



## Governance Assessment

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# PALAU: Country Partnership Strategy (2009–2013)

## COUNTRY SECTOR AND THEMATIC ROAD MAP

### GOVERNANCE

#### A. Introduction

1. On 31 July 2006, Asian Development Bank (ADB) approved its second Governance and Anticorruption Action Plan (GACAP II), which aims to improve ADB's performance in implementing governance and anticorruption policies in sectors where ADB is active. GACAP II requires the preparation of governance risk assessment and management plans (GRAMPs) as an integral part of country partnership strategies (CPSs). GRAMPs will focus on three specific thematic issues – public financial management (PFM), procurement, and anti-corruption – at the country level and in priority sectors where ADB is active.

2. ADB is piloting the preparation of GRAMPs in particular developing member countries (DMCs), to ensure it develops a robust and practical implementation approach that can be applied in all of its DMCs over time. In the meantime, ADB is required to include governance assessments in all CPSs. This appendix, although not fully aligned with GACAP II requirements in that it does not include a GRAMP matrix, provides an overview assessment of governance issues in Palau, with particular emphasis on the GACAP II themes of PFM, procurement and anti-corruption. It is based on readily available information rather than new analysis.

#### B. Background

3. Palau is one of the world's youngest and smallest nations. Administered by the United States of America (USA) as part of the UN Trust Territory of the Pacific Islands<sup>1</sup> from 1947, Palau adopted its own constitution in 1980 and thereafter achieved internal self-governance in 1981, and signed a Compact of Free Association with the USA in 1982. However, Palau was unable to ratify the Compact and obtain its independence until it agreed to suspend the anti-nuclear provisions of the Constitution of Palau. It took twelve years of debate before Palauans finally voted to suspend the anti-nuclear provisions. Thereafter, the country obtained its independence on 1 October 1994.<sup>2</sup> Palau was the last Trust Territory of the Pacific Islands to gain its independence. It is now a constitutional republic in free association with the USA. Under the fifty-year Compact, the USA will provide Palau with some US\$600 million in grant assistance, including direct budget support, over the first fifteen years (1994–2009). As part of the agreement, US\$70 million was set aside in a Trust Fund, for use after Compact grants cease in 2009. Palau is eligible to participate in more than 40 federal programs, and the USA retains responsibility for Palau's defense and security. Palau is now in the process of negotiating post-2009 Compact arrangements with the USA.

4. Palau's National Congress consists of two houses which sit for four-year terms. The *House of Delegates* has 16 members, one from each state. The *Senate* has 13 members, representing geographical districts. All are popularly elected. The President, also popularly elected, is both Head of Government and Head of State, and may serve as President no more than twice. Although there is nothing to prevent their formation, there are no formal political

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<sup>1</sup> Consisting of today's Republics of Palau and the Marshall Islands, the Federated States of Micronesia, and the United States Commonwealth of the Northern Mariana Islands.

<sup>2</sup> In the 2008 general election, Palau's citizens voted on 25 proposed amendments to the 1981 Constitution, which was approved by a Constitutional Convention in 2005.

parties in Palau. Strong factional alliances dominate allegiances within the Senate,<sup>3</sup> which controls the national budget, and has the power to confirm appointments. The President chooses the eight-member Cabinet from within the legislature.

5. In addition, each state elects its own governor and legislature, and has its own constitution. The states have special responsibilities for environmental protection, land-use planning, health and welfare but, at present, Koror is the only state with significant administrative capacities independent of those provided by the national Government. Further, the *Council of Chiefs* is an advisory body to the President, bringing together the highest traditional chiefs from each of the 16 states. Although Palau's clans and traditional systems have tended to be kept separate from the modern political system, they remain strong and retain considerable authority. Customary law is recognized under Palau's Constitution and the state boundaries match those of pre-colonial kinship groups. In some states, chiefs formally have the power to veto government policy and the authority to arbitrate over community disputes. In effect, traditional governance systems are embedded in the country's modern governance structures. The Council is consulted on matters concerning traditional laws and customs, and their relationship to the Constitution and the laws of Palau. The *Judiciary* in Palau is independent, and comprises the Supreme Court, National Court, Court of Common Pleas, and Land Court.

6. Having achieved political independence, Palau now faces the challenge of achieving economic independence. Although the country is a tightly clustered archipelago of 340 islands, only eight are inhabited and about two-thirds of the population of 20,000 lives on Koror.<sup>4</sup> Under the Compact, Palau will continue to receive direct financial assistance from the USA until 2009 for ongoing budget support and infrastructure development. Beyond 2009, the USA will continue to provide a range of services to Palau at no cost under the Compact<sup>5</sup> until 2044. Nevertheless, the Trust Fund, worth about US\$117 million at the beginning of 2009, will become Palau's primary source of funding.

