a share of GDP to an average of 14.7% during FY2015–FY2019, from 17.1% during FY2005–FY2014.

⁹ In FY2014, the government established a permanent general fund reserve as a fiscal buffer to be drawn on during states of national emergency or periods when projected local revenues fall by more than 5% from the previous year.

¹⁰ International Monetary Fund (IMF). 2021. *Republic of Palau: 2021 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for the Republic of Palau*. IMF Country Report No. 21/263. Washington, DC. Key economic and fiscal assumptions of the accompanying debt sustainability analysis remain valid and in line with the latest outlook.

¹¹ World Health Organization. [Palau—WHO Coronavirus Dashboard](#) (accessed 4 August 2022). COVID-19 cases in increased sharply during January 2022—from 13 border cases to more than 600—and totaled 5,234 by early-August.

¹² Government of Palau. [Visitor Arrivals](#) (accessed 11 May 2022).

¹³ Coronavirus Relief One-Stop Shop Act or CROSS Act, 2020 (Republic of Palau Public Law No. 10-56). Mitigation measures under the CROSS Program include unemployment assistance, temporary job schemes, concessional loans for businesses, and lifeline utility subsidies for affected households.

6. **Economic and fiscal outlook.** Palau started efforts to reopen its borders in April 2021 and became the first developing member country in the Pacific to initiate a travel bubble arrangement.¹⁴ Sustained progress on a national vaccination program that started in January 2021 resulted in 100% of Palau's eligible population being fully vaccinated against COVID-19 by April 2022. With reopening to all vaccinated travelers mainly through restored flight links via Guam, the economy is projected to return to growth of 9.4% in FY2022 and 18.3% in FY2023. ADB assesses the general direction of macroeconomic policies to be sound, with a projected rise in tax revenues and expenditure restraints as COVID-19 measures are unwound (Table 1). With the government's commitment to fiscal consolidation, the fiscal deficit is projected to decline from 12.6% of GDP in FY2022 to 3.2% by FY2024. The public debt–GDP ratio is seen to peak at 90.3% of GDP in FY2022 and to decline steadily thereafter under sustained economic growth (para. 32).

7. **Lingering downside risks.** The outlook is subject to significant risks. Tourism recovery is nascent since arrivals during the first half of FY2022 barely exceeded the small FY2021 total (para. 5). While an acceleration in the second half of FY2022 is possible, risks such as external shocks or disasters caused by natural hazards remain and could delay full tourism recovery.¹⁵ Inflation is expected to pick up from 0.5% in FY2021 to 4.3% in FY2022, and to 4.2% in FY2023, in line with projected trends in commodity prices.¹⁶ This could weigh down economic recovery, drive cost escalations, and potentially widen development financing needs (para. 30).

8. **Public sector reform critical to containing fiscal risks.** Accelerating improvements to Palau's fiscal policy and PFM is imperative to remove constraints to sustainable recovery. This calls for a formal fiscal responsibility framework to guide medium-term fiscal consolidation, particularly on the expenditure side, while also accounting for fiscal risks. The government needs to employ a medium-term fiscal strategy (MTFS) with a comprehensive and multiyear budgeting approach that better accommodates revenue volatilities while setting a clear fiscal policy direction.

9. Remaining inefficiencies in the tax regime weigh down revenues.¹⁷ The International Monetary Fund (IMF) estimates that full implementation of Palau's ongoing tax reforms can raise revenues by 1.0 percentage point of GDP. Current expenditures must be reprioritized and targeted to meet the needs of vulnerable groups. Capital spending lacks systematic prioritization, as well as gender-sensitive processes, that would ensure efficient infrastructure upgrades. Palau also needs to enhance oversight for any proposed public borrowing to maintain debt sustainability.

10. High subsidies and transfers to other public entities even ahead of the pandemic—averaging about 5.3% of GDP during FY2009–FY2018 before rising sharply to 11.1% in FY2019—need streamlining. The rise in government transfers in FY2019 reflects injections to Palau's social security funds—the Civil Service Pension Plan for public servants and the Social Security Administration open to all workers—totaling \$3.7 million (3.4% of recurrent spending) that stem from recent unfunded benefit adjustments.¹⁸ Comprehensive social security reform is

¹⁴ The bubble was with Taipei, China, Palau's third-largest tourist market before the pandemic (11% of arrivals). The bubble was temporarily suspended in May 2021 and again in January 2022 amid COVID-19 outbreaks. Palau further opened its borders in July 2021 to fully vaccinated travelers or registered tourists who receive vaccination on arrival.

¹⁵ Direct flight links with the Philippines, a key source of migrant workers, were restored in April 2022. Flight links with Japan and the Republic of Korea are likely to resume later in 2022 as these markets reopened to tourists in June.

¹⁶ Given Palau's limited trade and tourism relations with Europe and minimal dealings with the Russian Federation, the main impact of the Russian invasion of Ukraine is through commodity price shocks and market volatilities.

¹⁷ The tax system relies on gross revenue taxes, which discourages investment, and import duties. During FY2015–FY2019, Palau's tax–GDP ratio was 20.2%, below the 24.4%–29.0% range for tourism-driven Pacific economies.

¹⁸ In FY2017, an additional \$50 per month in benefits was legislated, supported by a government transfer of \$2 million and an increase in the contribution rates of employers and employees from 6% to 7%. A further \$50 per month was awarded to beneficiaries in FY2019, but with no compensating increase in rates, leaving the system imbalanced.

needed to mitigate any pressure for other unfunded adjustments. In FY2020, transfers rose further to the equivalent of 15.7% of GDP, reflecting temporary assistance measures such as an expanded lifeline utility subsidy for households through the Palau Public Utilities Corporation (PPUC). In the medium term, the IMF estimates that tariff reforms by the PPUC and reduced transfers to social security funds can generate savings of up to 1.5 percentage points of GDP.

11. **Constraints to further private sector development.** Weak legal frameworks constrain the recovery of the private sector. It is necessary to operationalize unified rules and procedures for international commercial arbitration to help encourage cross-border investment and reduce perceived risks from domestic dispute resolution mechanisms. To attract more public–private partnerships (PPPs) in the medium term, a formal PPP framework needs to be in place to guide the selection, monitoring, and regulation of private sector partners and thus minimize the potential for incurring new contingent liabilities that would add to the government’s debt burden.¹⁹ Palau’s corporations legislation is also outdated, and the absence of a modern electronic business registry leads to information gaps that can be exploited by beneficial owners of companies for tax avoidance or evasion and for possible money laundering.²⁰

B. Policy Reform, ADB’s Value Addition, and Sustainability

12. **Government’s reform agenda.** The government remains fully committed to completing a broad reform agenda to safeguard fiscal sustainability and support the recovery from COVID-19. This is exemplified in the timely completion of a wide range of policy actions under subprogram 1 in 2020–2021, even as demand for pandemic response stretched government capacity. The government is pursuing reforms in three areas: (i) strengthening the policy and legislative framework for PFM; (ii) reducing fiscal risks from weak management of public revenue, expenditure, and liabilities; and (iii) supporting further private sector development, as underscored by the President of Palau during his first State of the Republic Address in April 2021.

13. **Program description.** The program aligns with the government’s reform agenda and its strong policy actions to safeguard fiscal sustainability (para. 12). Subprogram 1 laid the foundation for stronger fiscal sustainability with upgraded policy frameworks; the approval of comprehensive evaluations; and the preparation and President’s transmittal of critical legislative bills for approval by the Palau National Congress, Olbiil Era Kelulau (OEK). All subprogram 1 actions were achieved and remain in effect. Subprogram 2 builds on this foundation by starting the implementation of upgraded policies and plans; adopting reform recommendations from reviews and evaluations; and institutionalizing and operationalizing key reforms. The reform targets take into account the constraints on implementation capacity given Palau’s small public administration. A policy-based loan remains appropriate to support the government’s reform agenda because the programmatic approach allows for prioritization and sequencing of policy actions to account for capacity constraints, while bridging budget support needs.

14. Subprogram 2 supports 10 prior actions, all of which have been completed. There are no material or substantive changes from the indicative policy actions proposed for subprogram 2 (footnote 2). Four policy actions were refined and strengthened from the corresponding indicative subprogram 2 actions, to reflect the passage of key legislation by the OEK.²¹ Four policy actions

¹⁹ In April 2019, Palau entered its first PPP arrangement—for the upgrade and management of a new international airport terminal—facilitated by the Japan International Cooperation Agency.

²⁰ ADB. 2017. *Private Sector Assessment for Palau: Policies for Sustainable Growth Revisited*. Manila.

²¹ These are (i) policy action 2.1 to recognize the passage of the Fiscal Responsibility Act (FRA), (ii) policy action 2.3 to recognize the passage of comprehensive tax reforms, (iii) policy action 2.6 to recognize the passage of the National Debt Management Act, and (iv) policy action 2.10 to recognize the passage of the updated Corporations Act.

were strengthened to include and clarify implementation steps.²² The subprogram 2 policy actions cover the same three reform areas as did subprogram 1 (Appendix 1) (paras. 15–24).

