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Testimony of
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Before the
Subcommittee on Insular Affairs
Committee on Natural Resources
U.S. House of Representatives

Oversight Hearing
'Implementation of the Compact of Free Association
between the United States and the Republic of Palau'

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I. INTRODUCTION

Madam Chair and Members of the Subcommittee, on behalf of the people and the President of the Republic of Palau, Tommy E. Remengesau, Jr., I offer greetings to your Committee on Natural Resources and the membership of the House of Representatives. I am Billy G. Kuartei, the President's Chief of Staff and Palau's lead representative regarding the on-going review of the Compact of Free Association between our two countries.

Madam Chair and Members of the Subcommittee, I am honored that you have extended this invitation for Palau to present its perspective on the implementation of the Compact. When Palau first entered into the Compact in 1994, we were excited about our new status, hopeful about the future and cautiously optimistic about Palau's ability to achieve our ultimate goal of assured self-reliance and economic self-sufficiency.



A mere 14 years after the Compact was implemented, I am proud to report that we have made excellent progress towards our objective, although we have great challenges ahead. President Remengesau reported to Members of Congress on his visit to the United States in February of this year that the Compact between our two countries has been a great success.

The people of Palau express their gratitude for U.S. assistance and its strong relationship with the United States, not merely through words, but also through actions. No action of greater significance to our people could indicate our support for our closest friend as the voice of international democratic principles than the service of our sons and daughters in the U.S. Armed Services at a per capita rate higher than that of any state in the United States. As you are well aware, some of our children have made the ultimate sacrifice to support our jointly held beliefs.

Our support in the international forum is equally as clear and consistent. Palau has demonstrated that it stands with the United States on critical issues, even when they do not have international popularity. In fact, frequently, the United States and Palau stand alone in votes on the floor of the United Nations. Our support for the United States in such matters speaks for itself.

In order to obtain an objective assessment of Palau's relationship with the United States and its performance under the Compact, the President requested that the Congress call for an audit by the U.S. Government Accountability Office (GAO). This request reflected our belief that Palau has acted with transparency and care in the use of funds received from the United States under the Compact. The GAO report has been presented to this Subcommittee today and it confirms Palau's confidence that its performance has warranted the pride of its people and the positive recognition by the United States. In general terms, Palau concurs with the findings and economic analyses set forth in the GAO Report. This being said, Palau recognizes that there are factors, including continuing fiscal constraints, that hinder its ability to sustain the progress that has been made. Palau therefore welcomes the report's recommendation for the Office of Insular Affairs to continue to assist Palau in building financial management capacity.

II. ACHIEVEMENTS UNDER THE COMPACT

As we are all aware, the Preamble of the Compact affirmed the interest of the Government of the United States in "promoting the economic advancement and self-sufficiency of the people of Palau." We would maintain that Palau has made considerable progress towards achieving this broad goal of economic advancement and self-sufficiency over the initial period of the Compact.

Over these 14 formative years, economic performance has been increasingly positive. During this period, the Palau economy has grown, in real terms at just over 2 percent per year. This increase is in excess of the population growth rate, hence per capita incomes have improved. While our economy remains vulnerable to external shocks beyond our control, economic



performance in the four years from 2004-2007 has been promising. During those years annual real GDP growth has averaged in excess of 5.5 percent per year.

Palau entered the Compact in a position of extreme reliance on United States assistance. Today, the total level of assistance from the United States represents a diminishing share in proportion to the size of Palau's economy. For example, flows from the Compact and related United States assistance at the beginning of the Compact were in excess of 36 percent of GDP and represented roughly 64 percent of current expenditures at that time. With the growth in Palau's economy, fiscal restraint, and changes in Compact and related United States funding, total United States assistance equals approximately 16 percent of GDP and represents 41 percent of current expenditures.

Likewise, increases in domestic revenue as a proportion of Gross Domestic Product have been achieved, from a low of 20 percent of GDP in FY 1997 to the level of 23 percent of GDP in FY 2007. In conjunction with expenditure restraint, especially in the most recent four years, domestic revenue has increased in relation to total current government expenditures. At the outset of the Compact in 1994, domestic revenues covered just 36 percent of current government expenditures and in FY2007 that proportion had increased to nearly 60 percent.

