



TECHNICAL ASSISTANCE REPORT

REPUBLIC OF PALAU

Managing Government Employment and
Compensation

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Fiscal Affairs Department

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Abbreviations and Acronyms

CEO	Chief Executive Officer
COLA	Cost-of-living adjustment
ECC	Employment and Compensation Committee
FAD	Fiscal Affairs Department
FAS	Freely Associated States
FY	Fiscal Year
GDP	Gross Domestic Product
IMF	International Monetary Fund
MHRCTD	Ministry of Human Resources, Culture, Tourism, and Development
MOF	Ministry of Finance
ODI	Overseas Development Institute
PICs	Pacific Island Countries
PGST	Palau Goods and Services Tax
WAP	Working-Age Population

Preface

At the request of the Minister of Finance of the Republic of Palau, a capacity development mission from the International Monetary Fund's Fiscal Affairs Department (FAD) visited Koror and Ngerulmud during the period November 9-22, 2023. The mission included Sébastien Walker (mission chief), Carolina Bloch, Céline Thévenot (all FAD), and Christopher Bender (FAD expert). The purpose of the mission was to review the levels and composition of government compensation and employment and provide policy options to ensure adequate and sustainable compensation spending.

The mission had fruitful discussions with President of the Republic of Palau Surangel S. Whipps, Jr. and his Chief of Staff Landisang Kotaro; Minister of Finance Kaleb Udui, Jr.; Minister of Human Resources, Culture, Tourism, and Development Ngiraibelas Tmetuchl; Minister of Health and Human Services Gaafar J. Uherbelau; Minister of Education Dr. Dale Jenkins; Koror State Government Finance Director Deanna Tmekei; Palau Community College President Patrick U. Tellei; and their staff, notably Ministry of Finance Executive Coordinator and Focal Point Désirée Ngirameked.

The mission also held productive meetings with Australian Ambassador Richelle Turner; Japanese Ambassador Extraordinary and Plenipotentiary Hiroyuki Oriyasa; US Embassy Political-Economic Officer Nar Dao; Asian Development Bank (ADB) Senior Country Representative Alfonsa Koshiba; United Nations Country Coordination Specialist Sharon Sakuma; and Mark Sturton (Graduate School USA).

The mission wishes to express its appreciation for the excellent collaboration and the hospitality provided by officials and staff of the above institutions and to recognize Désirée Ngirameked and Sherry Tadao (Ministry of Finance) for their outstanding logistical support. The mission gratefully acknowledges support from ADB staff Alfonsa Koshiba and Zoe Kintaro for hosting certain meetings. The mission is also thankful for the research assistance provided by Nusrat Chowdhury and Mengfei Gu and administrative assistance provided by Daine Hale and Yara Vásquez (all FAD).

Executive Summary

Palau is struggling to recruit and retain qualified staff to provide essential public services.

Significant net emigration (mainly to the US) and shortages of critical staff are impeding Palau's ability to secure adequate qualified staff for public service provision. As one of the smallest countries in the world, Palau has large staffing needs relative to the size of its population due to diseconomies of scale. Its compensation spending-to-GDP ratio has been trending mostly upward since Fiscal Year (FY) 2015, largely due to negative nominal GDP growth.

High inflation has eroded government employees' compensation. Recent inflation rate was significantly higher than that of comparators, adding to the already high pre-pandemic cost of living. Palauan authorities have responded to the increase in inflation by raising government employees' hourly wages by 75 cents across the board in FY2023 and FY2024.

Government compensation has become increasingly compressed over time, which has exacerbated difficulties in recruiting and retaining skilled workers. The practice of giving across-the-board fixed dollar increases in pay has contributed to pay compression. Palau now has one of the most compressed pay scales in the world. The mission identified the health and education sectors as facing notable staffing difficulties, while pay levels for nurses and teachers compare especially unfavorably with those in the US.

The mission's baseline projection suggests an opportunity to increase pay levels in a targeted way to support staffing objectives. Under the assumptions of a fixed government headcount and average pay rises in line with inflation, the mission's baseline projection envisages a declining compensation spending-to-GDP ratio (Figure). This trend is mainly driven by expectations of a strong economic rebound from the pandemic. These savings would largely be reversed in a "minimum wage" scenario, however, whereby all government employees receive a \$0.50 per hour increase in FY2026, FY2027, and FY2028, similarly to recent practice. However, the mission's baseline projection suggests an opportunity to increase pay levels in a more targeted way to support staffing objectives while holding compensation spending stable as a share of GDP. Pay levels could be increased further if the size of the government workforce were reduced through attrition which would also create fiscal space for the hiring of additional skilled workers.