15. Reform area 1: Policy and legislative framework for public financial management strengthened. The Fiscal Responsibility Act (FRA), developed in subprogram 1, was passed by the OEK and signed into law on 18 November 2021 under subprogram 2. It sets out principles for managing public revenue, expenditure, debt, and fiscal buffers; and specifies provisions to be operationalized through annual budgets.²³ To allow flexibility during shocks, the FRA prescribes a strict process requiring that the government may only deviate from FRA provisions provided that the departure is temporary, with reasonable justification and specification of a clear period after which fiscal policy must revert to adherence to FRA provisions. Under subprogram 2, the Ministry of Finance (MOF) operationalized the FRA by approving an Economic and Fiscal Update effective 7 June 2022 to underpin the FY2023 budget.²⁴ The implementation of future budgets will adhere to the FRA provisions, which were institutionalized by passing the FRA (para. 25).

16. Subprogram 2 supports the MOF in operationalizing the MTFS guidelines issued under subprogram 1 through a detailed MTFS that was approved by the President on 29 June 2022. Applying a multiyear budgeting approach, the MTFS tracks adherence to the FRA provisions and will be refined to reflect the macro-fiscal context, with annual budgets updating a rolling MTFS.

17. Reform area 2: Fiscal risks from weak management of public revenue, expenditure, and liabilities reduced. Stronger domestic resource mobilization, more efficient public spending, and more robust debt management will generate more fiscal space. This is paramount in view of higher debt servicing needs from new borrowing to manage COVID-19 impacts.

18. The OEK passed a comprehensive tax reform package, which was signed into law on 29 September 2021 under subprogram 2. Designed in subprogram 1, the package broadens the revenue base by replacing the general imports tax with the Palau goods and services tax—a value-added tax—that brings consumption of services into the tax net. This tax imposes a uniform 10% rate on the supply of goods and services, except zero-rated supplies such as exports. The package eliminates distortions through a new business profit tax that levies 12% on the net income of individuals or firms. This replaces the gross revenue tax, a turnover tax that applied to total receipts without deductions for production costs, which disproportionately burdened startups, including small and medium-sized enterprises that typically incur net losses in the first few years of operation. Further, by replacing import duties for alcohol and tobacco with an excise tax that also applies to local production, the tax system discourages the consumption of these products through a broader-based and non-distortionary instrument. The tax reforms promote equity and will boost the disposable incomes of lower-income households, including households headed by women, which earn 18% less in average monthly income than those headed by men.²⁵

²² These are policy actions 2.5 (para. 20), 2.6 (para. 21), 2.8 (para. 23), and 2.10 (para. 24). Policy actions 2.1, 2.2, and 2.5 were also rephrased to reflect minor changes that better align with Palau's budgeting processes.

²³ These provisions include (i) maintaining operating expenditures within medium-term targets; (ii) prioritizing capital spending to upgrade public assets over time; (iii) maintaining debt at prudent levels; (iv) preserving the real value of Palau's Compact Trust Fund by setting out investment and withdrawal rules; (v) adopting a modern and efficient tax regime suitable for a tourism-based economy; (vi) managing reserves as insurance coverage for cyclical downturns, disasters, and climate change impacts; and (vii) managing fiscal risks from public sector entities.

²⁴ The Economic and Fiscal Update informs the FY2023 budget in implementing a fiscal program that adheres to the FRA provisions, while also analyzing fiscal risks, including from Palau's noncompliance with global standards for eliminating the trafficking of persons.

²⁵ Equity is promoted by (i) retaining the bottom income bracket (the first \$8,000 in wages and salaries) that is subject to a tax of 6%; (ii) reducing the rate applying to the next income bracket (more than \$8,000 to no more than \$50,000) from 12% to 10%; and (iii) introducing an upper income bracket (more than \$50,000) at a tax rate of 12%.

19. Under subprogram 2, the MOF set up and operationalized a tax reform implementation committee, with 38% of its members being women, to oversee the implementation of the reform package, including the development of implementing rules and regulations and awareness raising materials. With support from the Government of Australia and ADB, the MOF engaged a long-term tax reform implementation adviser to provide day-to-day technical assistance (TA) to the Bureau of Revenue and Taxation on building institutional capacity, upgrading processes and procedures, and improving systems to roll out the reforms.²⁶

20. The MOF continued to implement gender-sensitive public expenditure reprioritization based on a review of budget execution during COVID-19, as initiated under subprogram 1. Under subprogram 2, the MOF implemented further reprioritization, including better targeting and delivery of COVID-19 assistance, based on the findings of the FY2021 Economic and Fiscal Review published on 7 June 2022. For example, the government reallocated funds to free up \$1 million in March 2022, channeling this toward further extending the availability of assistance under its Coronavirus Relief One-Stop Shop Program (footnote 13) into FY2022, to reinforce its success in averting declines in household incomes. Also under subprogram 2, the MOF operationalized the climate-resilient and gender-sensitive National Infrastructure Investment Plan (2021–2030) (NIIP), which it had endorsed under subprogram 1, by implementing NIIP priority projects during FY2022 and operationalizing a monitoring and evaluation framework for NIIP projects.²⁷ Future capital programs will be implemented in accordance with the institutionalized NIIP.

21. To further safeguard debt sustainability, under subprogram 2, the OEK passed the External Debt Management Act, which was signed into law on 18 November 2021. Developed under subprogram 1, the act strengthens the review of the fiscal and economic implications of new borrowing and improves debt transparency. A debt management unit within the MOF's Finance and Economic Intelligence Services was set up and is responsible for the technical due diligence and debt sustainability analysis of any proposed borrowing. The MOF commenced implementation of the act by approving a Public Debt Management Policy, effective April 2022, that details thresholds to total government borrowing. These include medium-term ceilings for the ratios of public debt to GDP (30%) and of debt service to domestic revenue (15%), which may only be breached in exceptional circumstances—such as the current pandemic—and with the OEK's approval.

22. To streamline transfers to public entities and control contingent liabilities, subprogram 2 supported the development of a social security reform bill and its transmittal on 16 May 2022 to the OEK for approval. The bill is informed by an actuarial evaluation of the social security pension fund, completed under subprogram 1, which assessed the adjustments required to restore balance in the long-term contribution–benefit ratio (para. 10).²⁸ The reforms in the bill involve (i) simplifying the benefit structure while retaining the system's progressivity and allowing for inflation-indexed adjustments to pensions to eliminate any pressure for legislated supplemental benefits; (ii) raising the contribution rate for employers and employees to 9% each (from 7%); (iii) applying a phased increase to the retirement age from 60 to 65 years during FY2023–FY2031;

²⁶ The tax reform implementation adviser was initially recruited with support from the Embassy of Australia in Koror. ADB is extending the engagement for at least another year and has mobilized the adviser for on-the-ground support starting in January 2022, through ADB. [Regional: Pacific Economic Management \(Phase 3\)](#).

²⁷ The NIIP emphasizes the need to upgrade and adequately maintain existing assets, in line with the FRA provision on prioritizing capital expenditures so as to increase Palau's national net worth.

²⁸ A subsequent analysis of reform options, considered during consultative stakeholder workshops in November 2021, helped identify the specific reforms to be included in the bill. ADB TA supported the actuarial evaluation and the subsequent report on reform options, and the consultative stakeholder workshops (footnote 26). ADB is also supporting similar work focusing on the Civil Service Pension Plan.

and (iv) providing for early retirement. The combination of reforms is seen to reestablish long-run financial sustainability.

23. **Reform area 3: Private sector development supported.** The program supports broadening the revenue base through further private sector development, which is critical for fiscal sustainability and long-term growth. Under subprogram 2, the OEK passed the International Commercial Arbitration Act 2021 developed under subprogram 1 with ADB's assistance, which was signed into law on 29 April 2021. The act allows for the international arbitration of commercial disputes in business contracts between local and foreign partners, to encourage more foreign direct investment by reducing perceived risks from domestic dispute resolution systems.

24. Under subprogram 2, the President issued an executive order effective 3 September 2021 that formalizes the Policy Statement for PPPs, based on findings of the interministerial technical working group set up under subprogram 1. The policy statement helps minimize contingent liabilities from PPPs with procedures guiding the selection, monitoring, and regulation of private sector partners and transactions. It is complemented by a parallel PPP Transparency Procedure, mandating the disclosure of key terms and conditions for prospective transactions, to strengthen market confidence and promote competition.²⁹ Alongside ongoing efforts to reform state-owned enterprises (SOEs)—including the development of an overarching SOE governance legislation and utility subsector reforms—the policy statement will help improve public service delivery through greater private sector participation.³⁰ The OEK also passed an updated Corporations Law, which was signed into law on 29 September 2021, under subprogram 2. The law contains additional provisions, most crucially for the development of an electronic companies registry, to promote increased transparency on beneficial ownerships to increase tax compliance, while also allowing for improved collection of sex-disaggregated data on business ownerships. More broadly, it streamlines and modernizes the processes for registering new companies, reducing the financial and time costs of starting a business. The MOF commenced implementation of the new Corporations Law by developing technical specifications to establish a new electronic registry system based on the law's requirements.

