

**GAO**

Testimony

Before the Subcommittee on Fisheries,  
Wildlife, Oceans, and Insular Affairs,  
Committee on Natural Resources, House  
of Representatives

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For Release on Delivery  
Expected at 2:00 p.m. EDT  
Monday, September 10, 2012

# COMPACT OF FREE ASSOCIATION

## Proposed U.S. Assistance to Palau through Fiscal Year 2024

Statement of David Gootnick, Director  
International Affairs and Trade



# COMPACT OF FREE ASSOCIATION

## Proposed U.S. Assistance to Palau through Fiscal Year 2024

Highlights of [GAO-12-798T](#), a testimony before the Subcommittee on Fisheries, Wildlife, Oceans, and Insular Affairs, Committee on Natural Resources, House of Representatives

### Why GAO Did This Study

The Compact of Free Association between the United States and the Republic of Palau, which entered into force in 1994, provided for several types of assistance aimed at promoting Palau's self-sufficiency and economic advancement. Included were 15 years of direct assistance to the Palau government; contributions to a trust fund meant to provide Palau \$15 million each year in fiscal years 2010 through 2044; construction of a road system, known as the Compact Road; and federal services such as postal, weather, and aviation. U.S. agencies also provided discretionary federal programs related to health, education, and infrastructure. In 2008, GAO projected that total assistance in fiscal years 1994 through 2009 would exceed \$852 million.

In September 2010, the United States and Palau signed an agreement (the Agreement) that would, among other things, provide for additional assistance to Palau beginning in fiscal year 2011 and modify its trust fund. Currently, there are two bills pending before Congress to implement the Agreement.

In this testimony, GAO updates a November 2011 testimony on (1) the Agreement's provisions for economic assistance to Palau, (2) its impact on the trust fund's likelihood of sustaining scheduled payments through fiscal year 2044, (3) the projected role of U.S. assistance in Palau government revenues, and (4) the pending legislation to implement the Agreement. GAO reviewed current trust fund data and new pending legislation for this testimony.

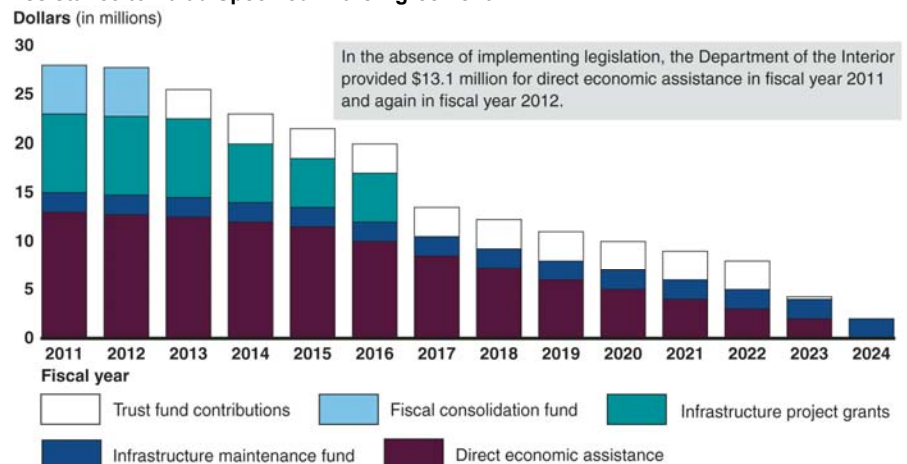
View [GAO-12-798T](#). For more information, contact David Gootnick at (202) 512-3149 or [gootnickd@gao.gov](mailto:gootnickd@gao.gov).

### What GAO Found

The Agreement would provide decreasing assistance, totaling approximately \$215 million through fiscal year 2024 and includes the following:

- direct economic assistance (\$107.5 million) for Palau government operations;
- infrastructure project grants (\$40 million) to build mutually agreed projects;
- infrastructure maintenance fund (\$28 million) for maintaining the Compact Road, Palau's primary airport, and certain other major U.S.-funded projects;
- fiscal consolidation fund (\$10 million) to assist Palau in debt reduction; and
- trust fund contributions (\$30.25 million) in addition to the \$70 million contributed under the compact

### Assistance to Palau Specified in the Agreement



Source: GAO analysis of the Agreement between the Government of the United States of America and the Government of the Republic of Palau Following the Compact of Free Association Section 432 Review, and Department of the Interior Budget Justifications and Performance Information, Fiscal Years 2012 and 2013.

Notes: All dollar amounts are in nominal dollars (i.e., unadjusted for inflation). Funds were not provided in fiscal years 2011 or 2012 to date for infrastructure projects, the infrastructure maintenance fund, or the fiscal consolidation fund.

Under the Agreement, the United States would contribute to the trust fund in fiscal years 2013 through 2023, and Palau would reduce its withdrawals by \$89 million in fiscal years 2010 through 2023. GAO projects that the fund would have a 90 percent likelihood of sustaining payments through fiscal year 2044 with these changes, versus 40 percent without these changes.

Estimates prepared for the Palau government project declining reliance on U.S. assistance under the Agreement—from 28 percent of government revenue in fiscal year 2011 to 2 percent in fiscal year 2024—and growing reliance on trust fund withdrawals and domestic revenues. The estimates show trust fund withdrawals rising from 5 percent to 24 percent and domestic revenues rising from 40 to 59 percent, of total government revenue. According to the estimates, U.S. assistance in fiscal years 2011 through 2024 would total \$427 million, with discretionary federal programs accounting for about half of that amount.

Congress has not approved legislation to implement the Agreement as of September 2012. Pending Senate legislation would implement the Agreement and appropriate funds to do so. Pending House legislation would implement the agreement, apply an inflation adjustment to assistance payments, and shift the timing of certain assistance payments to reflect the fact that 2011 has passed.

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Chairman Fleming, Ranking Member Sablan, and Members of the Subcommittee:

I am pleased to be here today to discuss the September 2010 agreement between the U.S. and Palau governments.<sup>1</sup>

The Compact of Free Association between the Government of the United States and the Government of the Republic of Palau, which entered into force in 1994,<sup>2</sup> provided for several types of assistance aimed at promoting Palau's economic advancement and eventual self-sufficiency.<sup>3</sup> In addition to establishing Palauan sovereignty and U.S.-Palau security and defense arrangements, the compact provided economic assistance to Palau.<sup>4</sup> This assistance comprised, among other things, direct economic assistance for 15 years to the Palau government; the establishment of a trust fund intended to provide Palau \$15 million annually from 2010 through 2044; investments in infrastructure, including a major road; and the provision of federal services, such as postal, weather, and aviation. The compact also established a basis for U.S. agencies to provide discretionary federal programs related to health, education, and infrastructure. In June 2008, we projected that U.S. assistance to Palau from 1995 through 2009 would exceed \$852 million, with assistance under the compact accounting for about 68 percent and assistance through discretionary programs accounting for about 31 percent.<sup>5</sup> We also reported in 2008 that the likelihood of the Palau trust

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<sup>1</sup>*The Agreement between the Government of the United States of America and the Government of the Republic of Palau Following the Compact of Free Association Section 432 Review* (Sept. 3, 2010).

<sup>2</sup>*The Compact of Free Association between the Government of the United States of America and the Government of the Republic of Palau* (Oct. 1, 1994).

<sup>3</sup>See *Proclamation 6726, Placing into Full Force and Effect the Compact of Free Association with the Republic of Palau*, 59 Fed. Reg. 49777 (Sept. 27, 1994). Congress approved the Compact of Free Association in Public Law 99-658 on November 14, 1986, and Public Law 101-219 on December 12, 1989. The grant funds specified by the compact are backed by the full faith and credit of the U.S. government.

<sup>4</sup>Unless otherwise noted, all years cited are fiscal years (Oct. 1-Sept. 30). In addition, all dollar amounts in this report are in nominal dollars (i.e., unadjusted for inflation).

<sup>5</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).

