

**COMPACT OF FREE ASSOCIATION: U.S. ASSISTANCE TO PALAU,  
ACCOUNTABILITY OVER ASSISTANCE PROVIDED, AND PALAU'S PROSPECTS  
FOR ECONOMIC SELF-SUFFICIENCY**

**June 12, 2008 Testimony Statement  
House Committee on Natural Resources, Insular Affairs Subcommittee  
David Gootnick, Director, International Affairs and Trade Team  
Government Accountability Office**

Madame Chairwoman and Members of the Subcommittee:

I am pleased to be here today to discuss compact and other U.S. assistance to the Republic of Palau. Since 1995,<sup>1</sup> when the Compact of Free Association between Palau and the United States entered into force, U.S. aid to Palau has included assistance provided for in the compact and related subsidiary agreements—direct assistance to the Palau national government, including investment in a trust fund intended to provide \$15 million annually from 2010 through 2044; federal postal, weather, and aviation services; and construction of a major road—with the U.S. interest of promoting Palau's self-sufficiency and economic advancement. U.S. assistance to Palau has also included discretionary federal programs, such as health, education, and infrastructure services, that are not provided for in the compact.<sup>2</sup>

Compact direct assistance is scheduled to expire on September 30, 2009. In addition, the related subsidiary agreement providing for federal services to Palau will expire on that date unless renewed or extended.<sup>3</sup> At that time, Palau's annual withdrawals from its trust fund can increase from \$5 million to \$15 million. The compact mandates that the U.S. and Palau governments review the terms of the compact and its related agreements in 2009 and concur on any modifications to those terms. (See attachment I for more information on key provisions of the compact and its related agreements.) The Department of the Interior's (Interior) Office of Insular Affairs (OIA) has primary responsibility for monitoring and coordinating all U.S. assistance to Palau, and the Department of State (State) is responsible for government-to-government relations.

To provide accountability for compact funds, the compact's related agreements require an annual audit of Palau's use of compact funds and require Palau to submit economic development plans, identifying planned expenditures of compact assistance, and annual reports on, among other topics, its implementation of these plans. The U.S. and Palau governments are also required to

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<sup>1</sup>Unless otherwise noted, all years cited are fiscal years (Oct. 1-Sept. 30). In addition, all dollar amounts in this report are in current (i.e., nominal) dollars.

<sup>2</sup>U.S. legislation establishes Palau's eligibility for these programs, with funding for the programs appropriated by Congress.

<sup>3</sup>The compact's federal programs and services agreement, which establishes the terms under which the U.S. government provides federal postal, weather, and aviation services to Palau, took effect in 1995 and expires in 2009 (see *Federal Programs and Services Agreement Concluded Pursuant to Article II of Title Two and Section 232 of the Compact of Free Association*).

hold annual economic consultations to review Palau's progress toward self-sufficiency and to consult regarding Palau's trust fund every 5 years.

My statement is based on our report, which was released this week.<sup>4</sup> In this report, we examined (1) the provision of compact and other U.S. assistance to Palau in 1995-2009, (2) Palau's and U.S. agencies' efforts to provide accountability over Palau's use of federal funds, and (3) Palau's prospects for achieving economic self-sufficiency. We conducted this performance audit from October 2007 to June 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## Summary

U.S. aid to Palau in 1995-2009 is expected to exceed \$852 million. Compact direct assistance, providing general budgetary support for Palau's government operations, is projected at \$411 million, or 48 percent of the assistance provided.<sup>5</sup> The provision of compact federal services—postal, weather, and aviation—is projected at about \$25 million, or 3 percent of the assistance, and the compact road construction accounted for \$149 million, or 17 percent of the assistance. Palau's receipt of discretionary federal program assistance is projected at \$267 million, or 31 percent of the total assistance provided. In 1995-2006, five U.S. agencies—the Departments of Education (Education), Health and Human Services (HHS), Interior, Defense (DOD), and Transportation (DOT)—contributed the majority of discretionary federal program assistance to Palau.

Palau has made progress in establishing financial accountability, despite limited capacity to address persistent internal control weaknesses, and has met most compact accountability requirements; however, Interior's monitoring of Palau's accountability has been limited. Palau's single audit reports for 1995-2006 show that it improved its timeliness in submitting the reports and improved the reliability of its financial statements. However, the reports show persistent weaknesses in Palau's internal controls over financial reporting; the reports also indicate that Palau has not complied with all federal award requirements and show persistent weaknesses in Palau's internal controls over compliance with these requirements. Although Palau has developed plans to correct these weaknesses, limited capacity in financial accounting resources and expertise puts at risk Palau's ability to sustain its improvements in financial accountability and to operate a major federal program within applicable requirements. Palau met the majority of the compact's and related agreements' accountability requirements, such as submitting annual reports and economic development plans. OIA and State officials, as well as officials from the government of Palau, reported that they participated in the required economic consultations but

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<sup>4</sup>GAO, *Compact of Free Association: Palau's Use of and Accountability for U.S. Assistance and Prospects for Economic Self-Sufficiency*, GAO-08-732 (Washington, D.C.: June 10, 2008).

<sup>5</sup>In this statement, "compact direct assistance" refers to the grants enumerated in sections 211-215 and section 221(b) of the compact. For further details about the compact direct assistance, see attachment IV of this statement.

that the meetings were not held annually. Moreover, U.S. and Palau officials acknowledged that the required trust fund consultations were not held at all. According to OIA officials, OIA has used Palau's single audit results and compact annual reports to monitor Palau's use of compact funds and has provided technical assistance funds to train Palau employees as well as funds to enhance Palau's financial management systems and processes. However, OIA officials said that Interior views its oversight role as limited.

Palau's prospects for economic self-sufficiency depend on four key factors: levels of continued U.S. assistance, the availability and value of trust fund withdrawals, fiscal reform to reduce Palau's dependence on these withdrawals, and private sector growth through an improved business environment.