7. Palau has approached the management of its Compact funds prudently and is implementing its development plans with the objective of achieving long-term sustainable economic growth.<sup>6</sup> At present, living standards in Palau are comparatively high, albeit the distribution of wealth and development across the country is uneven. Recognizing that management of potentially less generous Compact arrangements is central to Palau's development prospects over the medium term, the government has actively been positioning the country for the post-2009 period, planning the major infrastructure projects needed to provide the basis for future economic growth, creating employment opportunities and working to expand business and investment opportunities.

8. The single most important challenge for public management in Palau is the size of the public sector, which has been allowed to grow over the years because Compact funding has

<sup>3</sup> President Tommy Esang Remengesau Jr represents one of the Senate factions, while the opposition is more diverse. He was elected to his first term in 2000, and then re-elected in 2004. Remengesau is the son of a former President and had previously served as Vice-President to former long term President Kuniwo Nakamura. The next general election is due to be held in November 2008.

<sup>4</sup> Koror was home to the capital until 7 October 2006, when government officials moved their offices to Melekeok, located 20 kilometers northeast of Koror on neighboring Babelthaup Island.

<sup>5</sup> Such as air safety, weather prediction, health services and assistance in the event of natural disasters.

<sup>6</sup> Tourism is the main contributor to economic growth, and Palau has a rich fishery resource that is critical to domestic food supply. The licensing of vessels from the USA, Japan, Taipei, China and the People's Republic of China is also a significant source of foreign exchange. Congress also passed a bill in 2004 to enable oil exploration to begin in Kayangel.

meant funding was not a constraint. Without substantial external support, it is unaffordable. According to the recent economic report commissioned by ADB, the public service wages and salaries bill was the fastest growing component of current expenditure over the decade from 1995 to 2006, in spite of efforts to control it. Although the primary focus of reform effort is rightly on private sector led growth,<sup>7</sup> Palau will also need to downsize the public sector, in terms of both personnel and functions. Maintaining the hiring freeze, outsourcing services, wage restraint, streamlining the government structure, developing a retrenchment program, improving expenditure accountability and productivity through performance-based budgets, and developing political and community support for strategies that will reduce the complexity of public sector roles, structures and accountabilities will all be important steps in reducing spending to a sustainable level.

**Table 1: Governance Indicators, 2007**

	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
Palau	1.22	1.11	-0.49	n/a	0.91	n/a
Pacific Average	0.41	0.75	-0.54	-0.70	0.31	-0.24
Microstates Average	0.95	1.24	-0.52	-0.64	0.64	-0.01

Notes: The Pacific Average has been calculated for those countries for which data are available for the particular year, from the group comprising Cook Islands, Fiji Islands, Federated States of Micronesia, Kiribati, Papua New Guinea, Republic of the Marshall Islands, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu and Vanuatu. The indicators are measured in the range of -2.5 to +2.5, with a higher score indicating better governance. The Microstates Average has been calculated for those countries for which data are available for the particular year, from the group comprising Cook Islands, Federated States of Micronesia, Kiribati, Republic of the Marshall Islands and Tuvalu.

Source: Kaufmann, D., Kraay, M., and Mastruzzi, M. 2008. *Governance Matters VII: Aggregate and Individual Governance Indicators, 1996-2007*. World Bank Policy Research Working Paper No. 4654. Available at SSRN: <http://ssrn.com/abstract=1148386>.

9. As Table 1 illustrates, Palau's governance performance is well above the Pacific island average on most key indicators, with the notable exception of government effectiveness. There is a strong perception within the community and private sector that government effectiveness is less than adequate, and there is scepticism concerning government commitment to implementing reform. First, it is unclear just how well policy statements are supported by the legislature or integrated into line agency programs and activities. This is an area that needs deeper analysis. Second, the tendency for economic reforms to be rejected by the parliament has been attributed to the fact that senior business leaders and members of the legislature would be the most exposed to the consequent increase in competition.<sup>8</sup>

10. Based on readily available information rather than new analysis, following is a synopsis of the status of Palau's progress in each of the GACAP II thematic areas.

<sup>7</sup> As ADB's 2007 Country Environment Assessment points out, there is substantial potential for expansion of activities such as tourism, agriculture and aquaculture. This would boost revenue collection and allow for the transfer of some responsibility for infrastructure to the private sector. It would also provide an alternative source of employment for Palauans displaced from the public sector.