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fund's being able to sustain the planned payments through 2044 was uncertain.

The September 2010 agreement between the U.S. and Palau governments (the Agreement) followed a formal review of the compact's terms required 15 years after the compact entered into force.<sup>6</sup> Provisions of the Agreement would, among other things, extend economic assistance to Palau beyond the original 15 years and modify trust fund arrangements. The Agreement establishes an assistance schedule beginning in 2011. There are currently two bills pending before the Congress to approve and implement the Agreement. A bill now pending before the U.S. Senate would approve the Agreement and also appropriate funds to implement it.<sup>7</sup> However, the Senate bill does not reflect the fact that fiscal year 2011 has passed.<sup>8</sup> A bill now pending before the House would approve the agreement, apply an inflation adjustment to assistance payments, and shift the timing of certain assistance payments to reflect the passage of fiscal year 2011.<sup>9</sup>

The Senate Committee on Energy and National Resources held a hearing to review the pending bill on June 16, 2011; the Subcommittee on Asia and the Pacific of the House Committee on Foreign Affairs held a hearing to assess the formal review and proposed Agreement on November 30, 2011. We testified at both hearings and described the terms of the

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<sup>6</sup>Section 432 of the compact provides for the U.S. and Palau governments to formally review the terms of the compact and its related agreements and to consider the overall nature and development of their relationship, on the 15th, 30th, and 40th anniversaries of the compact's effective date. The governments are to consider the operating requirements of the government of Palau and its progress in meeting the development objectives set forth in section 231(a) of the compact. The terms of the compact shall remain in force until otherwise amended or terminated pursuant to title four of the compact.

<sup>7</sup>Senate Bill 343, as introduced in the Senate, amends Title I of Public Law 99-658; approves the results of the 15-year review of the compact, including the Agreement; and appropriates funds for the purposes of the amended Public Law 99-658 for fiscal years ending on or before September 30, 2024, to carry out the agreements resulting from the review. S. 343, 112<sup>th</sup> Cong. (2011).

<sup>8</sup>S. 343, as introduced in the Senate.

<sup>9</sup>House Bill 6040, as introduced in the House, amends Title I of Public Law 99-658; approves the results of the 15-year review of the compact, including the Agreement; shifts the schedule of certain assistance payments; creates an annual reporting requirement for the Department of the Interior; and includes an offset provision. H.R. 6040, 112<sup>th</sup> Cong. (2012).

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Agreement, assessed trust fund balances and disbursement plans under various assumptions and investment returns, and examined single audit reports and budget estimates prepared for the Palau government.<sup>10</sup>

My statement today updates our November 2011 statement.<sup>11</sup> In particular, it describes (1) the extension of economic assistance to Palau as outlined in the Agreement, (2) the impact that this assistance would have on the Palau trust fund's sustainability, (3) the projected role of U.S. assistance in Palau government revenues, and (4) the pending legislation to implement the Agreement. We used recent data from the Palau trust fund to update its sustainability, and we reviewed the bill pending before the House that was introduced in July 2012.<sup>12</sup> In addition, since Congress has not approved legislation implementing the agreement, we note that the Department of the Interior has provided direct economic assistance to Palau. We conducted this work from August and September 2012 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis we conducted, provide a reasonable basis for any findings and conclusions in this product.

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## Background

Palau consists of 8 main islands and more than 250 smaller islands, with a total land area of roughly 190 square miles, located approximately 500 miles southeast of the Philippines. About 20,000 people live in Palau, concentrated largely in one urban center around the city of Koror, and more than one-quarter of the population is non-Palauan.<sup>13</sup> Palau's

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<sup>10</sup>GAO, *Compact of Free Association: Proposed U.S. Assistance to Palau and Its Likely Impact*, [GAO-11-559T](#) (Washington, D.C.: June 16, 2011).

<sup>11</sup>GAO, *Compact of Free Association: Proposed U.S. Assistance to Palau for Fiscal Years 2011-2024*, [GAO-12-249T](#) (Washington, D.C.: Nov. 30, 2011).

<sup>12</sup>H.R. 6040.

<sup>13</sup>Palau's private sector relies heavily on foreign workers, mostly from the Philippines. We reported in 2008 that since 1994, foreign workers, as registered with Palau's Social Security Office, had grown to account for half of Palau's total labor force. Because many of these foreign workers send wage income back to their home nations, in 2005 the annual net outflow of remittances from Palau equaled an estimated 5.5 percent of its gross domestic product (GDP).

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economy is heavily dependent on its tourism sector and on foreign aid from the United States, Japan, and Taiwan.<sup>14</sup> Similar to many small island economies, Palau's public sector spending represents a significant percentage of its gross domestic product (GDP).<sup>15</sup>

U.S. relations with Palau began when American forces liberated the islands near the end of World War II. In 1947, the United Nations assigned the United States administering authority over the Trust Territory of the Pacific Islands, which included what are now the Federated States of Micronesia, the Republic of the Marshall Islands, the Commonwealth of the Northern Mariana Islands, and Palau. Palau adopted its own constitution in 1981. The U.S. and Palau governments concluded a Compact of Free Association in 1986; the compact entered into force on October 1, 1994. 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.

Key provisions of the compact and its subsidiary agreements address the sovereignty of Palau, types and amounts of U.S. assistance, security and defense authorities, and periodic reviews of compact terms. Table 1 summarizes key provisions of the Palau compact and related subsidiary agreements.

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<sup>14</sup>The International Monetary Fund (IMF) projected that in 2010, Palau's GDP was an estimated \$218 million and reported that Palau's GDP per capita was about \$10,500. Business and tourist arrivals were projected to be 78,000 in 2010. See IMF, *Republic of Palau Staff Report for the Article IV Consultation* (Apr. 12, 2010).

<sup>15</sup>According to the IMF, in 2010, Palau's public sector spending was projected at approximately 42 percent of its GDP.

**Table 1: Key Provisions of Palau Compact of Free Association and Subsidiary Agreements**

Compact section	Description of key provisions
Title one: Government Relations	<p><i>Sovereignty</i> Established Palau as a self-governing nation with the capacity to conduct its own foreign affairs.</p> <p><i>Immigration privileges</i> Provided 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. This privilege remains in effect as long as the compact agreement is not amended by mutual agreement or mutually or unilaterally terminated.</p>
Title two: Economic Relations	<p><i>Compact direct assistance</i> Established 15-year term of budgetary support for Palau, beginning on compact's effective date. This support included direct assistance for current account operations and maintenance and for specific needs such as energy production, capital improvement projects, health, and education.</p> <p><i>Trust fund</i> Required the United States to contribute to a trust fund for Palau.</p> <p><i>Compact Road</i> Required the United States to construct a road system (the Compact Road).<sup>a</sup></p> <p><i>Compact federal services</i> Required the United States to make available certain federal services and related programs to Palau, such as postal, weather, and aviation. The compact subsidiary agreement implementing such services was in force until October 1, 2009.<sup>b</sup></p> <p><i>Accountability for compact funds</i> Required Palau to report on its use of compact funds and required the U.S. government, in consultation with Palau, to implement procedures for periodic audits of all grants and other assistance.<sup>c</sup></p>
Title three: Security and Defense Relations	<p><i>U.S. authority for security and defense matters</i> Established that the United States has full authority and responsibility for security and defense matters in or relating to Palau, would take action to meet the danger of an attack on Palau, and may conduct activities on land, water, and airspace as necessary.</p> <p><i>Strategic denial</i> Foreclosed Palau to the military of any nation except the United States, unless they are invited by the United States and under the control of the U. S. armed forces.</p> <p><i>U.S. defense sites and operating rights</i> Established that the United States may establish land and sea defense sites in Palau and has certain military operating rights. The subsidiary agreement implementing this provision provides the United States exclusive use of certain land adjoining the airport and certain submerged land in Malakal Harbor and remains in effect through 2044.</p> <p><i>Service in the armed forces</i> Established eligibility of Palau citizens to serve in the U.S. armed forces. The provisions on U.S. authority for security and defense matters, U.S. defense sites and operating rights, and service in the armed forces remain in effect unless the compact is terminated by mutual agreement or, if the compact is unilaterally terminated, until October 1, 2044, and thereafter as mutually agreed. The strategic denial provision remains in effect through 2044 and thereafter until terminated or otherwise amended by mutual consent.</p>

Compact section	Description of key provisions
Title four: General Provisions	Established general provisions regarding approval and effective date of the compact, conference and dispute resolution procedures, and compact termination procedures. Required reviews of its terms on the 15th, 30th, and 40th anniversaries of the compact's entry into force—that is, in 2009, 2024, and 2034, respectively.