- **U.S. assistance.** Given the \$10 million scheduled increase in Palau's annual trust fund withdrawals in 2010, the expiration of \$13.3 million in U.S. compact direct assistance at the end of 2009 will likely cause a net decline of less than 4 percent in Palau's national government revenues. However, potential increases or reductions in future levels of discretionary federal programs—estimated at \$11.9 million in 2009—could have a significant fiscal impact. In addition, unless the federal programs and services agreement is extended by the U.S. and Palau governments, Palau will lose postal, weather, and aviation services projected to cost U.S. agencies almost \$1.6 million in 2009.
- **Trust fund withdrawals.** A compounded annual return of at least 8.1 percent will allow Palau to withdraw \$15 million per year from its trust fund for the planned 35 years. From 1995 through March 2008, the Palau trust fund earned a compounded return of 9 percent.<sup>6</sup> However, market volatility makes it possible that the trust fund will be depleted after 2016 even with a favorable long-term average rate of earnings. In addition, inflation will cause the withdrawals to lose value over time.
- **Fiscal reform.** To decrease its long-term reliance on trust fund financing, Palau will require fiscal reforms aimed at closing the gap between its revenues and expenditures. Specifically, experts suggest that Palau increase its tax income by addressing the problem of weak tax administration and reduce its expenditures by lowering the public sector wage bill.
- **Private sector growth.** To promote private sector growth, Palau will need to improve its business environment. Currently, restrictive foreign investment regulations and practices, deficient financial oversight, inadequate access to land, and an inability to attract skilled workers raise private sector costs and weaken investment incentives.

To improve Palau's ability to sustain its improvements in financial reporting and address its internal control weaknesses, our report recommends that the Secretary of the Interior direct OIA to formally consult with the government of Palau regarding Palau's financial management challenges and target future technical assistance toward building Palau's financial management capacity. Responding to a draft of our report, Interior agreed with our recommendation and identified steps it will take to implement it.

## Background

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<sup>6</sup>All trust fund return rates in this report are net of fees and commissions, unless otherwise stated.

Palau's territory of about 190 square miles includes 8 main islands and more than 250 smaller islands. As the westernmost cluster of the Caroline Islands in the North Pacific Ocean, Palau is located approximately 500 miles southeast of the Philippines. Roughly 20,000 people live in Palau, and more than one-quarter of the population is non-Palauan.

Palau's economy is heavily dependent on its tourism sector and on foreign aid from the United States, Japan, and Taiwan. Since 1994, Palau's economy has grown at a real annual average of 3 percent.<sup>7</sup> In 2006, Palau's gross domestic product (GDP) was about \$154 million and its GDP per capita was about \$7,500. International visitor arrivals—more than 82,000 in 2006—contributed about \$97 million to the economy. Similar to many small island economies, Palau also receives significant foreign aid, which finances a large public sector.

In 2006, Palau's national government expenditures were approximately \$89 million, equivalent to 58 percent of its GDP, and the United States and other donors provided grants totaling about \$44 million, equivalent to 28 percent of Palau's GDP (see attachment II). Palau's national government employed about one-third of all workers in 2006, and the government's wage bill constituted 37 percent of its total expenditures.<sup>8</sup> The national government's 2006 expenditures exceeded its total revenues; however, Palau has access to financing through interest earned on government assets and to annual withdrawals on the compact-provided trust fund. Palau's private sector relies heavily on foreign workers, mostly from the Philippines; since 1994, foreign workers have grown to account for half of Palau's total labor force.<sup>9</sup>

### **U.S. Assistance to Palau Is Projected to Exceed \$852 Million in 1995-2009**

The United States' cost of providing assistance to Palau in 1995-2009 is projected to exceed \$852 million. The three categories of assistance mandated by the compact—compact direct assistance, compact federal services, and compact road construction—represent approximately 48 percent, 3 percent, and 17 percent, respectively, of total projected U.S. assistance for 1995-2009. U.S. agencies provide the remaining 31 percent of total assistance through discretionary federal programs. (See attachment III.)

- **Compact direct assistance.** Compact direct assistance accounts for roughly half of projected U.S. assistance to Palau in 1995-2009, amounting to more than \$411 million. This assistance flows as a direct transfer payment to the government of Palau. The compact specifies general purposes for these funds—for example, current account operations and maintenance, energy production self-sufficiency, maritime zone surveillance and enforcement, and initial funding of the trust fund—but gives the Palau

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<sup>7</sup>After growing strongly in the first few years of the compact, Palau's GDP declined in 1999 and stagnated until 2003 due, in part, to negative impact on its tourism sector from the 1999 Asian Financial Crisis and the September 11, 2001 terrorist attacks. Growth resumed in 2004. Per capita GDP estimates include both Palauan-born citizens and foreign workers.

<sup>8</sup>See GAO-08-732 for more information on Palau's national government finances.

<sup>9</sup>Data on foreign workers are from Palau's Social Security office and exclude workers not registered with the office.

government broad discretion regarding their use.<sup>10</sup> Some direct assistance is provided annually for 15 years from the effective date of the compact (i.e., 1995-2009). However, more than half of the direct assistance was provided in the first 3 years of the compact, allowing Palau to invest some of these funds to generate additional income. All compact direct assistance will terminate in 2009. (See attachment IV.)

- **Compact federal services.** The compact provides for federal postal, weather, and aviation services in Palau at a level equivalent to the services provided the year before the compact was implemented. In 1995-2009, U.S. agencies provided compact federal services at a total cost of approximately \$25.3 million: the U.S. Postal Service spent about \$12.3 million, the National Weather Service spent about \$8.6 million, and the Federal Aviation Administration spent about \$4.4 million.
- **Compact road.** The compact required the United States to build a road system in Palau, based on specifications mutually agreed upon with the government of Palau, which was to be completed by October 1, 2000. The road project incurred several planning and construction delays and was completed on October 1, 2007, at a cost of approximately \$149 million. When the road was completed, Palau accepted responsibility for its operation and maintenance. Palau has since made efforts to maintain the road; however, both U.S. and Palau officials expressed concerns regarding Palau's ability to maintain the road in a condition that will allow for the desired economic development.
- **Discretionary federal programs.** Discretionary federal programs are projected to contribute approximately \$266.7 million, or almost a third of U.S. assistance to Palau in 1995-2009. In 1995-2006, more than 14 U.S. agencies provided approximately \$203 million in federal grants and other in-kind services to assist in areas such as education, health, infrastructure improvement, and telecommunications.<sup>11</sup> Five agencies— Education, HHS, Interior, DOD, and DOT—contributed the majority of this assistance (see attachment V). Most grants went to the Palau national government; the Palau Community College and the Palau Community Action Agency, a nonprofit organization, also received grants.