<sup>8</sup> ADB. 2005. *Country Economic Report: Republic of Palau*, CER:PAL 2005-07. Manila.

### C. Public Financial Management

11. On behalf of the Government and key development partners, including ADB, the Pacific Financial Technical Assistance Centre (PFTAC) has recently completed a scoping study to identify technical assistance needs to enable Palau to introduce medium-term budgeting.<sup>9</sup> Based on the findings of this scoping study, this is an ambitious goal in the short term. At present, for example, there are serious concerns about the quality of budget preparation and analysis prior to submission of annual budgets to Congress. The capacity within line ministries to make annual budget projections and link them to national and sectoral planning priorities is very weak. Likewise, cash planning and performance management systems are ineffective, hampering service delivery and failing to provide a reasonable basis on which to plan, manage or monitor expenditure. Added to this, the Ministry of Finance itself has very limited capacity (in terms of both staff numbers and skills) to analyze line ministry budget submissions effectively.

12. These findings are consistent with those of the most recent review of Palau's use of Compact funding over the past 11 years, undertaken by the US Government Accountability Office.<sup>10</sup> That report has concluded that Palau's financial accountability has improved, but that it still has persistent internal control problems in areas such as procurement, cash management, and equipment and real property management, some of which have been recurring for twenty years.<sup>11</sup> According to Palau officials, inadequate capacity in financial accounting resources and expertise limits Palau's ability to address these weaknesses in a timely way. For example, Palau relies heavily on one individual to prepare its financial statements and has had difficulty recruiting a Chief of Finance and Accounting. As a result, Palau is at risk of being unable to sustain the financial accountability improvements made to date.

13. All government audits in Palau are conducted by the Public Auditor or are contracted to private firms by the Public Auditor. There is no significant internal audit function in place in line ministries. The recent PFTAC scoping study points to this as a significant weakness that must be addressed early since, at present, heads of line ministries have no real guidance on issues such as the efficacy of their operations, the reliability of financial reporting, deterring and investigating fraud, safeguarding assets, or compliance with laws and regulations. In broad terms, the audit reports that have been done indicate a lack of adherence to established cash receipts and procedures, a need to strengthen expenditure controls, a need to review monthly bank reconciliations and accounts receivable, and a lack of internal control over financial reporting.

14. In the first instance, clear and streamlined systems need to be adopted and applied consistently, including for instance a formal budget timetable; a more detailed *Integrated Planning Process* and well-costed budget submissions that allow effective scrutiny; a good cash planning system; and more relevant performance measurement systems. At the same time, analytical capacity within the Ministry of Finance needs to be strengthened and accounting,

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<sup>9</sup> PFTAC. 2008. *Scoping Study to Introduce a Medium Term Budget in Palau and Requisite Technical Assistance Needs*, Draft Report, May.

<sup>10</sup> United States Government Accountability Office (GAO). 2008. *Compact of Free Association: Palau's Use of and Accountability for U.S. Assistance and Prospects for Economic Self-Sufficiency*, GAO Report to Congressional Committees, June. <http://www.gao.gov/new.items/d08732.pdf>.

<sup>11</sup> The GAO reports further on material weaknesses cited in Palau's 2006 single audit report. These include (i) lack of supporting documentation to support travel expenditures; (ii) lack of review of monthly bank reconciliations and non-resolution of reconciling differences; (iii) lack of policies and procedures to reconcile accounts receivable and prepayments; and (iv) lack of adherence to prescribed travel policies and procedures.

internal audit and cash management capacity needs to be built across line ministries to improve the quality of their public financial management.

#### **D. Procurement**

15. Palau has in place a *Procurement Law and Regulations*, which applies to the procurement of goods and services by the national and state governments and by most agencies of the national government.<sup>12</sup> Although the law designates procurement officers at the national and state levels to oversee procurement, Palau's procurement system is centralized. All procurement is processed through the Ministry of Finance, and the attorney general and his or her state counterparts must certify the form and legality of all contracts. The Procurement Law also contains specific provisions dealing with conflict of interest and the offering of gifts and gratuities that apply to all procurement personnel. In addition, the *Code of Ethics Act* contains provisions that apply to all civil servants. In an effort to strengthen its ability to detect corruption, the government requires procurement personnel to report attempts to influence their decisions to either the attorney general or special prosecutor. Importantly, however, procurement personnel do not receive any training in integrity issues.