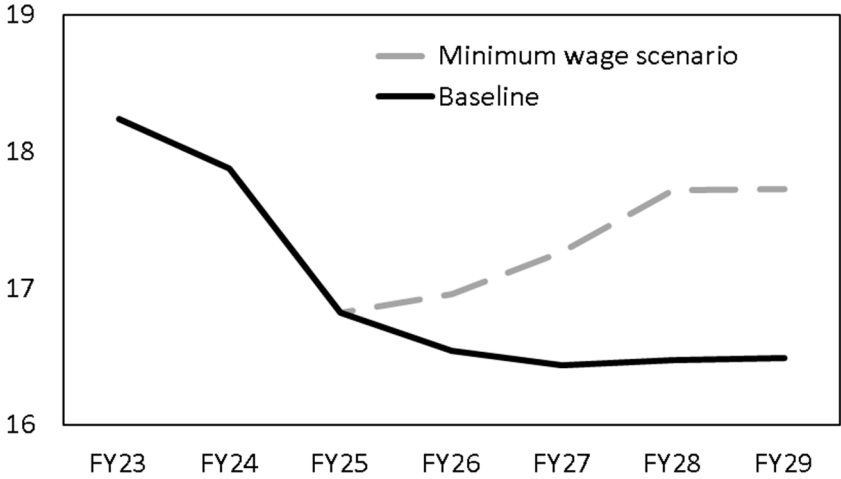
Pay increases should be awarded on a percentage basis to preclude further pay compression, be better targeted to support staffing objectives, and be conditioned on fiscal space. Differential increases should be targeted at those positions presenting the starkest recruitment and retention challenges. The two best options available to achieve this are: (i) differentiated percentage increases, with higher increases applied to higher pay grades, and, for some positions, (ii) job reclassification, whereby positions are reassigned to a higher grade in the pay scale.

Innovative approaches could also help support the more efficient delivery of public services. The authorities could consider merging some functions of the state governments under the national government, especially where there is functional duplication or overlaps. Such mergers would enable the national government to exploit the limited economies of scale available for public service provision in

Palau. Facilitating the recruitment of foreign workers into government service could expand the labor pool from which the government can recruit.¹ Some of the above-mentioned reforms could be implemented through regulatory changes, while others would require legislation; for instance, mobility protocols could be created to facilitate personnel movements between state and national governments. The resulting enhancements in public services could help to break the vicious circle between emigration and public service delivery challenges. In addition, risk-pooling mechanisms could partly address the cost of complying with traditional customary obligations, which has been identified as an important driver of emigration, including for government employees.²

The recent establishment of the Employment and Compensation Committee (ECC) is a notable achievement and an essential first step. Its primary role is to formulate a medium-term strategy on behalf of the government for employment and compensation to secure adequate staffing for public services in an efficient and fiscally sustainable manner. The recommendations in this report will inform such a strategy. A medium-term strategy is essential because it enables policy changes to be shaped by year-to-year resource availability, thereby ensuring fiscal flexibility, which is especially important in smaller economies which are by nature highly vulnerable to exogenous shocks. A medium-term strategy allows policy changes to be made incrementally in response to experience and enables employment levels to be reduced (where needed) through attrition rather than retrenchment.

Figure. Compensation Spending (Percent of GDP)



Source: IMF staff estimates.

Notes: The minimum wage scenario assumes wages for all national government workers are increased by \$0.50 per hour in FY2026, FY2027, and FY2028, mirroring the impact on pay resulting from the increases enacted in FY2023 and FY2024.

¹ Citizens of the Marshall Islands and the Federated States of Micronesia do not need work permits under existing rules.

² These notably involve an expectation of substantial monetary contributions by those attending funerals.