### **Palau Made Progress in Accountability but Has Limited Capacity to Address Internal Control Weaknesses, and Interior's Oversight Has Been Limited**

Although Palau's more recent single audit reports show improvement in its financial accountability, the reports show persistent weaknesses in its internal control over financial reporting, its compliance with some federal award requirements, and its internal control over compliance with these requirements. However, Palau has limited capacity to address these weaknesses in a timely way, putting Palau at risk of being unable to sustain its improvements in financial accountability and to operate a major federal program according to applicable

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<sup>10</sup>Palau includes an account of its implementation of direct assistance in the compact annual reports it submits to the U.S. government.

<sup>11</sup>This amount is based, in part, on information obtained in the single audits for 1995 through 2006. At the time of this report, audited financial data for 2007 were not yet available; Palau's 2007 single audit report is not due until June 30, 2008. Although this amount includes the cost to DOD of providing a Civic Action Team in Palau, it does not include the value of other in-kind assistance provided by DOD or other U.S. agencies and does not include the value of U.S. loans extended to Palau.

requirements. Palau met the majority of the compact's and related agreements' reporting requirements for accountability over compact funds, but Palau and the U.S. government did not meet all of the consultation requirements. Interior's oversight of Palau's accountability for compact assistance was limited.

Palau's timeliness in submitting single audit reports has improved in recent years. Although Palau submitted its single audit reports for 1998-2004 after the established deadlines, Palau submitted reports for 2005 and 2006 on time. Timely submission of single audit reports gives U.S. agencies current knowledge of the Palau government's ability to account for federal grant monies received and current knowledge of the government's internal control and compliance challenges.

In addition, the recent single audits show that the reliability of Palau's financial statements has improved. For 1995-2002, Palau received qualified audit opinions on its government's financial statements, indicating that significant issues prevented the auditor from concluding that the financial statements were reliable overall.<sup>12</sup> For 2003-2006, Palau's financial statements consistently received unqualified audit opinions, indicating that the auditor considered the statements reliable.

However, despite the improved reliability of its financial statements, Palau has long-standing and significant weaknesses in its internal control over financial reporting and has limited capacity to address these weaknesses. Palau's 2006 single audit report cited a number of significant weaknesses in basic internal control that impact its financial reporting, many of which were cited in previous audit reports. Palau has developed corrective action plans to address these weaknesses and is also updating its financial reporting policies and procedures. However, according to Palau's controller and Palau's current external auditor, Palau has inadequate staff and expertise to properly address its financial reporting weaknesses and make other necessary improvements in a timely manner. As a result, Palau is at risk of being unable to sustain its improvements in financial accountability.

Further, Palau has limited capacity to address weaknesses in its compliance with federal award requirements. Since 1995, Palau's single audit reports have consistently contained qualified opinions on its compliance with federal award requirements, owing to long-standing and significant internal control weaknesses over its compliance with such requirements.<sup>13</sup> These weaknesses could adversely affect Palau's ability to operate a major federal program within the

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<sup>12</sup>Auditors are required by the Single Audit Act and OMB Circular No. A-133 to provide an opinion (or disclaimers of opinion, as appropriate) as to whether financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles. Auditors render a qualified opinion when they identify one or more specific matters that affect the fair presentation of the financial statements. The effect of the auditors' qualified opinion can be significant enough to reduce the usefulness and reliability of the financial statements.

<sup>13</sup>In addition to requiring auditors to assess financial statements, the Single Audit Act and OMB Circular No. A-133 require auditors to determine and express an opinion as to whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major federal programs. When auditors identify instances of noncompliance, they are required to report whether the noncompliance could have a direct and material effect on a major federal program.

applicable requirements of laws, regulations, contracts, and grants. Palau has developed corrective action plans to address the 2006 single audit findings regarding its compliance with, as well as its internal control over compliance with, federal grant requirements. However, Palau's limited staff and expertise hinder its ability to address the single audit report's findings in a timely manner.

Regarding compliance with the compact and its related agreements, Palau met the majority of the reporting requirements, submitting the required economic development plans and annual reports. Palau and U.S. officials reported holding the required economic consultations but in most cases did not document their compliance. However, according to Palau and U.S. officials, the required trust fund consultations did not take place.

Interior provided limited oversight of Palau's accountability for compact and other U.S. assistance. Interior's OIA and Office of Inspector General (OIG) reported efforts to assist or oversee Palau's accountability for federal funds. For example, according to Interior officials, Interior has monitored Palau's progress in completing and issuing its single audit reports; used Palau's single audit and compact annual reports to monitor Palau's use of compact funds; and worked with Palau to track single audit findings and resolve issues. Also, according to Interior officials, OIA has provided general technical assistance funds to train Palau employees as well as funds to enhance Palau's financial management systems and processes. However, an OIA official said that its oversight of compact funding has not been extensive and that the compact gives Palau broad discretion in compact spending. Moreover, in a 2006 memorandum, Interior's OIG criticized OIA for its minimal oversight and monitoring of Palau's compact funding. Although the memorandum did not contain recommendations, it suggested that OIA commit additional resources, such as a full-time staff member, to oversee accountability for compact funds and any other U.S. assistance provided to Palau.

### **Palau's Prospects for Economic Self-sufficiency Depend on Multiple Factors**

Palau's prospects for achieving long-term economic self-sufficiency depend on at least four factors: levels of continuing U.S. assistance, the availability and value of trust fund withdrawals, fiscal reform to reduce Palau's long-term dependence on these withdrawals, and private sector growth through an improved business environment.

#### Levels of U.S. Assistance

Palau's prospects for economic self-sufficiency depend in part on levels of continuing discretionary federal program assistance and compact federal services. We estimate that in 2009, the Palau national government's potential revenues—compact direct assistance, discretionary federal programs, other donor assistance, and domestic revenues<sup>14</sup>—will total about \$87 million (see attachment VI).

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<sup>14</sup>Palau's domestic revenues include taxes, fees and charges, licenses, permits, and other direct revenues. In-kind foreign assistance, net investments—equal to the net change in the fair value of investments minus investment management fees—and other net financing are excluded owing to market volatility associated with investment earnings and the prominent role in net financing of the compact-provided trust fund, which was designed to provide Palau financing only until 2044. By 2009, Palau's domestic revenues are projected to grow to about \$44 million,

Although the expiration of compact direct assistance at the end of 2009 will reduce the national government's revenues by about \$13.3 million, Palau will gain access to an additional \$10 million in annual financing when its yearly trust fund withdrawals increase in 2010 from \$5 million to \$15 million. As a result, the net fiscal impact of expiring compact direct assistance will be about \$3.3 million annually, or less than 4 percent of the national government's revenues in 2009.