Not only has Palau reduced its external reliance levels, the Government has also managed to achieve significant reallocations toward the high priority areas of health, education and capital projects. For example, as a share of total government expenditures, spending on health has increased by over 40 percent, and spending on education has increased by 26 percent. In addition, capital expenditures have risen by over 25 percent.

From 1994 through 2007, major advancements were achieved in certain important health indicators that include:

- Reduction of the Infant Mortality Rate from 21.4 to 7.1 per thousand;
- Increased life expectancy from 68 to 72; and
- An immunization rate that has remained among the highest in the world at 98%.

There have also been significant improvements in maternal child health services, access to primary health care, water and food safety and environmental health.

During this same period, a number of accomplishments were also achieved in education including:

- Development of school improvement plans in all of Palau's public schools including the establishment of learning targets for grades 1-8, after-school and



- tutoring programs, community partnerships and implementation of computer technology infrastructure and integration;
- Development of a system-wide national student assessment test;
 - Development, maintenance and improvement of special education programs in 18 public schools funded through federal grants;
 - Development, maintenance and improvement of adult education programs; and
 - Western Association of Schools and Colleges (WASC) accreditation of the Palau High School.

Overall, these program initiatives resulted in the elementary schools of Palau achieving an elementary graduation rate of approximately 99% and a high school graduation rate of approximately 95%, with major improvements in core studies (English, Math, Science and Social Studies) as shown in the system-wide, national student assessment tests. At the post secondary level, these program initiatives have also resulted in:

- Over 1,162 graduates with degrees and certificates from Palau Community College;
- Over 19,573 Certificates of Completion and Achievement issued in different disciplines to participants from the other FAS States as well as Guam, the CNMI, and American Samoa. Over 95% of certificate recipients came from Palau;
- Accreditation of the Palau Community College by the Accrediting Commission for Colleges and Junior Colleges and the WASC, including many commendations for innovative ways of providing higher education programs; and
- Establishment of Baccalaureate and Masters programs in Palau as part of a 'National Professional Development Strategy'.

In regard to capital expenditures, Palau can report major progress across most areas of public infrastructure, including: power, roads, water, sewer and solid waste management, ports, airport, telecommunications, and public facilities. Financing has been dominated by assistance for the United States Compact Road, other CIP-funded projects, and support from external donor partners.

During a period in which fiscal balance was restored and expenditure restraint was the order of the day, Palau has achieved an impressive amount of budgetary re-structuring toward its three highest priority areas.

The private sector has also contributed significantly to the recent strong economic growth performance of Palau, particularly in recent years. During the last five years, the share of GDP



attributed to public administration has declined while the role of private enterprise has expanded. Key growth sectors responsible for this transition were tourism and construction. Overall, total formal sector employment grew at over 5.1 percent annually from 1995 through 2007. The private sector has created virtually all of the new jobs since 1999, while jobs within the category of public administration have remained nearly flat. The total workforce grew from 9,457 in 1999 to 12,036 in 2007.

III. THE CHALLENGES AHEAD

We know that Palau and our people would not have achieved this level of success without the economic assistance of the United States, and particularly, access to critical federal programs and services. A summary of projected financial support in 2009 in three main categories includes:

- \$11.3 million of direct payments;
- \$2.0 million in special program assistance; and
- \$11.9 million for discretionary federal program grant assistance.

While Palau has made significant progress over the last 14 years in reducing overall reliance on U.S. assistance, these funding sources remain a significant and critical funding resource to Palau, particularly for health and education program expenditures.

Despite our notable progress, we still have much work to accomplish before we attain our objective of economic self-sufficiency. Like most small island nations, we have a fragile economy and unique challenges. Often, we are only one economic event away from reversing the progress that we have made. I would refer you to the SARS epidemic that threatened global health and threw our economy into deficit spending. In the last few weeks, we experienced the bankruptcy of Taiwan's Far Eastern Airlines, which was responsible for flying approximately one-third of Palau's total tourists. At the same time, ever-increasing fuel costs are significantly endangering our recent but delicate economic achievements. Indeed, this may be Palau's greatest economic challenge to date.