16. In relation to procurement procedures, Palau does have model tender documents and contracts with anti-competition clauses. Procurement opportunities must by law be announced in a newspaper of general circulation. In addition, each procurement officer must notify all eligible contractors of every procurement opportunity.<sup>13</sup> Prequalification is available, and procurements must be advertised for 15 days before bidding begins. Although bidders are not present at the bid opening, the Procurement Law includes detailed procedures for bid opening aimed at enhancing transparency.<sup>14</sup> Although a committee may be set up to evaluate bids, the procurement officer makes the final decision. All bidders must be informed of the result and the reasons for the decision. There is a review process available to actual and prospective bidders, albeit one that would benefit from improvement.<sup>15</sup>

17. The Government of Palau is participating in the *ADB/OECD Anti-Corruption Initiative for Asia and the Pacific* and has undertaken a self-assessment of its procurement systems in that context. The most recent report of anti-corruption reform under the action plan's third implementation cycle (2006-2008) identifies the need to strengthen procurement rules as one of five key priorities in Palau's effort to reduce corruption. According to the report<sup>16</sup>, procedures and administrative measures are not yet adequate to promote transparent and fair competition in the public procurement process. Further, the lack of understanding of the procurement policies makes it difficult to administer the procurement process.

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<sup>12</sup> Semiautonomous agencies set their own procurement policies, which must at least meet the standards of the *Procurement Law and Regulations*.

<sup>13</sup> Contractors are added to the list of eligible contractors at their request.

<sup>14</sup> These include the presence of at least two witnesses, and the preparation of a summary of key information relevant to each bid and the bid opening process. This summary must be countersigned by the witnesses and, along with all bids, made available for public inspection.

<sup>15</sup> Concerns about a procurement process must first be addressed to the relevant procurement officer, within 14 days of knowing the facts underlying the complaint. As ADB/OECD has pointed out, this sort of deadline is unlikely to be sufficient to enable a complainant to verify the facts and estimate the risks of an appeal. If dissatisfied with the procurement officer's decision, the complainant may then seek judicial review. (See ADB/OECD. 2003. *Curbing Corruption in Public Procurement in Asia and the Pacific*, ADB/OECD Anti-Corruption Initiative for Asia and the Pacific, pp. 90-92).

<sup>16</sup> ADB/OECD. 2006. *Palau: Anti Corruption Reform under the Action Plan's 3rd Implementation Cycle (2006-2008)*, ADB/OECD Anti-Corruption Initiative for Asia and the Pacific, May.

18. The legislative framework needs to be strengthened in several areas, especially in terms of setting or tightening parameters around the use of particular procurement methods. The Procurement Law specifies competitive bidding as the standard procurement method for activities valued at US\$10,000 or more, and restricted tendering for procurements between US\$5,000 and US\$10,000. However, it does not define some critical terms, thus providing procurement personnel with considerable discretion. For example, competitive negotiation is allowed if a procurement officer deems competitive bidding to be “impractical” or “not advantageous”, but these terms are not defined; single-source procurement and emergency procurement are also available options in loosely defined circumstances; and procurement officers are allowed to reduce the standard 30–day bidding period for competitive bidding to 15 days if they find the shorter period reasonable. These sorts of issues leave staff very exposed to corruption risks.

19. Palau’s public procurement processes have not yet been subject to a detailed, independent review of the type normally undertaken by multilateral development institutions. This will be needed to allow objective assessment not only of the strength and appropriateness of Palau’s procurement rules and procedures, but also of the extent to which procurement processes are followed in practice. ADB will be undertaking an assessment of the integrity of public procurement practices as part of its forthcoming technical assistance program in Palau.

## **E. Anti-corruption**

20. Although there have been numerous documented cases of corruption in various forms, Palau does not have a culture of corruption. The country has an independent judiciary, trials are fair and the police and first response force maintain internal order. Freedom of speech and of the press are respected, and public access to information is guaranteed under the Constitution, as is a citizen’s right to “observe the official deliberations of any agency of government”<sup>17</sup>. Palau has a public auditor, who is appointed by the president and confirmed by the national congress. The existence, authority and independence of the position of public auditor are specified through a provision within the Constitution. Notably, Palau is the only Micronesian country with a special prosecutor. This means that, unlike its neighbors, Palau has the capacity to actually bring cases to court. The public prosecutor and public auditor work together well. According to Transparency International, “for nearly all the cases of reported misuse of funds, larceny, or embezzlement, the Special Prosecutor has initiated investigations based on information provided by the Public Auditor.”<sup>18</sup> In fact, Palau’s system for internal control of government abuse has been described as exemplary. The *Code of Ethics Act* spells out what is illegal for government officials, and the public auditor and the special prosecutor hold them accountable for failure to observe the law.