Any changes in the levels of discretionary federal program assistance and compact federal services after 2009 will affect Palau's fiscal condition. Discretionary federal program assistance, which grew from \$7.3 million in 2000 to \$18.8 million in 2006, is projected at \$11.3 million in 2008<sup>15</sup> and may total almost \$12 million, or 14 percent of the national government revenues, in 2009. However, the level of discretionary program funding after 2009 will depend on Palau's program eligibility status and the availability of appropriations; changes in either factor may increase or reduce the amounts received.<sup>16</sup> Absent affirmative action by Congress, Palau's eligibility for some federal programs could expire. The expiration of the compact's federal programs and services agreement in 2009 may also impact U.S. agencies' implementation of discretionary federal programs in Palau, although agency officials we interviewed expressed uncertainty about the extent of any such impact. Moreover, unless the federal programs and services agreement is renewed or extended past 2009, Palau will lose postal, weather, and aviation services that are estimated to cost U.S. agencies almost \$1.6 million in 2009.

#### Availability and Value of Trust Fund Withdrawals

Palau's prospects for economic self-sufficiency also depend in part on the availability of the planned \$15 million annual trust fund withdrawals and the value of those withdrawals over time. Palau will be able to withdraw \$15 million per year from its trust fund for the planned 35 years—from 2010 through 2044—if the fund earns a compounded annual return of at least 8.1 percent. To grow in perpetuity, the trust fund must earn a compounded return rate of 8.6 percent or higher. Both of these rates are lower than the 9 percent rate the trust fund has earned from its inception in 1995 through March 2008, however, forecasts of future returns are subject to considerable uncertainty. The historical rates of return for the asset classes held in the fund's portfolio differ depending on the time period considered. For example, the compounded rate of return was 8.1 percent for 1926-2007, 9.1 percent for 1970-2007, and 5.2 percent for 1998-

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from approximately \$30 million in 2000, based on the annual growth rate of 4.4 percent in 2000-2006. Other donor assistance is projected to grow to about \$18 million by 2009, from about \$6 million in 2000, based on its annual growth rate of 17.4 percent in 2000-2006. Palau's government will also have access to financing through earned interest and annual withdrawals from the U.S. trust fund and other government assets.

<sup>15</sup>The FAA's Airport Improvement Program grant to Palau represented more than \$9 million of this assistance in 2006; it expired in 2007. The Airport Improvement Program's reauthorization for 2008-2011 is currently pending before Congress. It contains language that would continue Palau's eligibility for this program.

<sup>16</sup> U.S. legislation establishes Palau's eligibility for these programs, with funding for the programs appropriated by Congress.



2007.<sup>17</sup> If the trust fund continues to earn the 9 percent annual return it has earned thus far, or any rate equal or greater than 8.6 percent, the trust fund will likely grow in perpetuity from its balance as of March 2008 (see attachment VII).

However, market volatility adds uncertainty regarding the availability of the trust fund withdrawals. Despite its historical compounded annual return rate of 9 percent as of March 2008, the trust fund's annual investment returns have ranged from 24 percent in 1998 to negative 12 percent in 2002. Future returns to the trust fund portfolio are uncertain. Even if the trust fund earns a favorable long-run return which could allow the fund to grow in perpetuity without market volatility, a few consecutive years of poor stock market performance could lead to the depletion the fund. Attachment VIII illustrates results from our analysis with the assumption that future returns are drawn from distributions based on the historical 1970-2007 return of the asset classes in which Palau's trust fund is invested. Our analysis shows that the trust fund will be able to disburse \$15 million per year through 2016 but is increasingly likely to be exhausted after 2016.

In addition, inflation will diminish the value of the annual trust fund withdrawals: because the withdrawals are not adjusted for inflation, they will lose real value over time. We estimate that by 2044—the last year of planned trust fund assistance—the value of the annual withdrawal will have decreased by about half compared with its value in 2010.<sup>18</sup>

### Fiscal Reform

Palau's prospects for economic self-sufficiency depend in part on fiscal reform to reduce Palau's long-term dependence on trust-fund withdrawals. Government officials and International Monetary Fund (IMF) experts have defined fiscal sustainability for Palau after 2009 as having sufficient domestic revenues, such as tax and fee income, to pay for operating expenditures, such as those for wages, goods, and services.<sup>19</sup> In 2000-2006, domestic revenues provided an average of 50 percent of national government revenue, while operating expenditures accounted for an average of 79 percent of national government spending. Palau could seek continued donor assistance to pay for capital expenditures; moreover, beginning in 2010, Palau will have access to the \$15 million annual trust fund withdrawals to finance the gap between its revenues and expenditures. However, Palau's long-term fiscal sustainability relies on reduced dependence on the full trust fund withdrawal, given (a) the uncertainty of continued donor assistance for capital

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<sup>17</sup>To calculate the compounded returns, we used the annual nominal returns published in Ibbotson Associates 2008 Yearbook. We rebalance the portfolio annually to maintain the asset allocation of 50 percent in U.S. large capital funds, 15 percent in U.S. small capital funds, and 35 percent in fixed income assets.

<sup>18</sup>We used the inflation rate projected by the Congressional Budget Office, which is lower than the historical inflation rate (1970-2007). A higher inflation rate will lead to further decline in value.

<sup>19</sup>See IMF, *Republic of Palau: 2005 Article IV Consultation – Staff Report* (Washington, D.C., March, 2006). <http://www.imf.org/external/pubs/cat/longres.cfm?sk=19023.0>. The IMF's analysis of Palau's fiscal sustainability prospects recognizes that Palau will undergo a period of adjustment after compact direct assistance expires at the end of 2009 while pursuing economic reforms they suggest for implementation over a 10- to 15-year period.

spending, (b) the declining real value of the annual withdrawal, and (c) the expected exhaustion of the trust fund after 2044 as well as the risk of its earlier exhaustion due to market volatility.

To close the gap between Palau's revenue and expenditures, implementation of tax and expenditure reforms will be needed according to economic experts, Palau officials, and the country's economic plans. However, full implementation of such reforms is expected to require 10 to 15 years.