An even more serious 'economic event' would be a disruption or a cessation of our access to U.S. assistance. It would be certain to have a detrimental impact on our continued development and move towards economic independence. Specifically, the loss of any one of anticipated 1) trust fund assistance, 2) discretionary programs, or 3) federal services (telecommunications, postal, weather and aviation services) would have a dramatic negative impact on Palau's efforts to continue to move towards self-sufficiency.

We have emphasized this point in our discussions with United States representatives in connection with the on-going review under the Compact. In the context of this review, Palau has provided a three-pronged economic proposal to the United States that will permit Palau to



continue on a sustainable growth path which reflects a smaller, but still critical, U.S. role in our economic development. Let me assure you that we have been as reasonable, sensible, transparent, and innovative as we could be in designing our proposal and sharing it with the U.S. Government.

IV. PALAU'S PROPOSAL

Palau is determined to end its reliance on extraordinary United States assistance levels. This proposal is designed to lead to a point in time when (relatively) large annual appropriations for direct, non-competitive program support to Palau will terminate. While this was an objective for both countries when the Compact was negotiated and is reflected in the initial provisions of the Compact, those provisions did not assume that this goal would necessarily be achieved by any fixed date, including the fifteenth anniversary of the Compact. Palau firmly believes that our request is fully consistent with the intent of the Compact and is supported by a rationale that will enable Palau to continue on its successful development path.

This proposal is based upon five principles that stand at the heart of our original Compact and its economic provisions:

- Assured stability and security of Palau and enhanced security within the Asia/Pacific Region;
- Sustained Economic Growth;
- Improved Education and Health Status;
- Enhanced Environmental Sustainability; and
- Assured Self-Reliance.

The proposal has three primary components:

- The enhancement of the Compact Trust Fund to a level that will securely provide the annual operational support that was originally projected to be necessary when the Compact was negotiated;
- Continued access to appropriate United States federal services and programs; and
- Support for appropriate infrastructure projects and maintenance that will enhance Palau's contribution to the security and stability needs of both of our countries, and move Palau towards its social and economic goals.

In regard to the Trust Fund, the United States initially provided Palau with a Trust Fund valued at \$70 million. It was the intent that at the end of the initial 15 years of the Compact, the Trust Fund would provide \$15 million per annum to replace Compact operational funding until 2044,



the 50th year of the Compact. Unfortunately, despite careful management of the Trust Fund through a single investment advisor and utilizing a cadre of respected professional money managers, the Trust Fund failed to perform up to original expectations (12.5% annual interest). In fact, the GAO has indicated in its recently published report that the fund could be depleted by as early as 2016.

In order to realize the original intent of the Compact, Palau has proposed the enhancement of the Trust Fund through either a one-time injection of approximately \$97.6 million, or, preferably, through a series of annual installments, which, if provided over a ten year period, would equal approximately \$12.5 million each year. Under this proposal, Palau would receive the originally envisioned annual drawdown of \$15 million without any inflation adjustment.

This presents significant fiscal adjustment challenges—which Palau is committed to addressing through the fulfillment of major structural adjustments during the first five years of renewed Compact support, FY 2010-2014.

With regard to federal services and programs, Palau is asking that federal services, programs and grants currently in operation be continued and that the access that Palau enjoys to discretionary, competitive grants through federal agencies be continued. Palau understands—and accepts—the risks inherent in *ad hoc* access to these federal programs and has no desire to “cash-out” or otherwise specify precise levels of United States assistance that may actually be realized over the medium-to-long-term.

Finally, with regard to the support for capital projects, Palau has proposed discussion of funding for three alternative capital projects, as follows:

- A new deep water seaport, estimated to cost \$80 million;
- A fiber optic submarine cable transmission system, estimated to cost \$55 million; and
- A Babeldaob Island Social Sector Infrastructure Development Project, estimated to cost \$73 million.