Source: GAO analysis of the Compact of Free Association between the Government of the United States and the Government of the Republic of Palau.

Notes:

The compact's subsidiary agreements relate to specific titles of the compact and, in many cases, contain implementing details of compact provisions.

Years are fiscal (Oct. 1-Sept. 30).

<sup>a</sup>The compact called for the United States to build the Compact Road according to mutually agreed specifications before October 1, 2000. The road was completed and turned over to Palau on October 1, 2007. See [GAO-08-732](#), appendix V, for more information.

<sup>b</sup>Federal Programs and Services Agreement Concluded Pursuant to Article II of Title Two and Section 232 of the Compact of Free Association, which took effect in 1995, established 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. Under this agreement, the United States Postal Service (USPS) conveys mail between the United States and Palau and offers other services such as Priority Mail®, Collect on Delivery, and USPS Domestic Money Orders. Palau maintains its own postal service for internal mail delivery. Under this agreement, the National Weather Service reimburses Palau for the cost of operating its weather station in Palau, which performs upper air observations twice daily and as requested for the purpose of Palau's airport operations and the tracking of cyclones that may impact other U.S. territories such as Guam; and the Federal Aviation Administration provides aviation services to Palau, including en-route air traffic control from the mainland United States, flight inspection of airport navigation aids, and technical assistance and training.

<sup>c</sup>In August 2012, the government of Palau submitted its annual single audit for fiscal year 2010 that was due in June 2011. However, the government of Palau has not yet submitted its annual single audit for fiscal year 2011 that was due in June 2012.

In addition to the U.S. assistance provided under the compact, U.S. agencies—the Department of Education, the Department of Health and Human Services (HHS), and Interior, among others—provide discretionary federal programs in Palau as authorized by U.S. legislation<sup>16</sup> and with appropriations from Congress. (See app. II for a complete listing of these programs in Palau.)

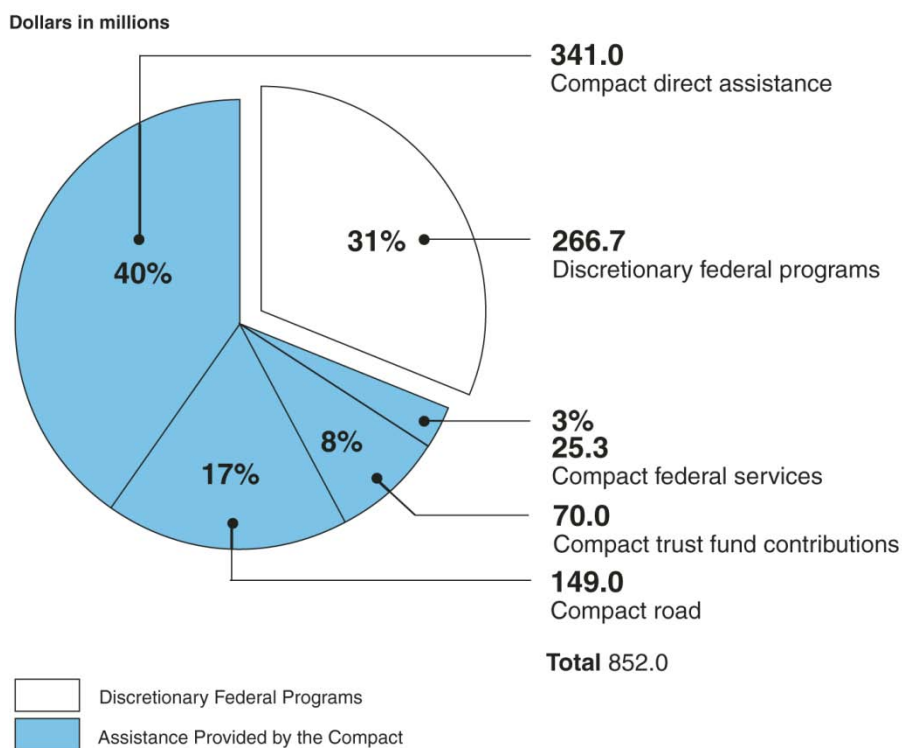
In our 2008 report, we projected that U.S. assistance to Palau from 1995 through 2009 would exceed \$852 million. Of this total, economic assistance under the compact accounts for a projected 68 percent and

<sup>16</sup>The compact's federal programs and services agreement, establishing the legislative framework for the provision of discretionary federal programs in Palau, was in force until October 1, 2009. These services continued under program authority in 2010 and 2011.



discretionary federal programs account for a projected 31 percent (see fig. 1).<sup>17</sup>

**Figure 1: U.S. Assistance to Palau in 1995-2009 as Projected in 2008**



Source: GAO analysis.

**Notes:**

Years are fiscal (Oct. 1-Sept. 30), and dollar amounts are in nominal dollars (i.e., unadjusted for inflation).

Percentages may not sum to 100 because of rounding.

Amounts shown for compact direct assistance, compact trust fund contributions, 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 Interior's budget justification to Congress for 2009.

Amount shown for compact federal services is based on GAO estimates of past expenditures by the National Weather Service, U.S. Postal Service, and Federal Aviation Administration.

<sup>17</sup>[GAO-08-732](#).

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Amount shown for estimated discretionary federal programs is the sum of (1) 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, (2) GAO estimates of U.S. agency program expenditures for 2007-2009, and (3) GAO estimates of DOD Civic Action Team costs for 1995-2009. Estimated and projected federal program expenditures do not include the value of U.S. loans to Palau. For more information, see [GAO-08-732](#).

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## Agreement Would Extend U.S. Assistance for 15 Years, with Annual Decreases

The September 2010 Agreement between the U.S. and Palau governments would extend assistance to Palau to 2024 but steadily reduce the annual amount provided. The Agreement would also extend the authority and framework for U.S. agencies to continue compact federal services and discretionary federal programs.<sup>18</sup>

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## Assistance to Palau Would Decline through 2024

Key provisions of the Agreement would include, among others, extending direct economic assistance to Palau, providing infrastructure project grants and contributions to an infrastructure maintenance fund, establishing a fiscal consolidation fund, and making changes to the trust fund. U.S. assistance to Palau under the Agreement would total approximately \$215 million through 2024.<sup>19</sup>

Legislation implementing the Agreement was not approved by Congress during 2011. Department of the Interior provided \$13.1 million for direct economic assistance in 2011 and again in 2012; however, funds were not provided either year for infrastructure projects, the infrastructure maintenance fund, or the fiscal consolidation fund.

- *Direct economic assistance (\$107.5 million)*. Under the Agreement, the U.S. government would provide direct economic assistance—

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<sup>18</sup>Other provisions in the Agreement would define reporting and auditing requirements and passport requirements. The Agreement would require that, by 2018, Palau resolve all deficiencies identified in annual single audit reports, which are required by the Compact's fiscal procedures agreement, such that no single audit report recommendations or deficiencies dating from before 2016 remain. In addition, the Agreement alters the entry procedures for citizens of Palau visiting the United States, requiring them to present a valid machine-readable passport to travel to the United States.

<sup>19</sup>The compact provided for direct assistance to Palau only through 2009. For 2010 through 2012, Interior provided \$13.1 million for direct assistance to Palau each year. For 2013, Interior's Budget Justification proposed \$34 million in direct assistance, while the Agreement provides for \$25.5 million.