- **Tax revenue.** In 2006, Palau's tax revenue provided about \$30 million and was equivalent to 19 percent of GDP, a level broadly comparable to that of other Pacific island nations. However, according to IMF and Asian Development Bank (ADB) experts, Palau's tax system is inefficient because of, among other problems, weak tax administration and ineffective tax policy. For example, fewer than 50 percent of active taxpayers are fully compliant, according to the IMF and ADB; the government rarely collects assessed penalties and interest or exercises its authority to suspend or revoke business licenses; and the current system does not tax nonwage income, such as that from profits, investment, or property, and taxes businesses on gross, rather than net, earnings.
- **Expenditures.** Economic experts and government officials suggest that Palau could lower its operating expenditures, at around \$67 million in 2006, by reducing the public sector wage bill. Although Palau has slightly reduced its nonwage operating expenditures since 2000, it has been less successful in reducing the wage bill. From 2000 through 2006, Palau's national government wage bill grew from 46 percent to 50 percent of its operating expenditures, with wage levels nearly twice those in the private sector. According to government officials, Palau instituted a freeze on public sector employment in 2001 that has not been observed, and recent public sector reclassification efforts will result in a further increase in wage expenditures.

### Private Sector Growth

Palau's prospects for economic self-sufficiency depend in part on the growth of its economy through private sector expansion, which will require an improved business environment. Palau's strategy for expanding its private sector focuses primarily on pursuing environmentally sustainable growth by promoting high-end tourism and capitalizing on growth opportunities from the new compact road. Officials, experts, and private sector representatives view the tourism sector as offering the most potential for growth. For example, the IMF estimates that every 2 percent increase in tourist arrivals creates a 1 percent increase in tourism-related employment and that more than a third of foreign direct investment occurs in this sector. Current Palau tourism strategies aim to capitalize on opportunities for high-end tourists from Asia and from U.S. military bases on Guam. The marine and agricultural industries together provide less than 5 percent of GDP; however, Palau is pursuing opportunities in aquaculture and considering whether foreign fishing license fees could be raised. In all cases, private sector development is dependent on sustained exploitation of Palau's fragile environmental resources.

However, according to Palau government officials, economic experts, and private sector representatives, problems related to Palau's foreign investment policies, financial systems, land ownership system, labor market, and commercial conditions create a costly business environment that discourages private sector growth. For example, Palau imposes stringent

requirements on foreign investment, restricting foreign investment in certain activities; Palau's financial markets do not effectively finance investment but instead supply large amounts of consumer credit; Palau's system of land ownership prevents the effective use of land for development; available skilled labor is lacking in Palau and Palau government officials expressed concern about illegal importation of unskilled foreign workers; and Palau's commercial legal system is outdated, lacking laws for bankruptcy, sales, and consumer privacy protection, and the government often reportedly delays payment of vendors for several years.

### **Conclusions and Recommendations**

In 2009, the U.S. and Palau governments will formally review the terms of the compact and its related agreements. Although compact direct assistance will expire that year, the provision of federal postal, weather, and aviation services may continue if the federal programs and services agreement is renewed or extended. Some discretionary federal programs will also likely continue. Interior's OIA will remain the cognizant agency for Palau for compact direct assistance through 2009 and will continue to review Palau's single audits as long as U.S. federal program funds are expended in Palau. However, unless Palau strengthens its financial accounting resources and expertise, its ability to sustain recent progress in financial accountability and to operate a major federal program according to applicable requirements is at risk. To strengthen Palau's ability to provide accountability and meet applicable requirements for federal assistance, our recent report recommends that the Secretary of the Interior direct the Office of Insular Affairs to formally consult with the government of Palau regarding Palau's financial management challenges and to target future technical assistance toward building Palau's financial management capacity. Interior agreed with our recommendation and identified steps that it will take to improve Palau's capacity.

Madame Chairwoman, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Subcommittee may have at this time.

**Attachment I**  
**Key Provisions of the Palau**  
**Compact of Free Association and Related Agreements**

Compact section	Description of key provision
<p>Title one: Government Relations</p>	<p><i>Sovereignty</i></p> <ul style="list-style-type: none"> <li>• Establishes Palau as a self-governing nation with the capacity to conduct its own foreign affairs.</li> </ul> <p><i>Immigration privileges</i></p> <ul style="list-style-type: none"> <li>• Provides Palauan citizens with certain immigration privileges, such as the rights to work and live in the United States indefinitely and to enter the United States without a visa or passport.</li> </ul>
<p>Title two: Economic Relations</p>	<p><i>Compact direct assistance</i></p> <ul style="list-style-type: none"> <li>• 15-year term of budgetary support for Palau, including direct assistance for current account operations and maintenance, and for specific needs such as energy production, capital improvement projects, health, and education.</li> <li>• Requires the United States to set up a trust fund for Palau.</li> <li>• This assistance expires in 2009.</li> </ul> <p><i>Compact road</i></p> <ul style="list-style-type: none"> <li>• Requires the United States to build a road system for Palau (the “compact road”).</li> </ul> <p><i>Compact federal services</i></p> <ul style="list-style-type: none"> <li>• Requires the United States to make available certain federal services and related programs to Palau, such as postal, weather, and aviation services.</li> <li>• The compact federal programs and services agreement—establishing the legal status of programs and related services, federal agencies, U.S. contractors, and personnel of U.S. agencies implementing both compact federal services and discretionary federal programs in Palau—expires in 2009.</li> </ul> <p><i>Accountability of compact funds</i></p> <ul style="list-style-type: none"> <li>• Requires Palau to report annually on its use of compact funds.</li> <li>• Requires the U.S. government, in consultation with Palau, to implement procedures for periodic audit of all grants and other assistance.</li> </ul>
<p>Title three: Security and</p>	<ul style="list-style-type: none"> <li>• Establishes that the United States has full authority and responsibility for security and defense matters in or relating to</li> </ul>

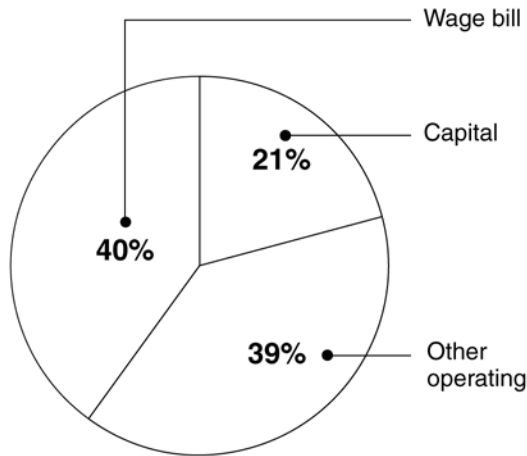
Defense Relations	<p>Palau.</p> <ul style="list-style-type: none"> <li>• Forecloses Palau to the military of any other nation except the United States.</li> <li>• The United States may establish defense sites in Palau and has certain military operating rights.</li> <li>• Security provisions specified in the subsidiary status of force agreement<sup>a</sup> are binding until 2044, 50 years from the effective date of the compact, or until the termination of title three of the compact, whichever is longer.</li> </ul>
Title four: General Provisions	<ul style="list-style-type: none"> <li>• Establishes general provisions regarding approval and effective date of the compact, conference and dispute resolution procedures, amendment and review requirements, and compact termination procedures.</li> </ul>

Source: GAO analysis of the Compact of Free Association.