The criteria for identifying these major potential infrastructure projects for support from the United States are as follows:

- Projects that will make an important and visible contribution to economic development consistent with Palau’s economic strategy and the five proposed Principles for the Extension of Assistance under the Compact;
- Projects with the potential to complement or augment our two Governments’ mutual security and defense priorities; and
- Essential projects that might not otherwise proceed without United States support and that are consistent with United States priorities and concerns.



In order for these three primary components of Palau's proposed assistance plan to achieve the ultimate goal of economic self-sufficiency as envisioned in the Compact, Palau intends, through ongoing discussions, to make explicit commitments for continued fiscal reform. Such commitments are necessary for four reasons:

- First and foremost, Palau has committed to ending reliance on extraordinary levels of United States assistance by a date-certain.
- Second, Palau is fully aware of the fiscal realities facing the United States at this time and cannot expect a level of funding support that would obviate the need for fiscal adjustments on the part of the Palau Government.
- Third, Palau must operate under a balanced budget constraint. The immediate decline in assistance at the end of the fifteenth year of the Compact, combined with the intention to take no inflation-adjustment on Trust Fund drawdowns requires an immediate and sustained fiscal adjustment effort to maintain budget balance.
- Fourth, there is an ongoing need for fiscal adjustment and expenditure re-allocations—already well underway—to implement an economic strategy that is conducive to private sector development, gives appropriate priority to health and education needs, and that addresses infrastructure bottlenecks in a timely manner.

In addition to our three-pronged economic proposal, Palau has also requested that a bi-lateral assessment of the defense and security arrangements be undertaken. We have made this request, taking consideration of the fact that there has been no overall review since inception of the Compact, or since 9/11. We believe that the new and more dangerous international situation makes such an assessment logical and practical and can only strengthen our response capacities in the region.

In sum, Palau's proposal is simply a reaffirmation of the economic determination and agreement made over 20 years ago when the Compact was negotiated – that, if Palau made appropriate economic and structural adjustments, approximately \$15 million per year from a trust fund should be sufficient to provide economic self sufficiency for Palau, notwithstanding its vulnerabilities as a small island economy. Our proposal commits Palau to continuing that progress while providing for only the economic assistance contemplated from the beginning of the Compact. Palau believes that the proposal assures that Palau will remain an important security and economic partner of the United States in the western Pacific and an example of success in the region.

At the conclusion of our meetings on Wednesday, June 4th, the issues of Palau's proposal were effectively left with the Department of State, the Department of Interior and other members of the Interagency Group for their consideration and response. It appears that a prerequisite to



further action on the part of the United States is obtaining a basic level of general and budget authority in order to proceed. While our discussions have been very constructive, and have clarified potential issues, no positions can be negotiated until basic authority has been provided. We are hopeful that this will occur so that we can meet our very ambitious and agreed upon time schedule for the conclusion of negotiations.

The agreed-upon timetable for future meetings includes:

- A third scheduled meeting in September;
- An interim meeting in late July; and
- Conclusion of negotiations by October 31, 2008.

V. CONCLUSION

Madam Chair and Members of the Subcommittee, Palau's proposal to the United States expresses our real need for ongoing support to consolidate Palau's progress to-date and to secure a sustained rate of growth to achieve the goal of "economic advancement and self-sufficiency" agreed upon in the Compact. At the end of the day, our efforts to complete our negotiations should reflect our close friendship, our mutual security desires and needs and the realistic requirements of Palau to achieve our mutual goal of economic self sufficiency.

Fourteen years ago, Palau and the United States agreed upon a new course and a new relationship under the Compact of Free Association. Under this new roadmap, the United States agreed to provide the building blocks to Palau's development, and Palau agreed to work, through good governance and appropriate economic policies, to enhance its development opportunities. We believe that we are meeting our obligations under this grand bargain. Today, we are merely asking that this partnership continue to its full fruition.

As President Remengesau has indicated on numerous prior occasions, we believe that there is significant advantage to both of our countries in finalizing our negotiations prior to the end of the year in order to take advantage of the close relations that have been strengthened during the parallel periods of our respective administrations.

In the end, friendship is based on trust and following through on mutual commitments. With the help and understanding of the United States, we believe that we can finalize this process and realize our national dream of economic and political independence. We ask for your continued support in our journey.