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budgetary support for Palau government operations and specific needs such as administration of justice and public safety, health, and education—amounting to \$13 million in 2011 and declining to \$2 million by 2023.<sup>20</sup> The Agreement also calls for the U.S. and Palau governments to establish a five-member Advisory Group to provide annual recommendations and timelines for economic, financial, and management reforms. The Advisory Group must report on Palau's progress in implementing these or other reforms, prior to annual U.S.-Palau economic consultations.<sup>21</sup> These consultations are to review Palau's progress in achieving reforms<sup>22</sup> such as improvements in fiscal management, reducing the public sector workforce and salaries, reducing government subsidization of utilities, and tax reform. If the U.S. government determines that Palau has not made significant progress in implementing meaningful reforms, direct assistance payments may be delayed until the U.S. government determines that Palau has made sufficient progress.

- *Infrastructure projects (\$40 million)*. Under the Agreement, the U.S. government would provide U.S. infrastructure project grants to Palau for mutually agreed infrastructure projects—\$8 million annually through 2013,<sup>23</sup> \$6 million in 2014, and \$5 million in both 2015 and 2016. The Agreement requires Palau to provide a detailed project budget and certified scope of work for any projects receiving these funds.
- *Infrastructure maintenance fund (\$28 million)*. Under the Agreement, the U.S. government would make contributions to a fund to be used for maintenance of U.S.-financed major capital improvement projects,

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<sup>20</sup>Congress did not pass legislation appropriating funds for this assistance in 2011 and therefore the earliest this assistance can begin is 2012.

<sup>21</sup>The Agreement requires that Palau undertake economic, legislative, financial, and management reforms giving due consideration to those identified by the IMF; the Asian Development Bank; and other creditable institutions, organizations, or professional firms.

<sup>22</sup>The compact requires that the United States and Palau consult annually regarding Palau's economic activities and progress in the previous year, as described in a report that Palau must submit each year. Our 2008 report noted that Palau had met reporting conditions associated with direct assistance but that, contrary to compact requirements, the bilateral economic consultations had not occurred on an annual basis; and had been informal and resulted in no written records. See [GAO-08-732](#).

<sup>23</sup>Under the Agreement, the U.S. government would have provided U.S. infrastructure project grants amounting to \$8 million in 2011; however, Congress did not pass legislation appropriating such funds in 2011.

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including the Compact Road and Airai International Airport.<sup>24</sup> Through 2024,<sup>25</sup> the U.S. government would contribute \$2 million annually, and the Palau government would contribute \$600,000 annually to the fund.<sup>26</sup>

- *Fiscal consolidation fund (\$10 million)*. Under the Agreement, the U.S. government would provide grants of \$5 million each in 2011<sup>27</sup> and 2012, respectively, to help the Palau government reduce its debts. Unless agreed to in writing by the U.S. government, these grants cannot be used to pay any entity owned or controlled by a member of the government or his or her family, or any entity from which a member of the government derives income. U.S. creditors must receive priority, and the government of Palau must report quarterly on the use of the grants until they are expended.
- *Trust fund (\$30.25 million)*. Under the Agreement, the U.S. government would contribute \$30.25 million to the fund from 2013 through 2023. The government of Palau will reduce its previously scheduled withdrawals from the fund by \$89 million.<sup>28</sup> From 2024 through 2044, Palau can withdraw up to \$15 million annually, as originally scheduled. Moneys from the trust fund account cannot be spent on state block grants, operations of the office of the President of Palau, the Olibiil Era Kelulau (Palau National Congress), or the Palau

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<sup>24</sup>In 2008, we reported that Palau and U.S. officials had expressed concerns about Palau's ability to maintain the Compact Road in a condition that would allow for the desired economic development. We also reported that Palau made initial efforts to maintain the road, but at levels that would cause the road to deteriorate over time and would not provide the economic development benefits envisioned for the people of Palau. See [GAO-08-732](#).

<sup>25</sup>The Agreement states that the United States shall provide a grant beginning in 2011. However, Congress did not pass legislation appropriating funds for this purpose in 2011 and therefore the earliest the U.S. contributions can begin is 2012.

<sup>26</sup>Under the compact, Palau owes the United States a total of \$3 million. Under the Agreement, Palau would deposit \$3 million in the infrastructure maintenance fund but not expend it. Any future income derived from the \$3 million must be used exclusively for the maintenance of the Compact Road.

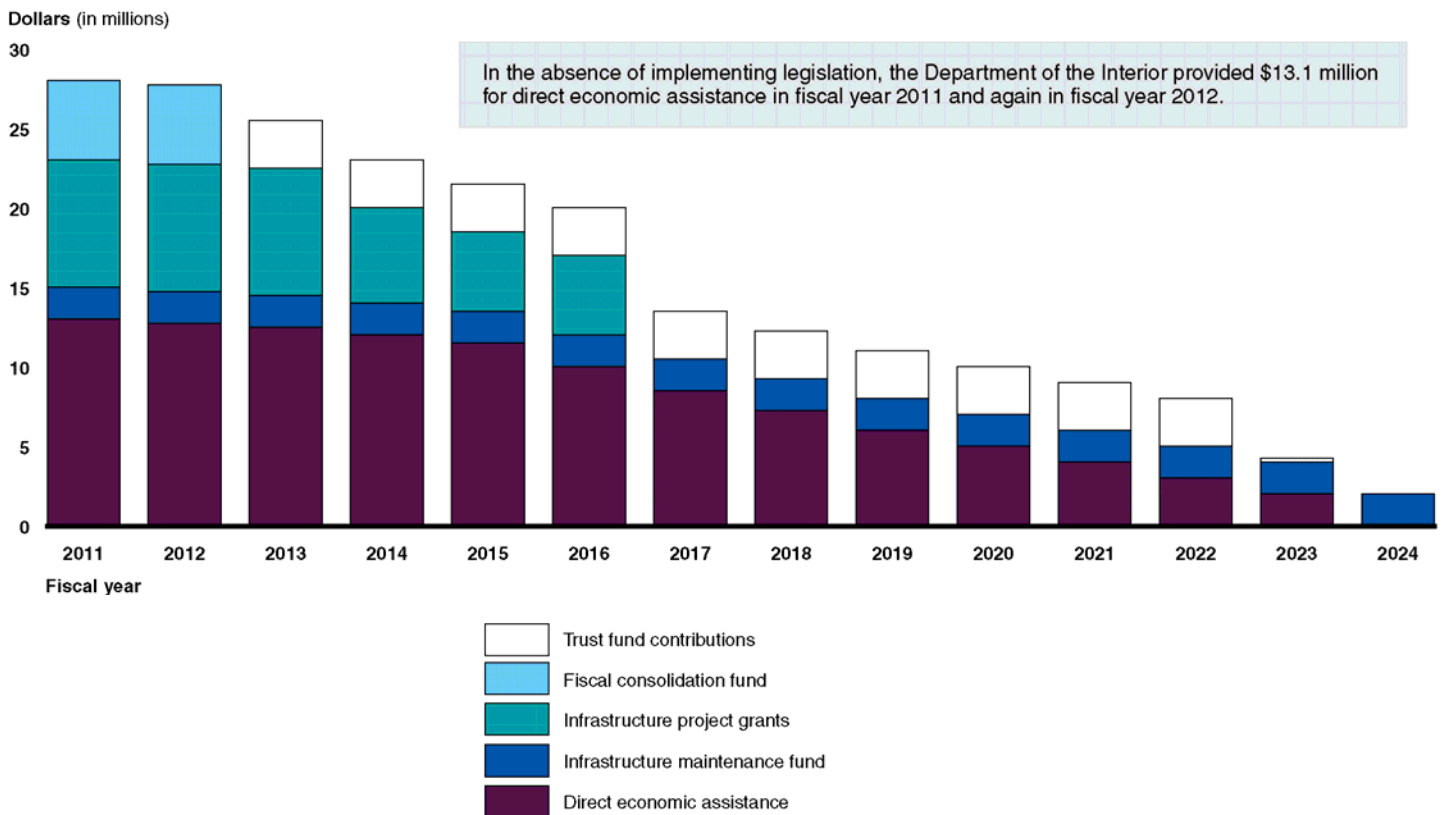
<sup>27</sup>Although the Agreement states that the United States shall provide a grant beginning in 2011, Congress did not pass legislation appropriating funds for this purpose in 2011 and therefore the earliest the U.S. contributions can begin is 2012.

