

**STATEMENT
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**BEFORE THE
HOUSE COMMITTEE ON NATURAL RESOURCES
SUBCOMMITTEE ON INSULAR AFFAIRS**

**REGARDING
IMPLEMENTATION OF THE COMPACT OF FREE ASSOCIATION
WITH THE
REPUBLIC OF PALAU**

JUNE 12, 2008

Madam Chair and members of the Subcommittee on Insular Affairs, I am pleased to be here today to discuss the implementation of the Compact of Free Association with the Republic of Palau (ROP). This hearing is particularly timely as the government of Palau and the Government of the United States prepare for the required review of the Compact. My statement will focus on the financial assistance components of the Compact for which the Department of the Interior has been responsible.

Palau's Compact of Free Association was implemented in fiscal year 1995. When Compact direct funding expires on September 30, 2009, the Department of the Interior will have provided approximately \$600 million of assistance to Palau, including \$149 million used to construct the turnkey 53-mile road system on Babeldoab, Palau's largest island. Three hundred and seventy two million dollars will have been expended on activities defined under Title Two of the Compact, and another \$38.7 million on Compact section 221 block grants for health care and education. Much of the funding provided directly to the ROP was partially adjusted for inflation. The amount of inflation payments will have been approximately \$99 million for the 15-year period.

The financial assistance package of Palau's Compact has always differed in key respects from the assistance that the United States has provided to the Republic of the Marshall Islands (RMI) and the Federated States of Micronesia (FSM) under their compacts. The most significant difference for Palau was the establishment of a trust fund capitalized with \$70 million within the first three years of the agreement. The object of the trust fund is to produce an average annual distribution of \$15 million for ROP government operations for thirty-five years beginning in fiscal year 2010. It was recognized that the fund might or might not produce this amount. Any excess or variance was to accrue or be absorbed by the Government of Palau. Trust fund proceeds have also provided operational funding for Palau since the fourth year of the agreement. The Compact, through its subsidiary agreements, also provided for the construction of the road around Babeldoab. The road, which was completed last year, became the largest public works project ever undertaken in the insular areas by the Department of the Interior.

Palau's Compact had other unique features. Palau's program of capital improvements was funded by a single payment of \$36 million to the government in 1995. By agreement, Palau also received \$28 million for energy purposes in a lump sum in fiscal year 1995.

Other direct funding mirrored the assistance granted to FSM and RMI. The ROP received annual funding for operations, communications, marine surveillance, scholarships, and special block grants. Funds were also provided by DOI to perform annual audits and to support operations of the National Weather Service, the Federal Aviation Administration, and the Postal Service. The National Weather Service and the Federal Aviation Administration now receive direct funding to support operations in Palau.

The Department of the Interior views the ROP and the Compact as a success story. Palau has made strong economic gains since approval of the Compact. Its average growth, in real terms, has been just over 2 percent. In recent years, 2004-2007, annual real GDP growth has averaged in excess of 5.5 percent per year. Domestic revenues have increased from 36 percent of government expenditures in 1994 to nearly 60 percent in 1997.

The strategies and funding mechanisms created under the Compact have been successful. As has been reported by the Government Accountability Office (GAO), the trust fund has a good chance of meeting its goal of producing an average annual amount of \$15 million for ROP government operations. 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. This rate is lower than the 9 percent rate the trust fund has earned from its inception in 1995 through March 2008.

As I noted earlier, the Palau Compact Road has been completed and now provides new opportunities for opening and developing Palau's largest island. Construction of the road was a turnkey responsibility of the United States. Originally described as a road to be "eighteen feet wide, with a double bituminous surface treatment and two foot shoulders on each side," the road instead is a modern roadway built to United States standards. The road bed travels the 53-mile circumference of Babeldoab. It links the business center of Koror with the new capital in Melekeok and makes formerly inaccessible land and natural attractions available for development. The road is a tribute to the fruitful partnership of the Department of the Interior, Palau, and the U.S. Army Corps of Engineers, which managed construction.

Concerns remain regarding Palau's ability to maintain the road in a condition that will permit current desires for economic development to be realized in the future. Recent legislation enacted by the United States Congress allows Palau to retain \$3 million to establish a maintenance trust fund to help mitigate this concern.

Palau has made progress in installing necessary public infrastructure using Compact funds and other outside donor assistance. Increased attention to management of its infrastructure, in addition to planning for maintenance and investment in maintenance, is

necessary. Currently, Palau relies on outside assistance for maintenance and is likely to continue to do so in the future.

Social services provided by Palau are meeting the needs of its community. Palau reports that its child immunization program reaches 98 percent of the targeted population. The infant mortality rate has decreased from 21.4 to 7.1 per thousand. Life expectancy has increased from 68 to 72. Palau has developed school improvement plans in all public schools and developed a system-wide, national student assessment test. Graduation rates at Palau's public school compare favorably with any nation. Based on my communication with the U.S. Department of Health and Human Services and the U.S. Department of Education officials, I understand that Palau is careful in choosing Federal domestic programs, but Palau also credits much of its improvement to assistance from these Departments.

The Department of the Interior has found Palau to be a reliable partner, especially in the past eight years. Palau has been a leader among all U.S.-affiliated insular areas in the area of accountability and financial management, making steady improvements in its ability to reliably report on the use of funds. 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. For 2003-2006, Palau's financial statements consistently received unqualified audit opinions, indicating that the auditor considered the statements reliable. Palau has also provided annual economic reports charting its use of Compact funds.

In conclusion, the Department of the Interior believes Palau's Compact has been a success. Palau has been a reliable partner and has utilized Compact funding effectively to achieve positive results. The Department of the Interior is participating in the bilateral consultations being held in anticipation of the 15-year review provided for in the Compact and looks forward to the continuation of those consultations and the subsequent review.