25. **Post-program partnership framework.** To support reform progression, ADB developed a post-program partnership framework with the government. Under reform area 1, the government will continue to implement annual national budgets in line with FRA provisions, and track fiscal outturns against the MTFS to periodically recalibrate the strategy. Under reform area 2, the government will (i) complete a needs assessment for a new tax administration information technology system; (ii) continue to implement expenditure reprioritization measures; (iii) maintain alignment of capital allocations in future national budgets with the NIIP; (iv) commence, through the debt management unit, rigorous scrutiny of the economic and fiscal implications of any new borrowing; and (v) undertake a social and gender impact analysis of social security reform initiatives. Under reform area 3, the government will coordinate with development partners in providing training to legal practitioners on international arbitration, strengthen the implementation of the Policy Statement for PPPs, and set out regulations for implementing the Corporations Law.

26. **ADB's value addition.** Subprogram 2 builds on ADB's experience with previous and ongoing policy-based operations and public sector management TA. In its direct response to the pandemic, ADB provided budget support in 2020 through the COVID-19 Pandemic Response Option and the drawdown of contingent disaster financing for Palau's relief and mitigation

²⁹ The PPP Transparency Procedure is supported under subprogram 2 of footnote 30.

³⁰ ADB. [Palau: Palau Public Utilities Corporation Reform Program \(Subprogram 1\)](#).

program.³¹ Further, the program complements (i) a social protection project with targeted interventions for vulnerable groups, including women;³² and (ii) a parallel policy-based operation supporting critical reforms at the PPUC (footnote 30). ADB supported a rapid assessment of COVID-19 impacts, an estimation of resulting financing needs, and the identification of reform opportunities to support recovery.³³ ADB mobilized complementary TA to help advance critical program reforms. These include facilitating tax reform implementation by cofinancing a long-term adviser (para. 19), supporting the consultative development of the NIIP as well as social security reform options, and preparing legislative bills.³⁴ Ongoing regional TA to public sector management helps improve data collection and analysis to build Palau's capacity to respond to future shocks.³⁵ On private sector development, ADB harnessed knowledge work to underpin reforms, particularly the update of the Corporations Law.³⁶ ADB regional TA also supported the preparation of the international arbitration bill, consultative development of the PPP policy statement, and the detailed review and update of the Corporations Law.³⁷

27. **Development partner coordination.** The program was developed in coordination with the IMF to ensure macroeconomic stability during the COVID-19 crisis. ADB participated in the IMF's 2021 Article IV staff consultation for Palau to align macro-fiscal surveillance and identify areas for further collaboration. ADB and Australia collaborated on the provision of complementary long-term TA toward the full implementation of the tax reform package (para. 19). The Pacific Financial Technical Assistance Centre (PFTAC) is supporting a needs assessment for a new information technology system in tax administration.³⁸ Through the Asia Pacific Tax Hub, ADB is coordinating with the Organisation for Economic Co-operation and Development (OECD) on completing Palau's commitments as a member of the Global Forum on Transparency and Exchange of Information for Tax Purposes, and on facilitating Palau's prospective membership in the Inclusive Framework on Base Erosion and Profit Shifting. The Asia Pacific Tax Hub is planning a short-term benchmarking and diagnostic study on tax reform implementation—potentially in coordination with other partners, like PFTAC—to evaluate economic impacts and identify possible refinements to improve effectiveness. An IMF assessment was provided.³⁹

28. **Lessons.** ADB has had a long engagement with Palau on public sector management (figure). Lessons highlight the need (i) to provide complementary TA to supplement the reform design and implementation capacities in key government agencies, along with coordinated consultations with development partners and stakeholders to mitigate the risks of reform delays; (ii) to account for potential political economy shifts that can affect the timely delivery of outputs; (iii) to support aggregate demand during economic shocks, while protecting the fiscal position through well-targeted stimulus packages; and (iv) to back government oversight mechanisms for SOEs, accountability, and governance risks.⁴⁰ These lessons informed the design of the program.

³¹ ADB. [Palau: Health Expenditure and Livelihoods Support Program](#); and ADB. [Palau: Disaster Resilience Program](#).

³² ADB. [Palau: COVID-19 Response for Affected Poor and Vulnerable Groups Project](#).

³³ ADB. [Regional: The Economic Impacts of the End of Compact Grant Assistance](#) and footnotes 26 and 35.

³⁴ ADB. [Regional: Pacific Region Infrastructure Facility Coordination Office—Leveraging Infrastructure for Sustainable Development](#) and footnote 26.

³⁵ ADB. [Regional: Assessing and Improving Policy Response to Economic Shocks in the North Pacific](#). The subregional coverage of the TA opens opportunities for knowledge sharing and replication, given that North Pacific economies (i.e., the Federated States of Micronesia, the Marshall Islands, and Palau) have similar histories and close ties with the United States.

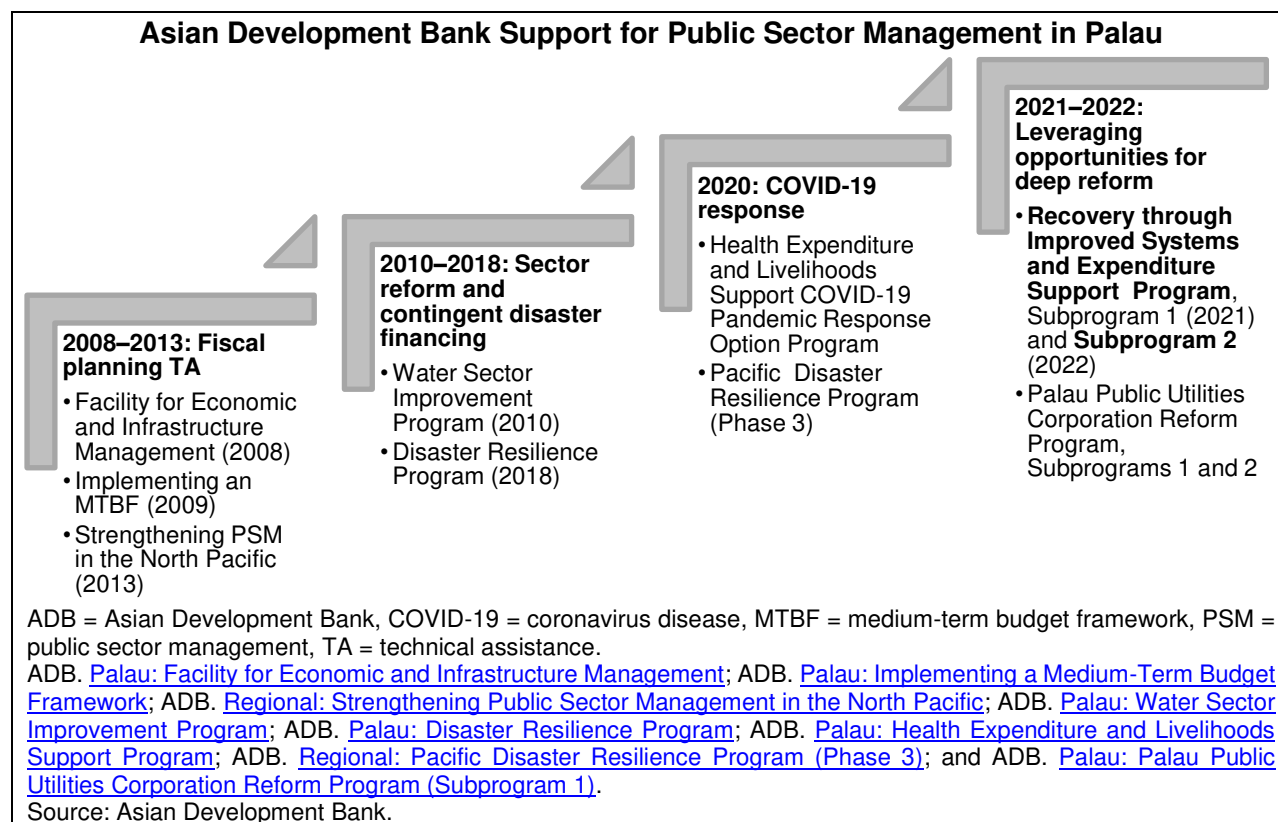
³⁶ ADB. 2017. [Private Sector Assessment for Palau: Policies for Sustainable Growth Revisited](#). Manila.

³⁷ ADB. [Regional: Promotion of International Arbitration Reform for Better Investment Climate in the South Pacific](#) and ADB. [Regional: Pacific Private Sector Development Initiative, Phase IV](#).

³⁸ PFTAC. 2021. [Annual Report 2022](#). Suva.

³⁹ The IMF confirmed on 23 March 2022 that the attached IMF Article IV Report for the Republic of Palau may serve as the IMF assessment letter (footnote 10).

⁴⁰ Independent Evaluation Department. 2018. [State-Owned Enterprise Engagement and Reform](#). Manila: ADB.