<sup>28</sup>Under the Agreement, Palau would withdraw \$5 million annually through 2013 and gradually increase its maximum withdrawal from \$5.25 million in 2014 to \$13 million in 2023.

Judiciary. Palau must use \$15 million of the combined total of the trust fund disbursements and direct economic assistance exclusively for education, health, and the administration of justice and public safety.

Annual U.S. assistance to Palau under the Agreement would decline from roughly \$28 million in 2011 to \$2 million in 2024. Figure 2 details the timeline and composition of assistance outlined in the Agreement.

**Figure 2: U.S. Assistance to Palau for 2011-2024, as Outlined in the Agreement**



Source: GAO analysis of the Agreement between the Government of the United States of America and the Government of the Republic of Palau Following the Compact of Free Association Section 432 Review, and Department of the Interior Budget Justifications and Performance Information, Fiscal Years 2012 and 2013.

**Notes:**

Years are fiscal (Oct. 1-Sept. 30), and dollar amounts are in nominal dollars (i.e., unadjusted for inflation).

Compact federal services and discretionary federal programs are not included in this analysis.

Funds were not provided in 2011 or 2012 to date for infrastructure projects, the infrastructure maintenance fund, or the fiscal consolidation fund.

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Agreement Would Continue Compact Federal Services and Extend Framework for Discretionary Federal Programs

The Agreement would extend the authority for the provision of compact federal services and discretionary programs in Palau.

- *Federal services.* The Agreement would amend the compact's subsidiary agreements regarding federal services. Specifically, the Agreement amends the terms of postal, weather, and aviation services to Palau.
- *Federal discretionary programs.* The Agreement would extend the framework for U.S. agencies to provide discretionary federal programs to Palau, with implementation of the programs contingent on annual appropriations to those agencies.

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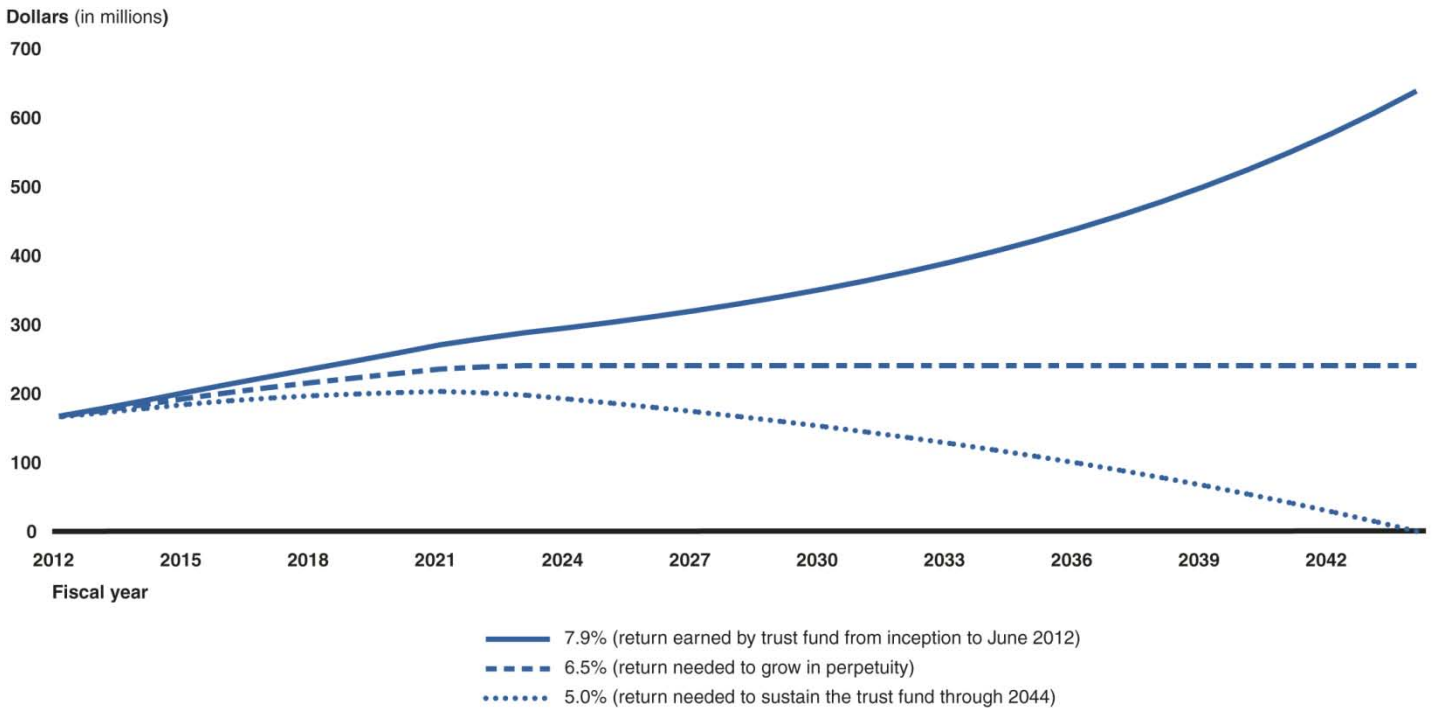
Agreement's Provisions Would Significantly Improve Prospects for Palau Trust Fund

The addition of \$30.25 million in U.S. contributions and the delay of \$89 million in Palau withdrawals through 2023, as provided by the Agreement, would improve the fund's prospects for sustaining scheduled payments through 2044. At the end of June 2012, the fund had a balance of approximately \$163 million. The trust fund would need a 5.0 percent annual return to yield the proposed withdrawals from 2011 through 2044 under the Agreement. This rate is well below the 7.9 percent return that the fund earned from its inception to June 30, 2012.<sup>29</sup> Figure 3 shows projected trust fund balances in 2012 through 2044 under the Agreement, with varying rates of return.

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<sup>29</sup>All rates of return on the trust fund are net of fees and commissions unless otherwise noted.

**Figure 3: Projected Palau Trust Fund Balance under the Agreement, with Varying Rates of Return, 2012-2044**



Source: GAO analysis.