21. Nevertheless, Palau is exposed to the same sorts of corruption risks and constraints on the enforcement of good governance practices as all microstates in the Pacific. The country’s small size and culture of reciprocity inevitably means boundaries become blurred. However, this is no longer considered an adequate excuse for inaction. As one Micronesian analyst has pointed out, “Exchange of food gifts for a traditional back massage is one thing, but an allotment

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<sup>17</sup> Shuster, D.R. 2004. *National Integrity Systems Country Study Report: Republic of Palau*, Report prepared for Transparency International through the Asia Pacific School of Economics and Government, Australian National University.

<sup>18</sup> Footnote 17 refers.

of a large government contract in return for several thousand dollars is quite another".<sup>19</sup> As noted earlier, an issue of particular concern in Palau is the widespread perception that legislation is passed or rejected on the basis of the personal and business interests of public officials or their associates rather than national and community interests.

22. Looking forward, Palau's challenge is to prevent any possibility for corruption to become endemic. The country's own history shows the destructive impacts can be dramatic. For example, in 1985, Palau's first President, Haruo I. Remeliik, was assassinated. The Minister of State was eventually found to be complicit in the crime. Palau's third President, Lazarus Salii, died in an apparent suicide in 1988 amid allegations of mismanagement and corruption. In more recent years, politics have been dictated by short-lived alliances, with a destabilizing effect on governance. In 2004, two lawmakers were charged with fraud. Further, the country has been plagued for some time now by reports of human and drug trafficking, prostitution, and money laundering by criminal groups.<sup>20</sup>

23. There are several areas in which Palau could strengthen its anti-corruption efforts. Firstly, the size and structure of government in Palau is as much a concern for corruption as it is for public expenditure control. With 14 full state governments to service a total population of 20,000, there have been charges laid against several governors and other state officials for mismanagement of funds. In particular, conflict of interest is potentially a serious problem since, in addition to their public responsibilities, congressmen routinely have side businesses (e.g., bank, retail outlet, rental business). The *Code of Ethics Act* addresses conflict of interest, establishes an Ethics Commission and specifies criminal and civil penalties. Nevertheless, there is a concern that congressmen and other public officials do not abstain from discussion, voting or decision making on legislation or policies that may directly or indirectly affect their own business interests.

24. Secondly, there is a real need to strengthen the protection available to the public prosecutor's position, possibly through constitutional amendment. The office has compiled an impressive record of convictions against government officials for misuse of public funds and other crimes since its establishment in 1999, and has more than paid for itself with the money it has recovered.<sup>21</sup> Importantly, it has conveyed clearly that misuse of public funds or authority will not be tolerated. Not surprisingly, there have been several political attempts to eliminate the position or render it ineffective. There have also been several instances of harassment or other threat made against the individual holding the office.

25. The third area that warrants highlighting is supervision of the financial system. Five financial laws were introduced in 2001 that allowed for establishment of the Financial Institutions Commission (FIC) to supervise banks and the Financial Intelligence Unit (FIU) to investigate suspicious transactions. Encouragingly, long overdue amendments to the *Financial Institutions Act* were finally passed in February 2008, allowing the FIC to issue prudential regulations without legislative approval; requiring all banks to have an annual audit; and granting legal immunity to FIC staff in carrying out official acts. However, whilst the amendments also

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<sup>19</sup> Hezel, F.X. 2005. *Micronesian Governance: A View from the Outside*, Analysis of Transparency International's Micronesian country studies of national integrity systems, Pacific Islands Report, Pacific Islands Development Program, East-West Center, April.

<sup>20</sup> In 1998, the Senate passed legislation making Palau an offshore financial center.

<sup>21</sup> To give just one example from the 2004 Transparency International report, over a 2-year period, the Public Prosecutor threatened law suits against all but one of the members of the National Congress for illegal use of travel funds. The congressmen agreed to a settlement with the government, returning US\$250,000 to the national treasury.

empower the FIC to examine for anti-money laundering issues, the March 2008 joint mission of the IMF and the Asia Pacific Group on Money Laundering has concluded that several legislative deficiencies remain.<sup>22</sup> Further, neither the FIC nor the FIU has ever had sufficient resources to provide effective supervisory oversight.

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<sup>22</sup> IMF. 2008. *Republic of Palau: 2008 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion for the Republic of Palau*, IMF Country Report No. 08/161, May.