Main recommendations

Develop a medium-term strategy for Palau's government human resources needs		
1.1	Determine a work plan for the ECC drawing on this report.	Short term
1.2	Take stock of essential skills in short supply in the government workforce.	Short term
1.3	Conduct pilot functional reviews of priority ministries to detect functional overlaps, prioritize essential government services, and right-size the workforce.	Short term
1.4	Define a medium-term path for targeted pay increases to support recruitment and retention of skilled workers.	Short term
1.5	Conduct functional reviews of the remaining ministries.	Medium term
Harness economies of scale and improve the efficiency of the government sector		
2.1	Document occupations and functions of state governments' workforce.	Short term
2.2	Consider merging some state functions into national government (e.g., park policing, road maintenance, trash collection, or vehicle registration).	Medium term
Strengthen human resources management		
3.1	Systematically and prominently advertise vacancies online.	Short term
3.2	Harmonize employment and compensation policies across workers, notably Palauan and foreign workers.	Short term
3.3	Review processes followed by the Bureau of Human Resources to eliminate unnecessary steps.	Short term
3.4	Develop human resource management training programs for new ministers and supervisory staff; reinforce managerial skills of middle managers.	Short term
3.5	Review enabling human resource laws and regulations to ensure that they are written to meet human resource needs.	Short term
Expand the pool of potential hires		
4.1	Recruit foreign workers into government service through fellowship or other programs for young professionals such as the Overseas Development Institute fellowship, Teach for America, and the Peace Corps.	Short term
4.2	Encourage younger Palauans to enter government service through internships and apprenticeship programs.	Medium term
4.3	Expand opportunities for higher education with in-country programs designed to support the government's human resource needs.	Medium term
4.4	Gradually raise the retirement age for government employees.	Medium term

Note: "Short term" is understood to mean within 1-2 years and "medium term" is understood to mean within 3-5 years.

I. Introduction

1. The authorities of Palau are concerned about emigration and its impact on government staffing. The authorities are concerned that low pay and the high cost of living are hindering the recruitment and the retention of essential personnel. The Compact of Free Association with the United States presents challenges in this regard because Palauan citizens are eligible to live, work, and study in the US.³ The factors behind sustained emigration include the sizeable differential in pay between Palau and the US, a rising cost of living, the limited supply of housing, the high cost of compliance with traditional cultural practices, and limited access to healthcare and educational opportunities within the country. For instance, the Palau Community College offers two-year associate degrees, as well as other degrees through distance learning in partnership with certain US and Japanese universities, but there is no full university in Palau. There also appears to have been a “catching-up” effect as pandemic-related travel restrictions were lifted. Once they have emigrated, few Palauans return. While many countries benefit from remittances from their diaspora, Palau reportedly does not. The outflows of Palauans are shrinking the pool of workers from which the government can hire to provide public services.

2. The authorities are committed to advancing reforms with respect to government employment and compensation policies. The Employment and Compensation Committee (ECC) was created by a Presidential Directive signed on November 8, 2023. The creation of the ECC was a central recommendation made by the FAD scoping mission which visited Palau in July 2023 and lays the foundation for the development of a comprehensive medium-term strategy. The authorities plan to complete the first two stages (out of three) of their study into compensation by December 2024.

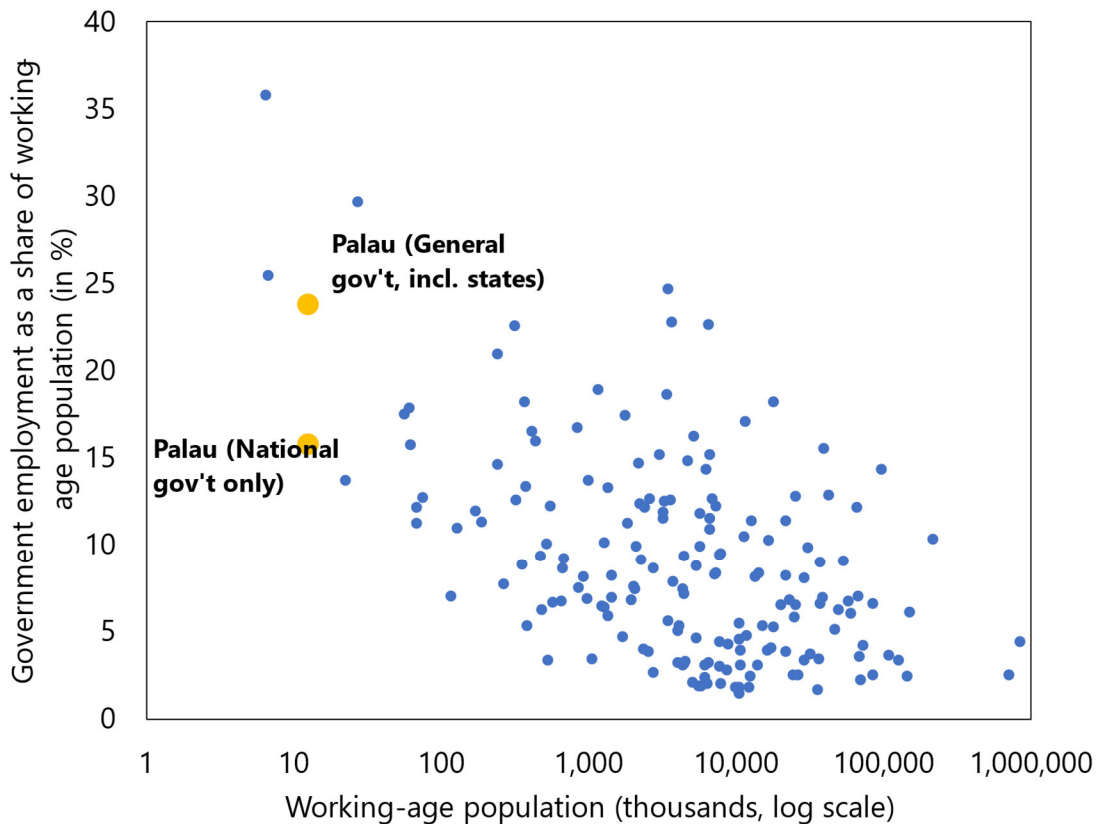
3. This report reviews government compensation and employment and provides options to support adequate staffing for public services in an efficient and sustainable manner. Section II reviews recent trends and developments with respect to employment and compensation. Section III analyzes salient issues in the employment and compensation frameworks which present challenges for recruitment and retention. Section IV summarizes options for reform, estimates their fiscal impact, and makes recommendations for structural reforms.