**Notes:**

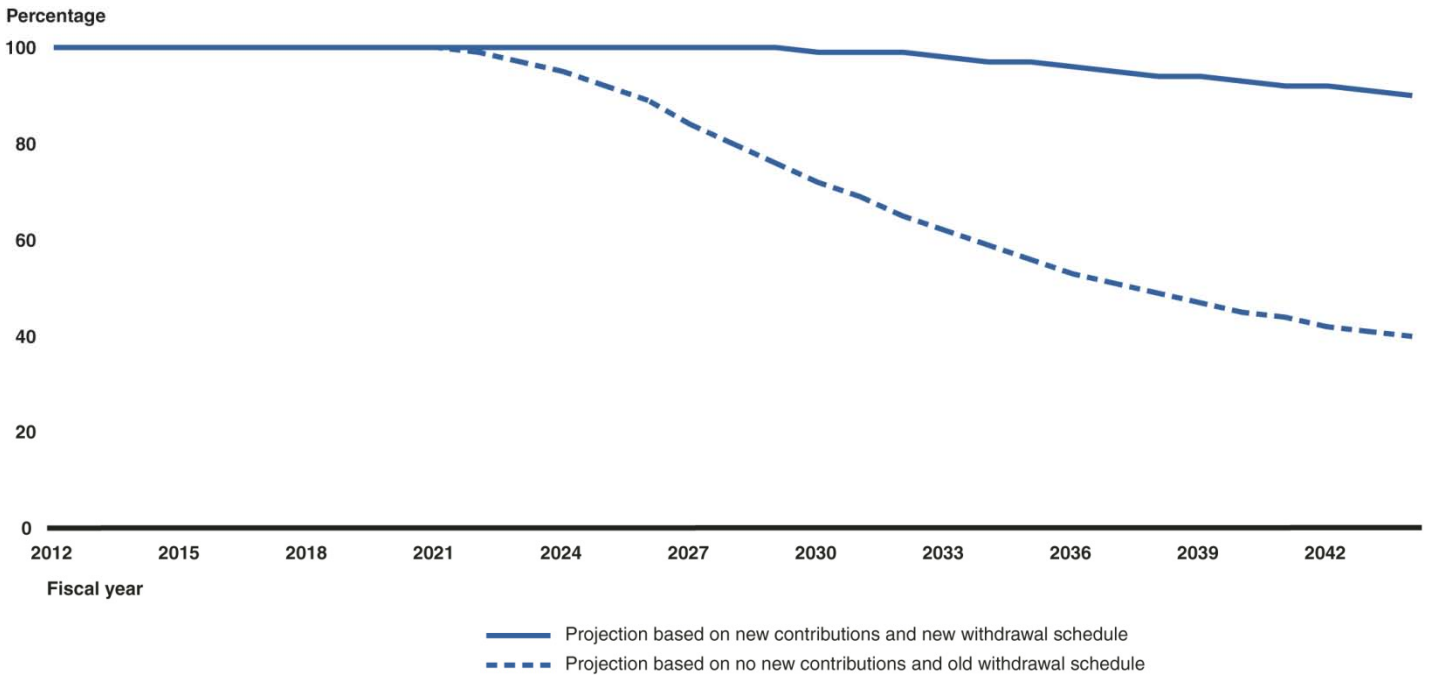
Years are fiscal (Oct. 1-Sept. 30), and dollar amounts are in nominal dollars (i.e., unadjusted for inflation).

The analysis shown is based on the fund's balance as of September 30, 2011, and assumes that the Agreement's provisions related to the trust fund—including additional U.S. contributions and reduced Palau withdrawals through 2023—are approved.

The additional contributions and reduced withdrawals scheduled in the Agreement would also make the trust fund a more reliable source of revenue under conditions of market volatility. With these changes, the trust fund would have an approximately 90 percent probability of sustaining payments through 2044. In comparison, the fund has a 40 percent probability of sustaining the \$15 million annual withdrawals scheduled under the compact through 2044.

Figure 4 compares the probability that the trust fund will sustain the proposed withdrawals under the terms outlined in the Agreement with the probability that the trust fund will sustain the withdrawals scheduled under the compact.

**Figure 4: Probability That Palau Trust Fund Will Sustain Scheduled Withdrawals under Two Scenarios**



Source: GAO analysis.

**Notes:**

Years are fiscal (Oct. 1-Sept. 30), and dollar amounts are in nominal dollars (i.e., unadjusted for inflation).

This figure depicts results from 10,000 trial runs. For each run, the returns of each asset class are randomly drawn from a distribution based on the historical returns. The account balances and the withdrawal amount from the trust fund are then calculated based on the returns and the withdrawal schedule. The probability of the trust fund's being able to disburse the scheduled amount is then generated from a distribution of 10,000 disbursements each year.

The figure's upper line shows the probability that the trust fund will sustain scheduled withdrawals under the Agreement's provisions of (1) annual U.S. contributions of \$3 million from 2013 through 2022 and \$250,000 in 2023 and (2) annual Palau withdrawals of \$5 million in 2011, gradually increasing to \$13 million in 2023, and \$15 million from 2024 through 2044. The figure's lower line shows the probability that the trust fund will sustain scheduled payments under the compact's provision of \$15 million annual withdrawals through 2044.



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## Estimates Prepared for Palau Project Declining Reliance on U.S. Assistance under the Agreement

Estimates prepared for the government of Palau project that Palau's reliance on U.S. assistance provided under the Agreement will decline, while its reliance on trust fund withdrawals and domestic revenue will increase.<sup>30</sup> These estimates show U.S. assistance, as provided under the Agreement, declining from 28 percent of government revenue in 2011 to less than 2 percent of government revenue in 2024. The estimates also show Palau's trust fund withdrawals growing from 5 percent of government revenue in 2011 to 12 percent in 2024. In addition, the estimates indicate that Palau's domestic revenue will rise from 40 percent of all government revenue in 2011 to 59 percent in 2024.<sup>31</sup> Finally, the estimates prepared for Palau project a relatively steady reliance on U.S. discretionary federal programs, ranging from 12 percent of all government revenue in 2011 to 14 percent in 2024. The estimates assume that discretionary federal programs will grow at the rate of inflation; however, discretionary programs are subject to annual appropriations and may not increase over time.

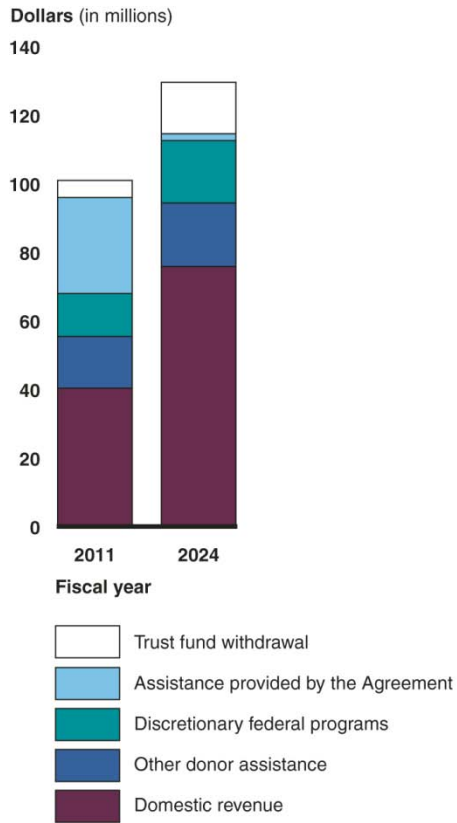
Figure 5 shows the types and amounts of Palau's estimated revenues for 2011 and 2024.

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<sup>30</sup>The government of Palau provided fiscal projections through 2024 to the Senate Committee on Energy and Natural Resources in January 2011. The estimates were prepared by an independent economist retained by the government of Palau.

<sup>31</sup>In March 2011, the IMF reported that Palau government revenues as a percentage of GDP are below average for island nations in the Pacific. The report cited opportunities for increased tax revenues by eliminating the gross revenue tax, replacing it with a corporate income tax, introducing a Value Added Tax, and increasing the level of taxation on high earners. The IMF also noted that Palau could reform its civil service to decrease wage expenditures. IMF, "Staff Visit to Republic of Palau—Concluding Statement of the IMF Mission" (Mar. 8, 2011).

**Figure 5: Estimated Palau Government Revenues for 2011 and 2024**



Source: GAO analysis and estimates prepared for the Government of Palau.

**Notes:**

Years are fiscal (Oct. 1-Sept. 30), and dollar amounts are in nominal dollars (i.e., unadjusted for inflation).

The years shown were chosen to illustrate the trend in Palau’s revenues from 2011, when the terms proposed by the Agreement would begin, through 2024, when assistance provided by the Agreement would expire.

Federal services were not included in the estimates prepared for Palau.

“Trust fund withdrawal” includes the maximum withdrawal for 2011 and 2024 as specified in the Agreement.

“Assistance provided by the Agreement” includes all funding specified in the Agreement.

“Discretionary federal programs” includes estimates prepared for the government of Palau for program funding and grants from U.S. agencies in 2011 and 2024.