C. Expected Outcome of the Reforms

29. The program's expected impact is the enhanced quality of life for current and future generations of Palauans.⁴¹ Program reforms will shift Palau's economic recovery onto a more sustainable fiscal path. A strengthened policy and legislative framework for PFM supports fiscally responsible and strategic budgeting for more efficient allocation of resources. By reducing fiscal risks and improving the management of public finances, the government can generate fiscal space for more productive spending. Incremental improvements in the business environment can help underpin further private sector development, broadening the tax base and promoting longer-term fiscal sustainability. Subprogram 2 reforms contribute to this by further building on and implementing the broad reforms initiated during subprogram 1 (paras. 15–24). The program is seen to help reduce the fiscal deficit to 5.5% of GDP or less, and raise the tax–GDP ratio to above the pre–COVID-19 average of 20.2% by FY2023. The implementation of revenue and spending reforms will help the government generate enough fiscal space to service higher debt.⁴²

D. Development Financing Needs and Budget Support

30. The continuing impacts of COVID-19 restrictions have resulted in substantial near-term financing needs, projected to total \$39.9 million during FY2022–FY2023 (Table 2). Of this, FY2022 needs are projected at \$30.6 million. To help meet these substantial needs, the government has requested a regular loan of \$30.0 million from ADB's ordinary capital resources to finance subprogram 2. Along with the parallel program supporting targeted utility subsector

⁴¹ Palau National Master Plan Task Force. 1996. *Palau 2020: National Master Development Plan: Issues, Options, and Strategies for Palau's Development*. Koror.

⁴² Program Impact Assessment (accessible from the list of linked documents in Appendix 2).

reforms at the PPUC, ADB's pipeline budget support totals \$35 million in FY2022 (footnote 30).⁴³ The loan will have a 15-year term, including a grace period of 3 years; an annual interest rate determined in accordance with ADB's Flexible Loan Product; a commitment charge of 0.15% per year; and such other terms and conditions set forth in the draft loan agreement.

Table 2: Development Financing Needs, FY2020–FY2023

Item	FY2020		FY2021e		FY2022p		FY2023p	
	(\$ million)	(% of GDP)	(\$ million)	(% of GDP)	(\$ million)	(% of GDP)	(\$ million)	(% of GDP)
Revenues	122.1	47.4	100.1	46.3	100.1	41.2	112.0	38.0
Expenditures	150.3	58.3	142.3	65.8	130.7	53.9	121.3	41.1
Fiscal balance	(28.2)	(10.9)	(42.2)	(19.5)	(30.6)	(12.6)	(9.3)	(3.2)
Financing needs	28.2	10.9	42.2	19.5	30.6	12.6	9.3	3.2
Government deposits	(6.8)	(2.6)	12.2	5.6	(4.4)	(1.5)	4.4	1.5
ADB CDF	15.0	5.8						
ADB HEALS	20.0	7.8						
ADB RISES			25.0	11.6	30.0	12.4		
ADB PPUC			5.0	2.3	5.0	2.1		
Other: TBD							4.9	1.7
Nominal GDP	257.7		216.2		242.7		294.9	

() = negative, ADB = Asian Development Bank, CDF = contingent disaster financing, e = estimate, GDP = gross domestic product, HEALS = health expenditure and livelihood support, p = projection, PPUC = Palau Public Utilities Corporation, RISES = recovery through improved systems and expenditure support, TBD = to be determined.

Note: The ADB CDF and HEALS program supported the Coronavirus Relief One-Stop Shop Program until September 2021. Excess funds were deposited in FY2020 (hence the negative financing entry) for use in FY2021. Similarly, a portion of ADB's FY2022 budget support may be deposited by the government, potentially for partial financing of the FY2023 deficit. Numbers may not sum precisely because of rounding.

Sources: International Monetary Fund (IMF). 2021. Republic of Palau: 2021 Article IV Consultation—Press Release; staff report; and Statement by the Executive Director for the Republic of Palau. *IMF Country Report No. 21/263*. Washington, DC; and ADB estimates.

31. Although the FY2022 financing needs are provisionally estimated at \$30.6 million, this is subject to significant uncertainties and downside risks, including cost escalations because of elevated oil prices and delays in the anticipated tourism recovery in the latter half of the fiscal year (para. 7). Under the current highly uncertain environment, the FY2022 financing needs may rise to \$55 million if the impacts of both high inflation and delayed tourism recovery are fully realized.⁴⁴

32. **Debt sustainability.** Palau's public debt is mostly external, with domestic debt at 4.7% of GDP as of FY2019. External debt fell from 38.3% of GDP in FY2009 to 23.1% in FY2015, before rising to 31.1% in FY2019 amid project investments supported by ADB.⁴⁵ COVID-19 impacts pushed the public debt–GDP ratio to 62.1% in FY2020, and to 85.7% in FY2021. Public debt–GDP is projected to peak at 90.3% in FY2022. ADB's debt sustainability analysis shows that with sustained recovery, public debt–GDP can revert below the pre-COVID-19 level by FY2032.⁴⁶ ADB's analysis concludes that Palau's debt remains sustainable, but heightened risks emphasize the need to sustain reforms. These results align with the conclusions of the IMF (footnote 10).

⁴³ ADB is Palau's only multilateral development partner providing general budget support under concessional financing.

⁴⁴ ADB's simulations suggest that a higher inflation environment can expand the government's expenses on goods and services from the IMF's estimate of \$25.7 million to about \$37.1 million, or an increase of \$11.4 million. Further, the deficit projection also involves an underlying assumption that visitor arrivals would reach more than 24,000 during FY2022. With arrivals in the first half of the fiscal year at only about 3,400, second-half arrivals would need to reach 47% of FY2019 levels (of 90,000) for the full-year projection to be realized. If visitor arrivals fall short—and only reach about the midpoint of the 8% of FY2019 monthly arrivals recorded in the first half of FY2022 and projected levels—fiscal year total arrivals would be less than 16,000. Simulations indicate that this level of visitor arrivals can reduce FY2022 tax revenue collections from the IMF's projected \$34.8 million to \$22.0 million, a shortfall of \$12.8 million.

⁴⁵ ADB. [Palau: Koror–Airai Sanitation Project](#); and ADB. [Palau: North Pacific Regional Connectivity Investment Project](#).

⁴⁶ Debt Sustainability Analysis (accessible from the list of linked documents in Appendix 2).

E. Implementation Arrangements

33. The MOF is the executing agency responsible for overall program monitoring, as well as the primary implementing agency coordinating progress toward policy actions. The other implementing agencies are the Bureau of Revenue and Taxation for tax reform, the Ministry of Justice for international arbitration, and the Palau Social Security Administration for pension fund reforms. A program steering committee headed by the minister of finance is continuously monitoring progress in reform implementation. ADB regional TA has been mobilized to facilitate the implementation of program policy actions (footnote 34). The implementation period is August 2021–July 2022 for subprogram 2. The proceeds of the policy-based loans will be withdrawn in accordance with ADB’s *Loan Disbursement Handbook* (2017, as amended from time to time).⁴⁷

III. DUE DILIGENCE

34. **Governance.** Although Palau has a strong track record of sound fiscal management—further bolstered by its commitment to reform during the pandemic—the IMF suggests additional actions to improve PFM (footnote 10). These include (i) conducting ex-post audits; (ii) enhancing transparency on the beneficial ownership of government contracts; (iii) improving the spending efficiency of COVID-19 support, e.g., by using administrative data to reduce processing times; and (iv) undertaking a formal Public Expenditure and Financial Accountability assessment. The PFTAC is preparing to conduct a streamlined assessment for Palau in FY2023 (footnote 38).

35. **Poverty and inequality.** Basic needs poverty was 19.4% of the population, as of the latest estimate in 2014.⁴⁸ Poverty was projected to rise to 26.5% in FY2021 under COVID-19 impacts, but assistance measures provided a stimulus to household incomes that helped to likely avert any substantial increase in the poverty rate. Strengthened PFM, along with reduced fiscal risks, will allow for adequate public spending on basic services and social protection. Private sector development will help expand income-generating opportunities.

36. **Gender.** Subprogram 2 is classified *effective gender mainstreaming* with proactive gender actions in all three reform areas. It ensures more resources to support disadvantaged groups and to preserve recent gender equality gains. A gender-responsive rollout of tax reform ensures that women have access to tailored information and services that will help them harness expanded business opportunities. Women entrepreneurs have highlighted that costs, and confusing and lengthy processes, are barriers to registering their businesses. The need to register in-person at multiple locations is an issue given women’s multiple caring and household responsibilities. The implementation of the new Corporations Law and the creation of the online registry help remove these barriers to formalizing women’s businesses by simplifying processes and reducing cost and time (as registration can be online), while allowing for expanded collection of sex-disaggregated data for the first time through the new electronic companies registry. The gender-responsive rollout of the registry and the implementation of the NIIP prioritize women’s needs by encouraging greater business activity and delivering infrastructure services. The Economic and Fiscal Update’s analysis of risks from noncompliance with global standards for eliminating people trafficking helps provide the impetus for resolving a critical issue that disproportionately impacts women and girls, and will inform FY2023 budget planning. An action plan and budget to tackle trafficking will be developed as part of the post-program partnership framework. Also, the FY2021 Economic and Fiscal Review again stressed gender-sensitive lessons from expenditure reprioritization.