<sup>a</sup>*Status of Forces Agreement Concluded Pursuant to Section 323 of the Compact of Free Association.*

## Attachment II Palau National Government Expenditures and Revenues, 2000-2006

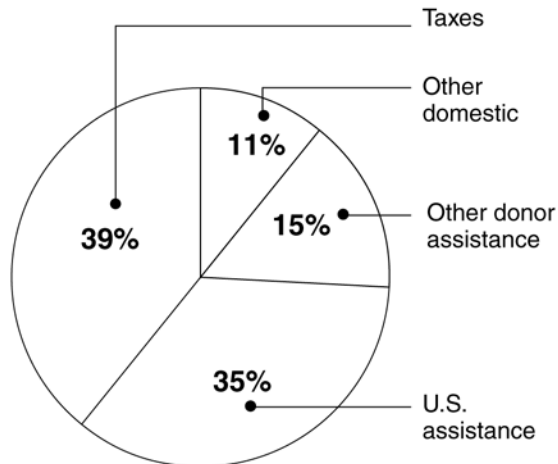
### 2000-2006 Average Expenditure by Type



### 2006 Expenditure Level

	Dollars in millions (\$)	Percentage of GDP (%)
Capital	22.7	15
Wage bill	33.2	22
Other operating	33.4	22
<b>Total</b>	<b>89.3</b>	<b>58</b>

### 2000-2006 Average Revenue by Source



### 2006 Revenue Level

	Dollars in millions (\$)	Percentage of GDP (%)
U.S. assistance	31.5	20
Other donor assistance	12.8	8
Taxes	29.4	19
Other domestic	9.6	6
<b>Total</b>	<b>83.3</b>	<b>54</b>

Source: GAO estimates based on Palau's single audit reports.

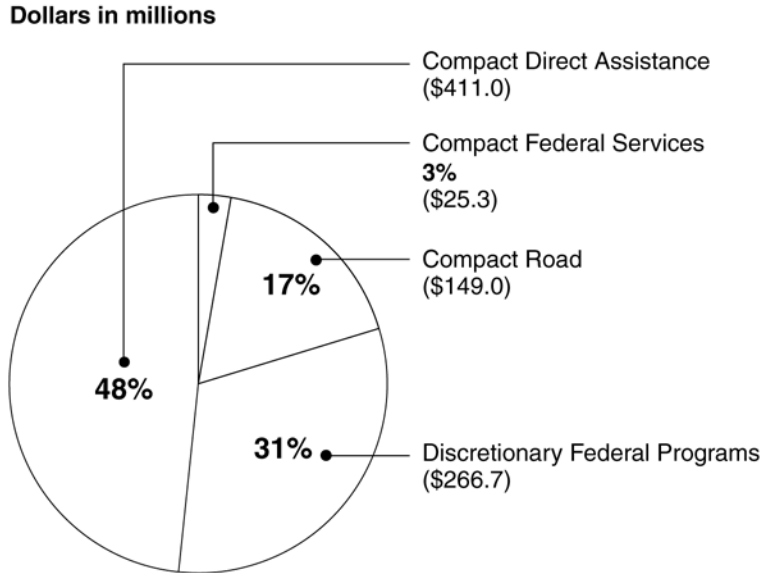
Notes: GDP = gross domestic product.

Figures and tables exclude (a) component units, such as the Palau Community College; (b) in-kind foreign assistance, such as compact federal services; and (c) annual net financing, such as Palau's \$5 million trust fund withdrawal from 2002-2006, to pay for the gap between revenues and expenditures. Net financing is excluded as a revenue source given that the trust fund was designed to provide Palau with financing only until 2044, in addition to the market volatility associated with investment earnings.

"Other operating" expenditures includes those for goods and services and "Other domestic" revenues include fees and charges, licenses, permits, and other direct revenues.

All years cited are fiscal years (Oct. 1-Sept. 30). All dollar amounts are in current (i.e., nominal) dollars.

### Attachment III Projected U.S. Assistance to Palau, 1995-2009



Source: GAO analysis.

#### Notes:

Figure shows funding for fiscal years (Oct. 1- Sept. 30). All dollar amounts are in current (i.e., nominal) dollars.

Projected U.S. assistance sums to \$852 million. Our calculations of direct compact assistance and the compact road are based on Interior's Office of Insular Affairs' actual and estimated payments to Palau for 1995-2009, as reported in its budget justification to Congress for 2009. Compact federal services are estimates of past and future expenditures by the National Weather Service, the U.S. Postal Service, and the Federal Aviation Administration. The calculation of estimated discretionary federal programs is the sum of U.S. agency program expenditures as reported in single audits for 1995-2006 for the Palau national government and for 1997-2006 for the Palau Community Action Agency and the Palau Community College. GAO projected U.S. agency program expenditures for 2007-2009. To this, we added an estimated cost of the Department of Defense's (DOD) Civic Action Teams for 1995-2009. Estimated and projected federal program expenditures do not include the value of U.S. loans to Palau. (For more details of our methodology, see GAO-08-732, appendix I.)