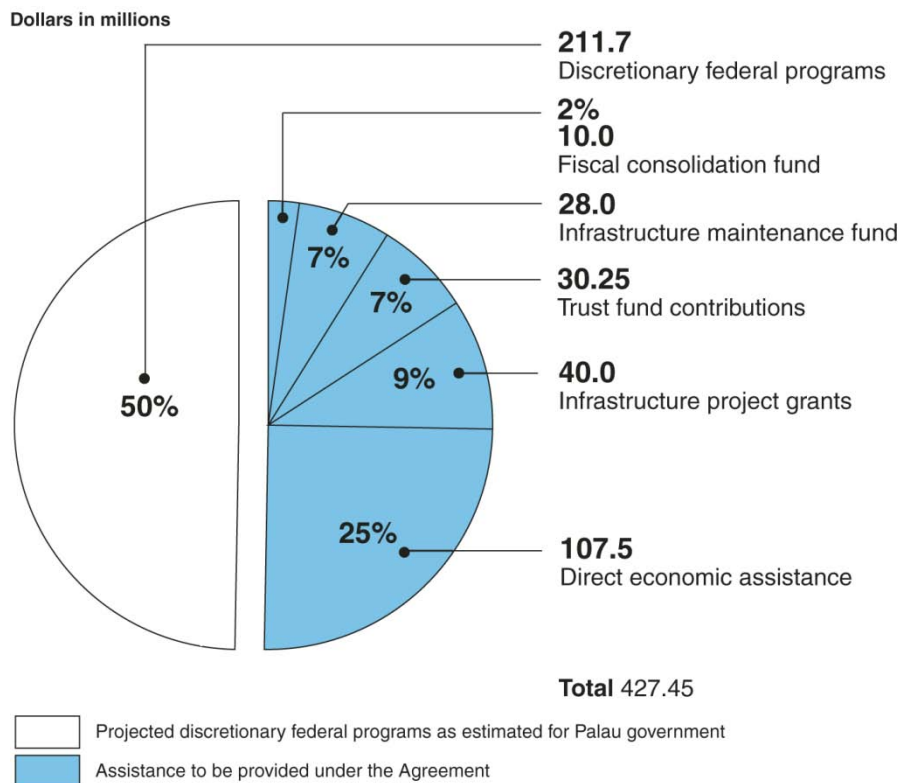
“Other donor assistance” includes estimates for assistance from other foreign donors for 2011 and 2024.

“Domestic revenue” includes estimates of taxes and fees to be collected by the Palau government in 2011 and 2024.

## Estimates Prepared for Palau Project Discretionary Program Funding as Half of U.S. Assistance

The estimates prepared for the government of Palau project that U.S. assistance to Palau from 2011 through 2024, including discretionary federal programs, will total approximately \$427 million. The estimates further project that discretionary programs will account for nearly half of U.S. assistance through 2024, with assistance amounts specified in the Agreement accounting for the other half. (See fig. 6.) In contrast, in 2008, we estimated discretionary program funding accounted for less than one-third of total U.S. assistance to Palau from 1995 through 2009.

**Figure 6: U.S. Assistance to Palau in 2011-2024 as Estimated for Palau and as Provided under the Agreement**



Source: GAO analysis of the Agreement between the Government of the United States of America and the Government of the Republic of Palau Following the Compact of Free Association Section 432 Review, estimates prepared for the Government of Palau.

**Notes:**

Years are fiscal (Oct. 1-Sept. 30), and dollar amounts are in nominal dollars (i.e., unadjusted for inflation).

The analysis depicted is based on the estimates prepared for the government of Palau and on the Agreement's provisions. This analysis does not include federal services, which are not addressed in the estimate prepared for Palau and generally are not specified in the Agreement.

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"Discretionary federal programs" includes all funds appropriated to federal agencies for assistance to Palau. The discretionary federal program estimates prepared for the government of Palau include annual adjustments for inflation, but not for population growth, from 2009 through 2024. Although the Agreement does not specify funding for discretionary federal programs, it extends authority for U.S. agencies to provide them in Palau subject to annual appropriations.

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## Pending Legislation Would Approve and Implement the Agreement

Legislation has been introduced in both the Senate and the House that would approve and implement the September 2010 agreement between the U.S. and Palau governments.

In February 2011, a bill was introduced in the Senate that would implement the Agreement, as written.<sup>32</sup> The Senate bill would authorize and appropriate funds to Interior for specified assistance. The Senate bill would also extend the authority, and authorize appropriations, for the provision of compact federal services in Palau. However, the proposed legislation does not appropriate funds for compact federal services. As of September 2012, the Senate has not acted on this bill.

In June 2012, a bill was introduced in the House that would approve and implement the Agreement, with some modifications.<sup>33</sup> Specifically, the pending House bill:

- Shifts the timing of the provision of some specified Agreement assistance to account for the fact that fiscal year 2011 has passed.
- Extends the full faith and credit provision of the compact<sup>34</sup> to the U.S. commitments of assistance under the Agreement for direct economic assistance, the trust fund, the infrastructure maintenance fund, the fiscal consolidation fund, and infrastructure projects.
- Applies an inflation adjustment to the Agreement assistance for direct economic assistance and infrastructure project grants, and payments

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<sup>32</sup>S. 343.

<sup>33</sup>H.R. 6040.

<sup>34</sup>Pursuant to this compact provision, should the United States fail to provide a payment covered by the pledge, Palau would be able to seek relief in the U.S. Claims Court or its successor court.

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to the trust fund, infrastructure maintenance fund, and fiscal consolidation fund.<sup>35</sup>

- Extends a pledge of the full faith and credit of the United States for the full payment of the amounts necessary to conduct the audits of the assistance provided, as called for under the Agreement.<sup>36</sup>

In addition, the Senate and House bills implementing the Agreement would amend the sections of the Agreement that extend the authority for the provision of compact federal services and discretionary programs in Palau. The proposed Senate and House legislation would authorize annual appropriations for weather and aviation services.<sup>37</sup> The proposed Senate and House legislation would extend the eligibility of the people, government, and institutions of Palau for certain discretionary programs, including special education and Pell grants.<sup>38</sup> However, the proposed bills differ in how they would authorize appropriations to subsidize postal service to Palau, the Republic of the Marshall Islands, and the Federated States of Micronesia. The Senate legislation would have authorized appropriations of \$1.5 million to Interior for 2011 through 2024, to subsidize postal services provided by the U.S. Postal Service.<sup>39</sup> The proposed House legislation would authorize appropriations of \$1.5 million to Interior beginning in 2012 and through 2024, to subsidize postal services. Under the proposed House bill, Interior would be authorized to transfer these funds to the U.S. Postal Service under the condition that domestic postage may be used for mail to these countries.<sup>40</sup>

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<sup>35</sup>Adjusting direct economic assistance, infrastructure project grants, and payments to the trust fund, infrastructure maintenance fund, and fiscal consolidation fund for inflation would increase the value of U.S. assistance to Palau. Our analysis shows that adjusting for inflation and reducing fiscal consolidation fund as outlined in H.R. 6040, the value of U.S. contributions would increase approximately \$12 million.

<sup>36</sup>Under the Agreement, the government of Palau is to bear the cost of these audits. According to an Interior official, the cost of the audits is approximately \$500,000 per year.

<sup>37</sup>S. 343 as introduced in the Senate and H.R. 6040 as introduced in the House.

<sup>38</sup>*Ibid.*

<sup>39</sup>S. 343.

<sup>40</sup>H.R. 6040.

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Chairman Fleming, Ranking Member Sablan, and Members of the Subcommittee, this completes my prepared statement. I would be happy to respond to any questions you may have at this time.

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## GAO Contact and Staff Acknowledgments

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.

Emil Friberg (Assistant Director), Ming Chen, David Dayton, Brian Hackney, Reid Lowe, Grace Lui, and Valérie L. Nowak made key contributions to this statement. Robert Alarapon, Benjamin Bolitzer, Rhonda Horried, Farahnaaz Khakoo, Jeremy Sebest, Cynthia Taylor, and Anu Mittal provided technical assistance.