⁴⁷ List of Ineligible Items (accessible from the list of linked documents in Appendix 2).

⁴⁸ Government of Palau. 2019. [Pathway to 2030: Progressing with Our Past toward a Resilient, Sustainable, and Equitable Future: First Voluntary Review on the Sustainable Development Goals](#). Koror.

37. **Safeguards.** An evaluation of the potential impacts of supported policy actions confirms that the program will not result in any adverse consequences for the environment, involuntary resettlement, or indigenous peoples. In line with ADB's Safeguard Policy Statement (2009), the program is categorized *C for environment, involuntary settlement, and indigenous peoples*.

38. **Risks and mitigating measures.** Major risks and mitigating measures are summarized in Table 3, and described in detail in the risk assessment and risk management plan.⁴⁹

Table 3: Summary of Risks and Mitigating Measures

Risks	Mitigation Measures
Further economic shocks. A disaster, delayed recovery in global tourism, or high inflation following global price trends exacerbate the ongoing economic downturn.	ADB replenished Palau's CDF in November 2020, restoring its ability to access quick-disbursing funds in case of further shocks. ADB will consider additional assistance as needed, in consultation with development partners, if the downturn deepens.
Institutional capacities stretched thin. Continuing reform needs across various areas amid COVID-19 impacts can expose fragilities in public sector capacities.	Parallel technical assistance from development partners—such as ADB, the Government of Australia, and the Pacific Financial Technical Assistance Centre—is supplementing government capacities, particularly for tax reform implementation.

ADB = Asian Development Bank, CDF = contingent disaster financing, COVID-19 = coronavirus disease.
Source: Asian Development Bank.

39. Integrity due diligence was conducted on Palau Social Security Administration and its board of trustees and key staff members.⁵⁰ They do not appear to constitute a significant or potentially significant integrity risk to the program. It has been confirmed that they do not pose potential integrity risks relating to money laundering or terrorism financing in the program jurisdiction. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government.

IV. ASSURANCES

40. The government has assured ADB that the implementation of the program shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan agreements. No disbursement shall be made unless ADB is satisfied that the government has completed the policy actions specified in the policy matrix relating to the program.

V. RECOMMENDATION

41. I am satisfied that the proposed policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$30,000,000 to the Republic of Palau for subprogram 2 of the Recovery through Improved Systems and Expenditure Support Program, from ADB's ordinary capital resources, in regular terms, with interest to be determined in accordance with ADB's Flexible Loan Product; for a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Masatsugu Asakawa
President

5 August 2022

⁴⁹ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

⁵⁰ ADB. 2003. *Enhancing the Asian Development Bank's Role in Combating Money Laundering and the Financing of Terrorism*. Manila.

POLICY DESIGN AND MONITORING FRAMEWORK

Country’s Overarching Development Objectives			
Quality of life for current and future generations of Palauans enhanced (Palau 2020 National Master Development Plan) ^{a,b}			
Outcome Palau’s economic recovery from the COVID-19 crisis shifted toward a more sustainable fiscal path.		Risks and Critical Assumptions R1: A disaster, delayed recovery in global tourism, or high inflation following global price trends exacerbate the ongoing economic downturn. R2: Continuing reform needs across various areas amid COVID-19 impacts can expose fragilities in public sector capacities.	
Prior Actions: Subprogram 1 Completed: July 2020–July 2021	Policy Actions: Subprogram 2 Completed: August 2021–July 2022	Outcome Indicators	Post-program Partnership Framework August 2022–September 2024
Reform Area 1: Policy and legislative framework for public financial management strengthened.			
1.1 The President has transmitted to the OEK for approval a Bill for the national government’s FRA which includes provisions for managing public revenue, expenditure, debt, and fiscal buffers supporting fiscal sustainability to be reflected in Palau’s future annual national budgets. ^c	2.1 In order to strengthen the medium-term framework for fiscal consolidation: 2.1.1 the OEK passed the FRA which was signed into law by the President on 18 November 2021; and 2.1.2 the MOF operationalized the FRA by approving effective 7 June 2022 an Economic and Fiscal Update that will underpin the FY2023 budget which (i) implements a fiscal program in adherence to FRA provisions for strengthening management of public revenue, expenditure, debt, and fiscal buffers, and (ii) analyzes fiscal risks, including from non-compliance to the minimum standards for eliminating trafficking of persons. ^d	By September 2023: a. Fiscal deficit as a percentage of GDP reduced to 5.5% or less (FY2020 baseline: FY2022 fiscal deficit projected at 14.4% of GDP). Source: Annual Economic and Fiscal Updates and national budget documents; Graduate School USA economic statistics and reports. ^e b. Operating expenditures (i.e., government expenditures excluding capital outlays) should be	The government will (i) develop an action plan with budget toward ensuring Palau’s compliance with minimum standards for eliminating trafficking of persons toward minimizing associated fiscal risks, and (ii) continue to implement fiscal program in annual national budgets, in adherence to FRA provisions. The government will track fiscal outturns against the MTFS to inform the periodic calibration of the strategy
1.2 The President has issued a Directive for the implementation of Guidelines for preparing and updating an MTFS, applying a comprehensive and multi-	2.2 The MOF commenced implementation of the MTFS Guidelines by approving an MTFS effective June 2022, calibrated to		

Prior Actions: Subprogram 1 Completed: July 2020–July 2021	Policy Actions: Subprogram 2 Completed: August 2021–July 2022	Outcome Indicators	Post-program Partnership Framework August 2022–September 2024
<p>year budgeting approach that better accommodates revenue volatilities while setting a clear fiscal policy direction, with procedures for updating as part of annual national budget preparation; and the Guidelines have been published for transparent fiscal governance.</p>	<p>maintain appropriateness of policy directions to account for any changes in the economic landscape to safeguard fiscal sustainability.^f</p>	<p>less than or equal to operating revenues (i.e., government revenues including recurrent grants) over the medium-term (FY2021 baseline: operating expenditures at 132.5% of operating revenues). Source: Annual Economic and Fiscal Updates and national budget documents.</p>	<p>toward maintaining appropriateness of policy directions and adjusting for any changes in the economic landscape.</p>
<p>Reform Area 2: Fiscal risks from weak management of public revenue, expenditure, and liabilities reduced.</p>			
<p>1.3 The President has transmitted a Tax Reform package—which (i) broadens the revenue base by replacing the general imports tax with a value-added tax that brings consumption of services into the tax net, (ii) eliminates distortions by moving from gross revenue taxation to a net profits tax and replacing import duties for alcohol and tobacco with an excise tax that also applies to local production, (iii) promotes equity by adjusting income thresholds for the wages and salaries tax and aligning the net profits tax with the highest marginal tax rates for wages and salaries, and (iv) includes actions to help remove barriers to</p>	<p>2.3 In order to improve domestic revenue mobilization for fiscal sustainability: 2.3.1 the OEK passed the Tax Reform package which was signed into law by the President on 29 September 2021; and 2.3.2 the MOF commenced its implementation by establishing and operationalizing a Tax Reform Implementation Committee, with 38% female members, to oversee a timebound action plan for gender-responsive implementation of the Tax Reform package, including through the development of implementing rules and regulations and identification of systems upgrading and capacity</p>	<p>By September 2023: c. Tax–GDP ratio exceeds the pre-COVID-19 average level (FY2015–FY2019 baseline: 20.2% average tax–GDP ratio). Source: Annual Economic and Fiscal Updates and national budget documents; Graduate School USA economic statistics and reports.</p>	<p>The government, with assistance from development partners, will complete a needs assessment for a new tax administration information technology system that will underpin the full implementation of the Palau Goods and Services Tax and other components of the comprehensive tax reform program, and collect sex-disaggregated data on business ownership.</p>