**Attachment IV**  
**Compact Direct Assistance to Palau, 1995-2009**

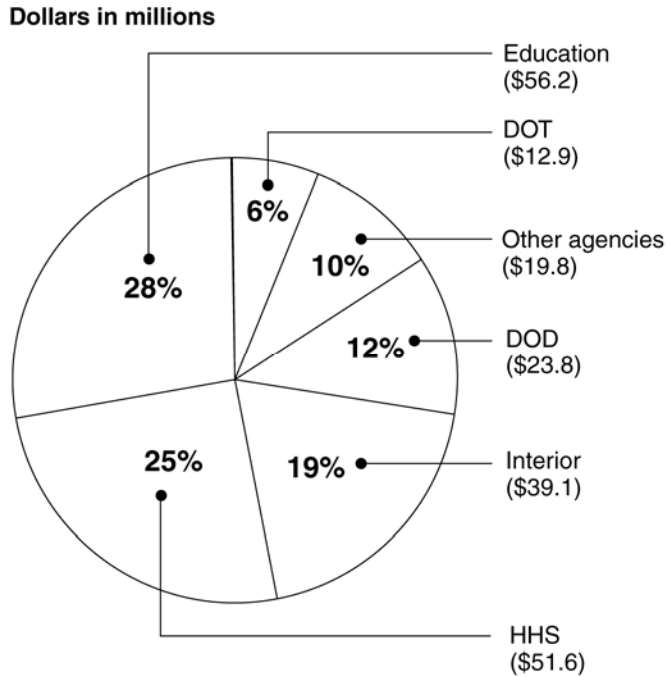
<b>Compact section</b>	<b>Compact-mandated assistance</b>	<b>Amount provided 1995–2009 (projected)</b>
211(a)	<i>Current account operations and maintenance</i> \$12 million annually for 10 years (1995-2004) and \$11 million annually for the next 5 years (2005-2009). Beginning in 1999, \$5 million of this amount shall come from the trust fund set up in 211(f).	\$120 million
211(b)	<i>Energy production self-sufficiency</i> \$2 million annually for 14 years (1995-2008).	\$28 million
211 (c)	<i>Communications</i> \$150,000 annually for 15 years (1995-2009) for current account operations and maintenance of communications systems plus a sum of \$1.5 million in 1995 for acquiring communications hardware or for another operating or capital account activity as Palau selects.	\$3.75 million
211(d)	<i>Maritime zone surveillance and enforcement, health programs, and postsecondary scholarship fund</i> \$631,000 annually for 15 years (1995-2009).	\$9.5 million
211(e)	<i>Maritime zone surveillance and enforcement start-up activities</i> One-time contribution of \$666,800.	\$0.7 million
211(f)	<i>Trust fund</i> \$66 million in 1995 plus \$4 million in 1997.	\$70 million
212(b)	<i>Capital account purposes</i> One-time contribution of \$36 million in 1995.	\$36 million
213	<i>Defense use impact fund</i> One-time contribution of \$5.5 million in 1995.	\$5.5 million
215	<i>Inflation adjustment</i> Yearly adjustment of amounts provided in sections 211(a), 211(b), 211(c), and 212(b).	\$98.9 million
221(b) and federal programs and services agreement	<i>Special block grants for health and education</i> \$2 million annually for 15 years (1995-2009), \$4.3 million in 1995, \$2.9 million in 1996, and \$1.5 million in 1997.	\$38.7 million
<b>Total direct assistance</b>		<b>\$411 million</b>

Source: GAO analysis of the Compact of Free Association and OIA budget justification 2009.

Note: All years cited are fiscal years (Oct. 1-Sept. 30). All dollar amounts are in current (i.e., nominal) dollars.



**Attachment V**  
**U.S. Agencies' Expenditures for Discretionary Programs in Palau, 1995-2006**



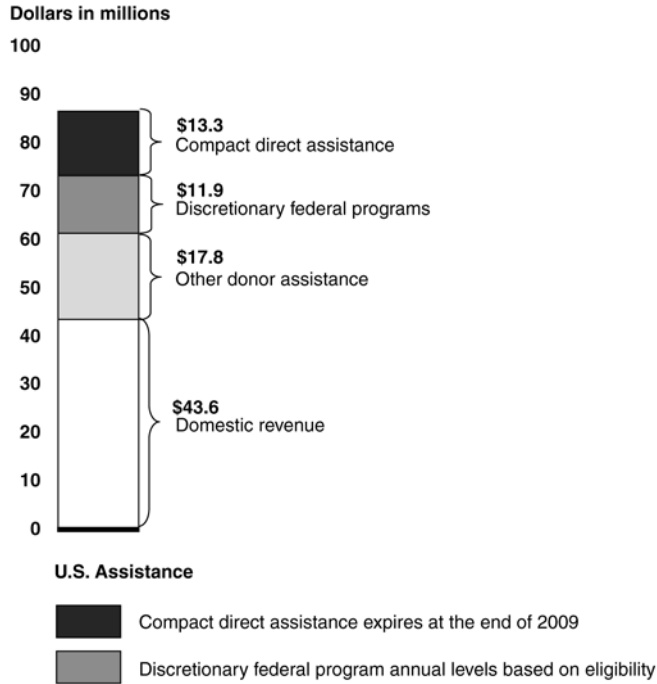
Source: GAO analysis.

Notes:

Figure shows expenditures for fiscal years (Oct. 1-Sept. 30). All dollar amounts are in current (i.e., nominal) dollars.

Agencies' expenditures sum to approximately \$203 million. For all agencies except DOD, we used expenditure information reported in the single audits from the Palau national government, the Palau Community College, and the Palau Community Action Agency. We estimated DOD's expenditures for its Civic Action Team operating costs based on information provided by DOD officials. The figure does not include the value of other in-kind assistance provided by DOD or any other U.S. agency and does not include the value of U.S. loans extended to Palau.

## Attachment VI Palau National Government's Potential Revenues in 2009



Source: GAO analysis.

### Notes:

Domestic revenue includes taxes, fees and charges, licenses and permits, and other direct revenues and excludes net investment earnings. Total revenues exclude revenues for component units and in-kind assistance, such as compact federal services. In addition to revenues, Palau will have access to financing, including a \$5 million annual trust fund withdrawal. See GAO-08-732, appendix III, for additional information.