# Appendix I: U.S. Assistance to Palau Provided Under the Compact and Outlined in the Agreement

Table 2 shows the assistance provided to Palau under the compact from 1995 through 2009. Table 3 shows the proposed assistance to Palau for 2011 through 2024, as outlined in the Agreement.

**Table 2: Compact Assistance Provided to Palau in 1995-2009**

Dollars in millions																
Types of assistance	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Total
Direct assistance	\$126.5	\$23.5	\$22.4	\$21.2	\$13.6	\$13.6	\$13.8	\$13.9	\$14.1	\$14.1	\$12.7	\$12.8	\$12.9	\$13.0	\$13.1	<b>\$341.1</b>
Infrastructure	53.0	0	96.0	0	0	0	0	0	0	0	0	0	0	0	0	<b>149.0</b>
Trust fund contributions	66.0	0	4.0	0	0	0	0	0	0	0	0	0	0	0	0	<b>70.0</b>
<b>Total</b>	<b>\$245.5</b>	<b>\$23.5</b>	<b>\$122.4</b>	<b>\$21.2</b>	<b>\$13.6</b>	<b>\$13.6</b>	<b>\$13.8</b>	<b>\$13.9</b>	<b>\$14.1</b>	<b>\$14.1</b>	<b>\$12.7</b>	<b>\$12.8</b>	<b>\$12.9</b>	<b>\$13.0</b>	<b>\$13.1</b>	<b>\$560.1</b>

Source: GAO analysis of the Interior OIA Budget Justifications and Performance Information fiscal year 2012.

Note: Years are fiscal (Oct. 1-Sept. 30), and dollar amounts are in nominal dollars (i.e., unadjusted for inflation).

**Table 3: Proposed Assistance to Palau as Outlined in the Agreement**

Dollars in millions																
Types of assistance	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Total	
Trust fund contributions	\$0	\$0	\$3.00	\$3.00	\$3.00	\$3.00	\$3.00	\$3.00	\$3.00	\$3.00	\$3.00	\$3.00	\$0.25	\$0	\$30.25	
Infrastructure maintenance fund	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	28.00	
Infrastructure project grants	8.00	8.00	8.00	6.00	5.00	5.00	0	0	0	0	0	0	0	0	40.00	
Fiscal consolidation fund	5.00	5.00	0	0	0	0	0	0	0	0	0	0	0	0	10.00	
Direct economic assistance	13.00	12.75	12.50	12.00	11.50	10.00	8.50	7.25	6.00	5.00	4.00	3.00	2.00	0	107.50	
<b>Total</b>	<b>\$28.00</b>	<b>\$27.75</b>	<b>\$25.50</b>	<b>\$23.00</b>	<b>\$21.50</b>	<b>\$20.00</b>	<b>\$13.50</b>	<b>\$12.25</b>	<b>\$11.00</b>	<b>\$10.00</b>	<b>\$9.00</b>	<b>\$8.00</b>	<b>\$4.25</b>	<b>\$2.00</b>	<b>\$215.75</b>	

Source: GAO analysis of the Agreement between the U.S. government and the government of the Republic of Palau following the Compact of Free Association Section 432 review.

Note: Years are fiscal (Oct. 1-Sept. 30), and dollar amounts are in nominal dollars (i.e., unadjusted for inflation).

# Appendix II: U.S. Discretionary Program Funds Expended in 2009

Table 4 lists discretionary U.S. federal program funds expended by the Palau national government, the Palau Community College, and the Palau Community Action Agency, as reported in the organizations' single audit reports for 2009.

**Table 4: U.S. Federal Program Expenditure in Palau as Reported in 2009 Single Audit Reports**

U.S. agency	Federal program	2009 expenditure
Agriculture	Cooperative Forestry Assistance	\$155,422
Agriculture	Community Facilities Loans and Grants	124,745
Agriculture	Unknown	1,604
Commerce	Special Oceanic and Atmospheric Projects	306,485
Commerce	Unallied Management Projects	1
Education	Pell Grant	2,250,348
Education	Freely Associated States-Education Grant Program	1,309,324
Education	Special Education-Grants to States	859,119
Education	Upward Bound Program	315,164
Education	Talent Search	204,406
Education	Upward Bound Math and Science	198,998
Education	Gaining Early Awareness and Readiness for Undergraduate Programs	198,205
Education	Student Support Services Program	189,771
Education	Special Education-Grants to States	122,755
Education	Federal Work-Study	109,923
Education	Academic Competitiveness Grant	78,346
Education	Supplemental Educational Opportunity Grant	52,600
Education	Byrd Honors Scholarships	46,500
Education	Adult Education-State Grant Program	29,038
HHS	Head Start	1,670,508
HHS	CDC and Prevention-Investigations & Technical Assistance	976,068
HHS	Consolidated Health Centers	564,525
HHS	Substance Abuse and Mental Health Services-Projects of Regional and National Significance	431,171
HHS	National Bioterrorism Hospital Preparedness Program	387,003
HHS	Public Health Emergency Preparedness	343,717
HHS	Epidemiologic Research Studies of AIDS and HIV Infection in Selected Population Groups	260,367
HHS	Material and Child Health Federal Consolidated Programs	201,257
HHS	Family Planning-Services	171,235
HHS	Maternal and Child Health Services Block Grant to the States	149,718



**Appendix II: U.S. Discretionary Program Funds  
Expended in 2009**

<b>U.S. agency</b>	<b>Federal program</b>	<b>2009 expenditure</b>
HHS	Project Grants and Cooperative Agreements for Tuberculosis Control Programs	116,313
HHS	Immunization Grants	113,372
HHS	Block Grants for Prevention and Treatment of Substance Abuse	111,340
HHS	Universal Newborn Hearing Screening	95,591
HHS	DEH-PHCI	72,266
HHS	Cooperative Agreements to Support Comprehensive School Health Programs to Prevent the Spread of HIV and Other Important Health Problems	67,785
HHS	Basic/Core Area Health and Education Center	62,506
HHS	Block Grants for Community Mental Health Services	58,245
HHS	Consolidated Knowledge Development and Application (KD&A) Program	55,430
HHS	Preventive Health Services - STD Control Grants	48,079
HHS	Cooperative Agreements for State-Based Diabetes Control Programs and Evaluation and Surveillance Systems	44,845
HHS	HIV Care Grants	38,249
HHS	ARRA-Grants to Health Center Programs	20,990
HHS	HIV/Aids Surveillance	19,372
HHS	Preventive Health and Health Services Block Grant	17,375
HHS	Drug Free Communities Support Program Grants	12,759
HHS	Civil Rights and Privacy Rule Compliance Activities	12,620
Interior	Social, Economic and Political Development of the Territories	628,346
Interior	Historical Preservation-Grants in Aid	254,436
Justice	Juvenile Justice and Delinquency Prevention-Allocation to States	1
Labor	ARRA WIA Dislocated Workers Program	128,027
Labor	WIA Dislocated Workers Program	118,574
Labor	ARRA WIA Youth Activities	81,112
Labor	WIA Adult Program	63,241
Labor	WIA Youth Activities	62,637
Labor	ARRA WIA Adult Program	49,162
Transportation	Airport Improvement Program	\$4,309,960
<b>Total</b>		<b>\$18,370,956</b>

Source: GAO analysis of Republic of Palau National Government Independent Auditor's Reports on Internal Control and on Compliance Year Ended September 30, 2009; Palau Community College Comprehensive Annual Financial Report Fiscal Year Ended September 30, 2009; and Palau Community Action Agency Report on the Audit of Financial Statements in Accordance with OMB Circular A-133 Year Ended September 30, 2009.

Notes:

Year is fiscal (Oct. 1-Sept. 30), and dollar amounts are in nominal dollars (i.e., unadjusted for inflation).

HHS = Department of Health and Human Services.

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