Prior Actions: Subprogram 1 Completed: July 2020–July 2021	Policy Actions: Subprogram 2 Completed: August 2021–July 2022	Outcome Indicators	Post-program Partnership Framework August 2022–September 2024
<p>businesses owned by women and reduce the cost of goods—to the OEK for approval.</p> <p>1.4 The MOF has implemented in FY2021, recommendations to reprioritize expenditures based on the FY2020 <i>Economic and Fiscal Review</i>—a new annual budget execution evaluation mechanism that the government is implementing while COVID-19 impacts remain in place—which includes a comprehensive evaluation of COVID-19 relief measures delivered during FY2020 to assess their (i) efficiency, (ii) targeting, and (iii) cost effectiveness.</p> <p>1.5 The MOF has endorsed the NIIP (2021–2030), which supports the FRA principle of allocating adequate resources for capital expenditures in annual national budgets to ensure rising national net worth over time, while also providing for gender-sensitive processes and climate-resilience considerations for filtering, prioritization, and selection of projects to ensure that women’s needs for infrastructure services are adequately addressed.</p> <p>1.6 The President has transmitted the External Debt Management Bill—which specifies provisions for strengthening review of the fiscal and</p>	<p>building needs.^g</p> <p>2.4 The MOF continued implementation of gender-sensitive expenditure reprioritization measures in FY2022, further informed by the FY2021 <i>Economic and Fiscal Review</i>, published on 7 June 2022 (as part of the Economic and Fiscal Update FY2022), which accounts for evolving COVID-19 impacts and identifies necessary adjustments to the delivery of relief measures to cost-effectively address continuing needs.^{h,i}</p> <p>2.5 In order to meet the NIIP’s objectives of raising national net worth over time while also supporting infrastructure services that specifically address women’s needs, the MOF operationalized the gender-responsive NIIP (2021–2030) by:</p> <p>2.5.1 implementing NIIP priority projects during FY2022; and</p> <p>2.5.2 establishing and operationalizing a monitoring and evaluation framework for NIIP projects.^j</p> <p>2.6 In order to strengthen transparency and oversight for any proposed public or publicly-guaranteed borrowing, toward ensuring positive returns to</p>	<p>d. Public debt sustainability assessment rating of sustainable is maintained based on IMF debt sustainability analysis (December 2021 baseline: Rated sustainable). Source: International Monetary Fund Article IV Consultation and Staff Visit reports</p> <p>e. Retirement age for members of the Palau Social Security Pension Fund increased to 61 or older, as a first step of phased increases until FY2031 (FY2021 baseline: retirement age of 60). Source: Social Security Administration reports.</p>	<p>The government will continue to implement expenditure reprioritization measures—as identified in the FY2022 and FY2023 economic and fiscal reviews—and will prepare similar reviews for succeeding fiscal years while COVID-19 impacts remain in place.</p> <p>The government will maintain alignment and implementation of capital allocations in future national budgets with the NIIP (2021–2030) which will be updated periodically to ensure consistency with national development goals—by applying the prioritization and selection processes prescribed by the Plan.</p> <p>The government, through a newly-established debt management unit within the Finance and Economic</p>

Prior Actions: Subprogram 1 Completed: July 2020–July 2021	Policy Actions: Subprogram 2 Completed: August 2021–July 2022	Outcome Indicators	Post-program Partnership Framework August 2022–September 2024
<p>economic implications of any new borrowing, including through the creation of a debt management unit, while promoting debt transparency—to the OEK for approval.</p> <p>1.7 The MOF has endorsed an actuarial evaluation of the social security pension fund, to provide strong policy basis for reforms to restore sustainability in the long-term contribution–benefit ratio, particularly in the context of additional pressures stemming from the COVID-19 crisis.</p>	<p>Palauan society as a whole:</p> <p>2.6.1 the OEK passed the Debt Management Act which was signed into law by the President on 18 November 2021; and</p> <p>2.6.2 the MOF commenced its implementation by approving a Public Debt Management Policy effective April 2022, as per provisions of the External Debt Management Act.^k</p> <p>2.7 The President transmitted a Social Security Reform Bill on May 2022—with provisions to strengthen fiscal sustainability of the social security pension fund—to the OEK for approval.^l</p>		<p>Intelligence Services (FEIS) of the Ministry of Finance, will undertake rigorous scrutiny of the economic and fiscal implications of any new proposed public or publicly-guaranteed borrowing.</p> <p>The government, in coordination with development partners, will undertake a social and gender impact analysis of social security reform initiatives to identify and initiate further reforms.</p>
Reform Area 3: Private sector development supported.			
<p>1.8 The President has transmitted the International Arbitration Bill—which recognizes international arbitration of commercial disputes to encourage more foreign direct investment and boost business and employment opportunities in Palau—to the OEK for approval.</p> <p>1.9 The President has issued a Directive establishing an inter-agency technical working group to develop a</p>	<p>2.8 In order to provide an alternative, cost-effective, and time-efficient means of dispute resolution between parties in international commercial disputes, the OEK passed the International Commercial Arbitration Act 2021 which was signed into law by the President on 29 April 2021, and the law was posted on the official website for Republic of Palau Public Laws to be freely accessible to the public.^{m,n}</p> <p>2.9 The President issued an executive order formalizing the Policy Statement for PPPs effective 3 September 2021</p>	<p>By September 2023:</p> <p>f. All international commercial disputes are arbitrated through provisions of the International Commercial Arbitration Act 2021 (FY2021 baseline: not applicable). Source: Ministry of Justice reports.</p>	<p>The government, in coordination with development partners, including ADB, will provide relevant training to legal practitioners on international arbitration rules and procedures.</p>

Prior Actions: Subprogram 1 Completed: July 2020–July 2021	Policy Actions: Subprogram 2 Completed: August 2021–July 2022	Outcome Indicators	Post-program Partnership Framework August 2022–September 2024
<p>Policy Statement for PPPs, which will provide formal guidance on the selection, monitoring, and regulation of the government’s private sector partners to improve the performance of SOEs and reduce their requirements for government transfers while expanding the tax base.^o</p> <p>1.10 The MOF has completed and endorsed a review of the corporations bill, to provide strong policy basis for additional necessary provisions, including for the development of an electronic companies registry that supports increased transparency on beneficial ownership to increase tax compliance and reduce integrity risks.^q</p>	<p>filling a regulatory gap and supporting more efficient and effective service delivery by government, SOEs, and private sector partners.^p</p> <p>2.10 In order to reduce the financial and time costs associated with starting a business:</p> <p>2.10.1 the OEK passed the updated Corporations Law which was signed into law by the President on 29 September 2021; and</p> <p>2.10.2 the MOF commenced its implementation by developing technical specifications to establish a new electronic registry system, based on the requirements in the approved law, that would (i) streamline and modernize processes for applications and approvals of new companies thereby simplifying and reducing costs associated with formalizing businesses, including by women entrepreneurs, and (ii) enable the collection and analysis of sex-disaggregated data on business ownership.^r</p>	<p>g. All new PPP transactions are reviewed and implemented in accordance with the Policy Statement for PPPs (FY2021 baseline: not applicable). Source: Ministry of Finance reports.</p>	<p>The government will publish a PPP project pipeline, to be updated semi-annually, in line with the PPP transparency procedure adopted alongside the Policy Statement for PPPs, while following the guidance of the Policy Statement for PPPs in selecting, monitoring, and regulating private sector partners in public service delivery.</p> <p>The government will (i) develop the corresponding regulations to fully implement the provisions of the Corporations Law, including the use of an electronic companies registry that modernizes process for business applications and approvals while supporting transparency, and (ii) implement a gender-responsive rollout of the electronic companies registry, with an information awareness campaign targeting current and potential women entrepreneurs.</p>
<p>Budget Support Subprogram 1: ADB: \$25 million loan</p>			

Subprogram 2: ADB: \$30 million loan

A = assumption, ADB = Asian Development Bank, COVID-19 = coronavirus disease, FRA = fiscal responsibility act, FY = fiscal year, MOF = Ministry of Finance, MTFS = medium-term fiscal strategy, NIIP = national infrastructure investment plan, OEK = Olbiil Era Kelulau (Palau's national congress), PPP = public-private partnership, R = risk, SOE = state-owned enterprise.

Note: The fiscal year of the Government of Palau and its agencies ends on 30 September. "FY" before a calendar year denotes the year in which the fiscal year ends, e.g., FY2020 ends on 30 September 2020.