³ Palau, the Marshall Islands, and the Federated States of Micronesia, which are all part of the Compact of Free Association, are known as the Freely Associated States (FAS).

II. Background

4. **At about 18 percent of GDP in FY2022, Palau’s national (central) government compensation spending is broadly in line with other Pacific Island Countries (PICs).**⁴ Given their inability to exploit economies of scale for public service provision, PICs, and small states in general, tend to have large government staffing needs relative to their population (Figure 1), resulting in a disproportionate size of the government sector by international standards. With a total population of around 18,000, Palau is no exception – in FY2022, the national government employed 16 percent of the working-age population (WAP), with a corresponding compensation spending of 18 percent of GDP (Figure 2). These numbers rise to 25 percent of the WAP and 22 percent of GDP respectively when adding state governments (Box 1 discusses state governments).

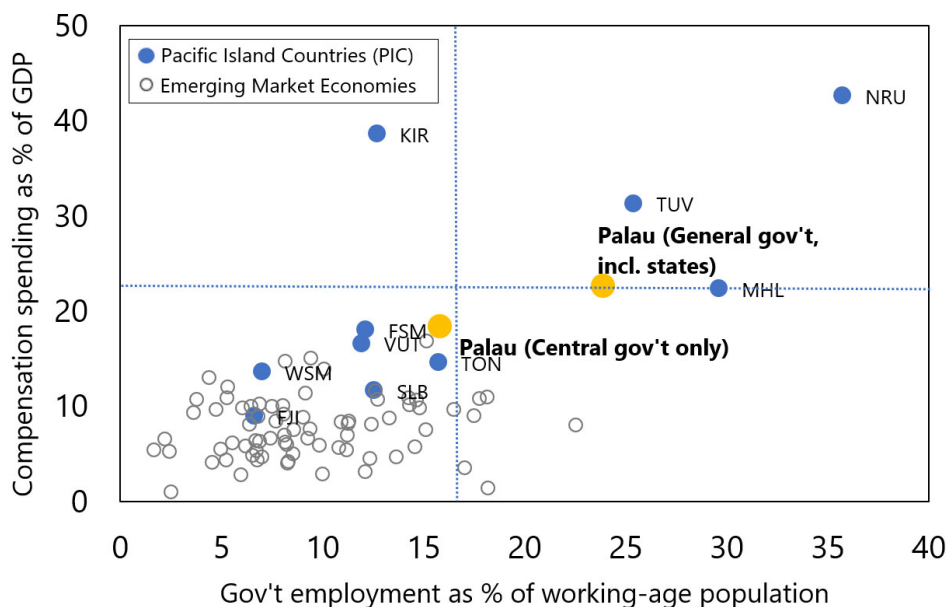
Figure 1. Government Employment and Working-Age Population, Latest Available Values



Source: Palauan authorities and IMF FAD Government Compensation and Employment Dataset.
 Note: Palau data are for FY2022.

⁴ The fiscal year runs from October 1 to September 30.