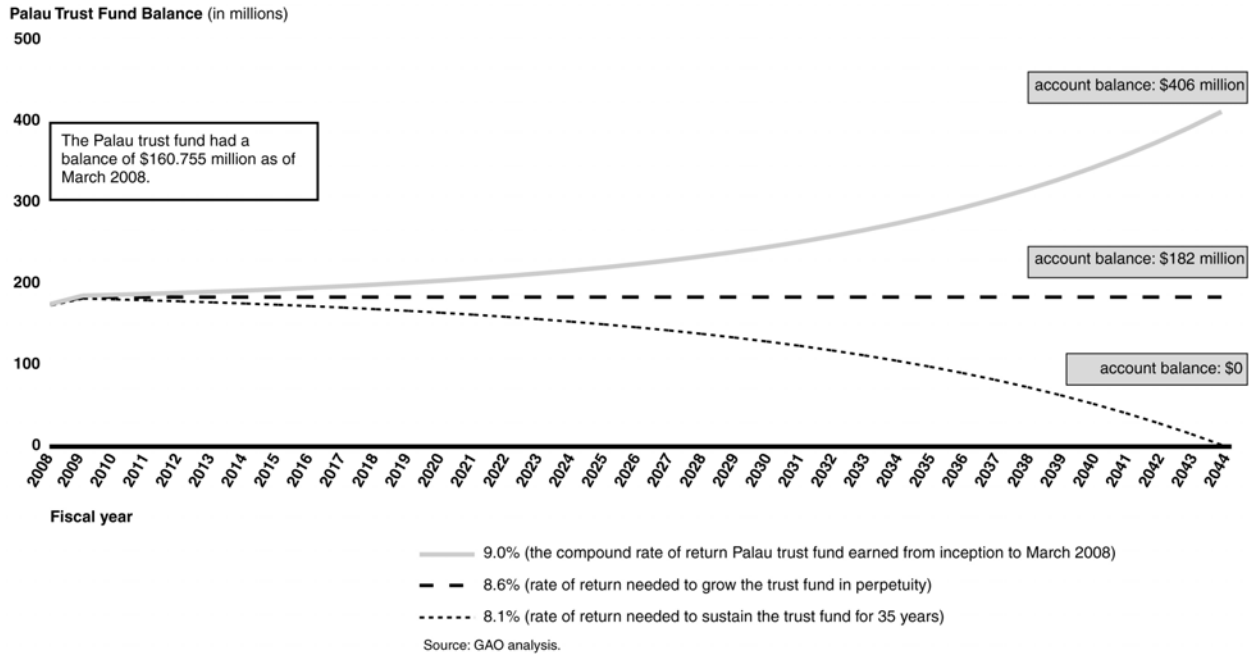
To estimate potential 2009 domestic revenue and the level of other donor assistance, we reviewed Palau single audit data for 2000-2006 and Palau budgets for 2007 and 2008 and applied the average annual growth rate from 2000-2008.

Discretionary federal programs exclude the value of DOD's Civic Action Team program that is provided in-kind. To estimate potential 2009 discretionary federal program levels, we reviewed Palau budget data for 2008 and assumed the same level of federal programs would be provided in 2009, adjusted for inflation.

The 2009 level of compact direct assistance is based on U.S. agency budget data.

Years cited are fiscal years (Oct. 1-Sept. 30). All dollar amounts are in current (i.e., nominal) dollars.

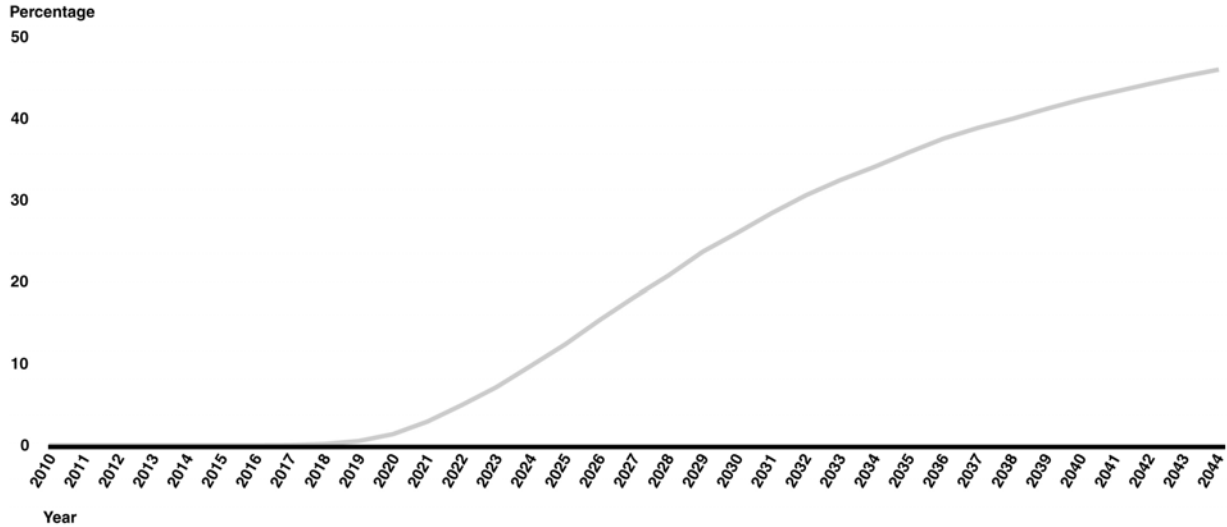
## Attachment VII Palau's Projected Trust Fund Account Balance with Three Rates of Return



Note: Years shown are fiscal years (Oct. 1-Sept. 30). All return rates are net of fees and commissions.

## Attachment VIII

### Probability That Palau Trust Fund Will Be Depleted Given Market Volatility, 2010-2044



Source: GAO analysis.

#### Notes:

This chart depicts results from 10,000 trial runs. For each run, the returns of each of the asset classes are randomly drawn from a distribution based on the historical returns (1970-2007). The account balances and the amount of disbursements from the trust fund are then calculated based on the returns. The probability of not being able to disburse \$15 million is then generated from a distribution of 10,000 disbursements each year.

All years cited are fiscal years (Oct. 1-Sept. 30)

## **Attachment IX**

### **GAO Contacts and Acknowledgments**

#### **GAO Contacts**

For further information about this statement, please contact David Gootnick at (202) 512-3149 or [gootnickd@gao.gov](mailto:gootnickd@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Staff making key contributions to this statement were Emil Friberg, Assistant Director; Kate Brentzel; Ming Chen; Cheryl Clark; Leslie Locke; Reid Lowe; Grace Lui; Matthew Reilly; Kendall Schaefer; and Doris Yanger.

#### **Congressional Relations**

Ralph Dawn, Managing Director, [dawnr@gao.gov](mailto:dawnr@gao.gov) (202) 512-4400, U.S. Government Accountability Office, 441 G Street NW, Room 7125, Washington, D.C. 20548.

#### **Public Affairs**

Chuck Young, Managing Director, [youngc1@gao.gov](mailto:youngc1@gao.gov) (202) 512-4800, U.S. Government Accountability Office, 441 G Street NW, Room 7149, Washington, D.C. 20548.