- ^a Palau National Master Plan Task Force. 1996. *Palau 2020: National Master Development Plan: Issues, Options, and Strategies for Palau's Development*. Koror.
- ^b Government of Palau. 2009. *Actions for Palau's Future: The Medium-Term Development Strategy, 2009 to 2014*. Koror.
- ^c The FRA provisions include: (i) maintaining operating expenditures within medium-term targets; (ii) managing capital spending to upgrade public assets over time; (iii) maintaining debt at prudent levels; (iv) preserving the real value of Compact Trust Fund by establishing investment and withdrawal rules; (v) adopting a modern and efficient tax regime suitable for a tourism-based economy; (vi) managing reserves as insurance coverage for cyclical downturns, disasters, and climate change impacts; and (vii) managing fiscal risks from public sector entities, including SOEs and social security funds.
- ^d The FY2023 Economic and Fiscal Update will underpin the FY2023 budget, detailing and confirming the adherence of the government's FY2023 fiscal program to FRA provisions, including maintaining operating expenditures over the medium-term within operating revenues and in relation to the rate of growth of the economy. Since the FRA was passed in November 2021, it was not operationalized through the FY2022 budget which was approved in September 2021. Implementation of future budgets, starting FY2023, will adhere to FRA provisions, which have been institutionalized through the OEK's passage of FRA. Further, Palau was recently downgraded to the Tier 2 watch list in the [2021 Trafficking in Persons Report: Palau](#) prepared by the United States Department of State's Office to Monitor and Combat Trafficking in Persons. The report highlights the disproportionate impact of trafficking on women and girls. The FY2023 Economic and Fiscal Update identifies the downgrading as a fiscal risk, as it can potentially have adverse impacts on Palau's eligibility for some development assistance flows. As FRA provisions require the government to implement actions toward mitigating all identified sources of fiscal risk, the government is committed to developing an action plan toward ensuring Palau's compliance with minimum standards for eliminating trafficking of persons. This is captured by the corresponding post-program partnership framework action.
- ^e Graduate School USA is an independent nonprofit organization that, through its Pacific and Virgin Islands Training Initiatives, manages the [Economic Monitoring and Analysis Program](#) (EconMAP), with funding primarily from the US Department of Interior's Office of Insular Affairs. EconMAP monitors economic performance and assists with annual comprehensive updates of fiscal and economic statistics across the Federated States of Micronesia, Marshall Islands, and Palau.
- ^f The MTFS is to be refined annually to reflect the prevailing macro-fiscal context, with annual budget statements supplementing and updating the rolling MTFS. The Presidential Directive issued under subprogram 1 provides the institutional basis.
- ^g Information on the approved tax reform package is summarized in para. 18 of the report and recommendation of the President. A long-term Tax Reform Implementation Adviser was onboarded on 1 February 2022 who contributed to operationalizing a gender-responsive implementation action plan for the Tax Reform package. The Tax Reform Committee, which includes the Tax Reform Implementation Adviser, has completed various initiatives toward ensuring Palau's readiness to implement the Palau Goods and Services Tax (PGST) and the Business Profits Tax (BPT), including: (i) a staff assessment of the Bureau of Revenue and Taxation gauging technical and administrative capacity to help guide training and development plans; (ii) drafting of training manuals and administrative/user guides for the PGST and BPT; (iii) development of new PGST and BPT forms, along with revised/updated forms for other taxes; and (iv) design and development of communications and information dissemination materials (e.g., brochures on a general overview of tax reform as well as for specific business/taxpayer types; a "Tax Tuesday" social media campaign). Further, the implementation plan includes proactive outreach activities targeting women entrepreneurs, including a women in business tax reform and literacy workshop. Over the medium-term, the tax reform package will help minimize disincentive for new and small businesses, including potential and existing women entrepreneurs, with a more efficient and equitable net profits tax. The adjustments to the wages and salaries tax are expected to increase the disposable incomes of lower-income households, including women-headed households that on average earn 18% less in average monthly income than those headed by men.
- ^h The FY2021 Economic and Fiscal Review includes gender analysis of sex-disaggregated data on beneficiaries reached and outlines measures to ensure women and girls are accessing pandemic relief support.
- ⁱ For example, the government further extended the availability of mitigation measures under its Coronavirus Relief One-Stop Shop Program to into FY2022—allocating an additional \$1 million in March 2022—to reinforce its success in averting substantial declines in household incomes. Further, in response to COVID-

19 community transmission in January 2022, the government reallocated funds to free up \$200,000 and channel this amount toward providing a one-time benefit to temporarily-affected employees.

- j The NIIP highlights the importance of ensuring investments in infrastructure take into account the needs of gender and disability. It includes a specific gender-sensitive, equality, and social inclusion (GESI) criterion in its initial project readiness filter, multi-criteria analysis to aid project prioritization, and monitoring and evaluation framework. Infrastructure services that address the needs of women, as highlighted in the NIIP, include specialist health services, childcare centers and women's shelters, among others. The NIIP (2021–2030) will continue to be implemented, with the institutional basis provided by its endorsement by the MOF under subprogram 1.
- k The Public Debt Management Policy details corresponding thresholds to total government borrowing, both in terms of the public debt–GDP ratio as well as debt service as a proportion of government revenues, along with other measures aimed at ensuring positive societal returns from public borrowing. See para. 21 of the of the report and recommendation of the President.
- l The Social Security Reform Bill will be deliberated upon by each of the two chambers of OEK: the House of Delegates and the Senate. After the bill is adopted by both chambers, it will be presented to the President for signing into law. This process can take up to 6 months to complete. An outcome indicator relating to the planned phased increases in the retirement age is included in the Policy Design and Monitoring Framework, to capture the enactment and successful implementation of critical social security reforms. The provisions in the Bill are summarized in para. 22 of the report and recommendation of the President.
- m As subprogram 1 was approved by ADB on 23 April 2021, the passage of the International Commercial Arbitration Act 2021 on 29 April 2021 is supported under subprogram 2. The government completed policy action 2.8.1 ahead of schedule and a few months prior to the target subprogram 2 implementation period, demonstrating strong reform momentum and commitment.
- n Based on model legislation that provides rules and procedures for parties to conduct arbitration, the law covers all stages of the arbitral process from the arbitration agreement, the composition and jurisdiction of the arbitral tribunal, and the extent of court intervention through to the recognition and enforcement of the arbitral award. All international commercial disputes will be arbitrated under the law.
- o The Technical Working Group for Developing a Policy Statement for Public–Private Partnerships includes members from key divisions from the MOF and the Ministry of Public Infrastructure, Industries, and Commerce.
- p The policy statement lays out formal procedures guiding the selection, monitoring, and regulation of potential private sector partners and transactions. It is complemented by a parallel PPP Transparency Procedure, mandating the disclosure of key terms and conditions for prospective PPP transactions, to strengthen market confidence and promote greater competition.
- q The bill was first introduced in the OEK in 2018 but was stalled as it was deemed incomplete, given the lack of provisions for a modern companies registry. It also became outdated. The government sought development partner TA to complete the bill. The review, supported by ADB's technical assistance, addresses the need for an electronic companies registry.
- r Confusing and expensive processes are cited as a key barrier for women entrepreneurs to formalizing their business.

Contribution to Strategy 2030 Operational Priorities: Operational priority indicators to which this operation will contribute results are detailed in Contribution to Strategy 2030 Operational Priorities (accessible from the list of linked documents in Appendix 2).

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=54284-002-3>

1. Loan Agreement: Regular Ordinary Capital Resources
2. Sector Assessment (Summary): Public Sector Management
3. Contribution to Strategy 2030 Operational Priorities
4. Development Coordination
5. International Monetary Fund Assessment Letter¹
6. Summary Poverty Reduction and Social Strategy
7. Program Impact Assessment
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items
10. Approved Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loans for Subprogram 1 to the Republic of Palau for the Recovery through Improved Systems and Expenditure Support Program

Supplementary Document

11. Debt Sustainability Analysis

¹ The International Monetary Fund (IMF) confirmed on *23 March 2022* that the attached IMF Article IV Report for the Republic of Palau may serve as the IMF assessment letter.

DEVELOPMENT POLICY LETTER



KALEB UDUI, JR.

Minister

30 May 2022

Serial No.: MOF-2022-103

Mr. Masatsugu Asakawa
President
Asian Development Bank

REPUBLIC OF PALAU

Office of the Minister

Ministry of Finance

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Subject: Republic of Palau Recovery through Improved Systems and Expenditure Support (RISES) Program, Subprogram 2

Dear ADB President Asakawa,

On behalf of the Republic of Palau (ROP), let me again express my appreciation for the Asian Development Bank's (ADB) continuing strong support as we undertake critical public sector management reforms, which would help underpin our recovery from the severe impacts of the COVID-19 pandemic. This development policy letter reiterates our interest in obtaining a \$30 million policy-based loan under the proposed Subprogram 2 of the Palau Recovery through Improved Systems and Expenditure Support or RISES program, to help bridge our projected financing gaps during FY2022 and FY2023.

Although the ROP entered the current pandemic period from a position of fiscal strength through sound macroeconomic management, COVID-19 impacts mainly through our vital tourism sector have been severe. From a pre-pandemic average of over 118,000 during FY2010–FY2019, tourist arrivals fell to less than 42,000 in FY2020 and further to about 3,400 in FY2021. With the collapse in tourist arrivals, along with delays in government capital projects amid COVID-19 travel restrictions, the ROP's economy contracted sharply by 9.7% in FY2020 and by a further 17.1% in FY2021. Declining tax collections due to subdued economic activity, along with additional spending needs to mitigate adverse impacts on the private sector authorized under the Coronavirus Relief One-Stop Shop (CROSS) Program, translated to fiscal deficits equivalent to 10.9% of GDP in FY2020 and 19.5% in FY2021.

However, through sustained progress on our national vaccination program, we have already fully vaccinated 100% of the ROP's eligible population. This has allowed steps toward the reopening of our borders to tourists. Despite community transmission of the Omicron variant in January 2022, tourist arrivals during the first half of FY2022 have already exceeded the total for FY2021 total.

Nonetheless, adverse fiscal impacts linger. Near-term fiscal deficits are projected to be the equivalent of 12.6% of GDP in FY2022 and 3.2% in FY2023. These translate to near-term financing needs totaling at least \$39.9 million during FY2022–FY2023. This is inclusive of FY2022 financing needs estimated to be at least \$30.6 million. However, it is worth noting that this provisional estimate is subject to major uncertainties and downside risks. Among others, these include: (i) potential delays in the anticipated tourism recovery in the second half of FY2022, including from the possible emergence of further disruptive variants of COVID-19, or disasters from natural hazards, to which Palau is highly vulnerable; and (ii) cost escalations due to elevated oil prices amid supply disruptions due to the ongoing conflict in Ukraine. In this highly uncertain environment, FY2022 financing needs can increase to as high as \$50 million to \$55 million, further underscoring the gravity of the fiscal impacts that the ROP is currently facing and need to address.



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Beyond this challenging near-term fiscal outlook, we are confident that the ROP's sound macro-fiscal policy framework can facilitate a return to sustained fiscal surpluses—like those achieved during FY2011–FY2019—over the medium-term, as the pandemic's impacts dissipate. We fully recognize that accelerating improvements to fiscal policy, public financial management (PFM), and the enabling environment for private sector development are all critical to safeguarding fiscal sustainability during and in the immediate aftermath of COVID-19. The ROP's commitment to reform is exemplified by a wide range of policy actions completed under subprogram 1 of the RISES program in 2020–2021, even as demand for pandemic response stretched government capacity. Our commitment to reform is only further bolstered by the challenges that lie ahead and by the impressive progress we have achieved to date.

The ROP remains fully committed to sustaining momentum towards completing a broad-ranging reform agenda to safeguard fiscal sustainability amid the COVID-19 crisis. This is demonstrated in our commitment to push forward with much-needed reforms, as started with subprogram 1 of the RISES program, in three areas: (i) strengthening the policy and legislative framework for PFM; (ii) reducing fiscal risks from weak management of public revenue, expenditure, and liabilities; and (iii) supporting further private sector development.

Reform area 1: Strengthening the policy and legislative framework for public financial management. Our national congress, *Olbiil Era Kelulau* (OEK), passed the *Fiscal Responsibility Act* (FRA) on November 18, 2021. The FRA sets out the following principles for managing public revenue, expenditure, debt, and fiscal buffers: (i) maintaining operating expenditures within medium-term targets; (ii) prioritizing capital spending to upgrade public assets over time; (iii) maintaining debt at prudent levels; (iv) preserving the real value of Palau's Compact Trust Fund by establishing investment and withdrawal rules; (v) adopting a modern and efficient tax regime suitable for a tourism-based economy; (vi) managing reserves as insurance coverage for cyclical downturns, disasters, and climate change impacts; and (vii) managing fiscal risks from public sector entities, including state-owned enterprises and social security funds. Further, we, in the Ministry of Finance (MOF), have operationalized the FRA by approving an Economic and Fiscal Update that will underpin the FY2023 budget.

Further, we have also prepared a detailed MTFS applying a comprehensive and multiyear budgeting approach. The MTFS will be refined annually to reflect the prevailing macro-fiscal context, with subsequent annual budget statements updating the rolling MTFS.

Reform area 2: Reducing fiscal risks from weak management of public revenue, expenditure, and liabilities. The OEK passed the *Comprehensive Tax Reform Package* on September 29, 2021. This package is one of the main pillars of our reform agenda that will underpin a fiscally sustainable recovery from the ongoing downturn caused by COVID-19. The tax reform package:

1.
 - (i) **Broadens the revenue base** by replacing the general imports tax with the *Palau Goods and Services Tax* (PGST), a value-added tax (VAT) that expands the revenue base by bringing consumption of services into the tax net. The PGST imposes a uniform 10% rate on the supply of goods and services, except zero-rated supplies such as for exports, in place of the previous imports tax;



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- 2.
- (ii) ***Eliminates distortions*** through the introduction of the Business Profits Tax, which applies a 12% rate to the net income of individuals or firms. This replaces the previous gross revenue tax that disproportionately burdened startups including small and medium enterprises. Further, by replacing import duties for alcohol and tobacco with an excise tax that also applies to local production, the tax system continues to discourage consumption of these products, but with a broader-based instrument; and
- 3.
- (iii) ***Promotes equity*** by retaining the bottom income bracket covering the first \$8,000 in wages and salaries that is subject to a tax of 6%; reducing the rate applying to next income bracket of over \$8,000 to no more than \$50,000 from 12% to 10%; and introducing an upper income bracket of over \$50,000 for which a tax rate of 12% applies. Equity is also promoted by aligning the business profits tax rate with the highest marginal tax rates for wages and salaries.

To facilitate the implementation of the tax reform package, we have established a tax reform implementation committee, with half of its members being women, to oversee the implementation of the reform package, including the development of implementing rules and regulations and awareness raising materials. Further, we have also engaged a long-term Tax Reform Implementation Adviser—with support from the Government of Australia and ADB—technical assistance to the Bureau of Revenue and Taxation on building institutional capacity, upgrading processes and procedures, and improving systems to roll out the reforms.

On expenditures, we are continuing to implement gender-sensitive public expenditure reprioritization based on a review of budget execution during COVID-19. More specifically, the MOF implemented further reprioritization, including better targeting and delivery of COVID-19 assistance, based on the findings of the FY2021 Economic and Fiscal Review. We have likewise commenced implementation of the climate-resilient and gender-sensitive National Infrastructure Investment Plan (2021–2030) (NIIP), by implementing NIIP priority projects during FY2022 and operationalizing a monitoring and evaluation framework for NIIP projects.

To further safeguard debt sustainability, the OEK has passed the *External Debt Management Act*, which was signed into law along with the FRA on 18 November 2021. A debt management unit within the MOF's Finance and Economic Intelligence Services has been established and is responsible for the technical due diligence and debt sustainability analysis of any proposed borrowing. We have commenced implementation of the Act by approving a Public Debt Management Policy that details thresholds to total government borrowing.

To streamline transfers to public entities and control contingent liabilities, the President of the ROP has transmitted the social security reform bill to the OEK for approval. The bill includes reforms to: (i) update to simplify the benefit structure, while retaining the system's progressivity and allowing for inflation-indexed adjustments to pensions to eliminate any pressure for legislated supplemental benefits; (ii) raise the contribution rate to 9% each from employer and employee from the previous 7%; (iii) implement phased increases to the retirement age from 60 to 65 during FY2023–FY2031; and (iv) provide for early retirement.



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Reform area 3: Supporting further private sector development. The OEK passed the International Commercial Arbitration Act 2021 on 29 April 2021. This allows for and recognizes clauses on the international arbitration of commercial disputes in business contracts between local and foreign partners, toward encouraging more foreign direct investment.

Further, the President of the ROP issued an executive order effective 3 September 2021 formalizing the Policy Statement for PPPs. The policy statement fills a previous regulatory gap and minimizes the potential for incurring contingent liabilities from PPPs through formal procedures guiding the selection, monitoring, and regulation of private sector partners and transactions.

Finally, the OEK passed an updated Corporations Law on 29 September 2021. The law includes additional provisions, including on the development of an electronic companies registry, to promote increased transparency on beneficial ownership to increase tax compliance, while also allowing for improved collection of sex-disaggregated data on business ownership. The law streamlines and modernizes processes for applications and approvals of new companies toward reducing the financial and time costs associated with starting a business. We in the MOF have commenced implementation of the new Corporations Law by developing technical specifications to establish a new electronic registry system.

To support these broad-ranging reforms and to help us bridge substantial remaining financing gaps during FY2022–FY2023, the ROP confirms its request for financing of \$30 million through a policy-based loan from ADB under subprogram 2 of the RISES program. The proposed subprogram 2 financing will help cover 75.2% of the ROP's combined FY2022 and FY2023 financing needs amounting to \$39.9 million.

We remain committed to continuing our partnership with ADB under the post-program partnership framework (PPPF) to ensure the sustainability of reforms. ADB developed a PPPF with the government. Under reform area 1, the government will continue to implement annual national budgets in line with FRA provisions, and track fiscal outturns against the MTFS to periodically recalibrate the strategy. Under reform area 2, the government will: (i) complete a needs assessment for a new tax administration information technology system, in coordination with development partners; (ii) continue to implement expenditure reprioritization measures; (iii) maintain alignment of capital allocations in future national budgets with the NIIP; (iv) commence, through the debt management unit, rigorous scrutiny of the economic and fiscal implications of any new borrowing; and (v) undertake a social and gender impact analysis of social security reform initiatives. Under reform area 3, the government will coordinate with development partners in providing training for legal practitioners on international arbitration, strengthen implementation of the Policy Statement for PPPs, and develop implementing regulations for the Corporations Law.

As with subprogram 1, the ROP requests for the swift review and approval of subprogram 2 of the RISES Program to help shift Palau's economic recovery from the COVID-19 crisis toward a more sustainable fiscal path. I remain fully confident that the RISES Program will contribute to an enhanced quality of life for current and future generations of Palauans over the longer-term.



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In closing, I would like to again thank the ADB for its responsiveness to the ROP's needs during this pandemic. Rest assured that the ROP remains firmly committed to maintaining our close collaboration in pushing the public sector management reform agenda forward, toward ensuring maximum development effectiveness from all assistance received.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Kaleb Udui Jr.', written over a horizontal line.

Kaleb Udui Jr.
Minister of Finance