Figure 2. Compensation Spending and Employment in Pacific Island Countries and Emerging Market Economies, Latest Available Values



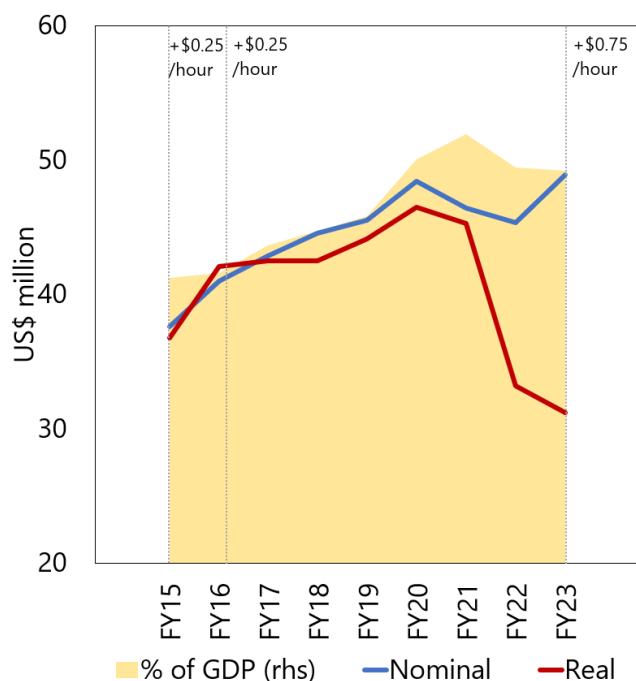
Source: Palauan authorities, IMF Staff estimates, IMF FAD Government Compensation and Employment Dataset.
 Note: Palau data are for FY2022.

5. Since FY2015, changes to Palau’s compensation spending-to-GDP ratio have been essentially driven by fluctuations in nominal GDP, as compensation spending has remained stable in nominal terms. National government compensation spending gradually rose from 13 percent of GDP in FY2015 to 16 percent in FY2019, with compensation spending growing slightly more than the economy. The sharp increase of the compensation spending-to-GDP ratio during FY2020 and FY2021, reaching a historical high of 20 percent, was primarily due to a decline in nominal GDP, while national government compensation spending fluctuated between 38 and 48 million US dollars over the same period (Figure 3.b). During the COVID-19 pandemic, in particular, national government compensation spending dropped both in nominal and real terms, but the GDP contraction was such that the compensation spending-to-GDP ratio increased by 4 percentage points between FY2019-FY2021 (Figure 3.a). More recently, nominal compensation spending has started to increase again in FY2023, reflecting the 75 cents raise in hourly wages of all government employees.⁵ However, this was not enough to catch up with high inflation in FY2022 and FY2023 (see below), so real compensation spending has continued to fall (as did the compensation spending-to-GDP ratio during FY2022 and FY2023).

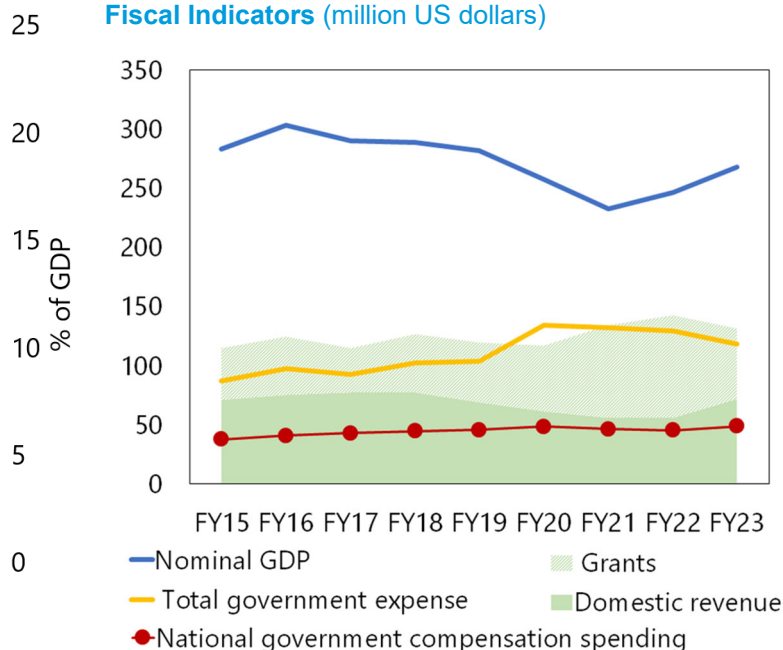
⁵ This measure was the fourth of a series of fixed dollar pay increases: in FY2014, FY2015 and FY2016, the hourly government wages were raised by 25 cents each year. After the 75 cents increase in FY2023, another 75 cents increase was approved for FY2024, which put the minimum wage for the government sector at \$5 per hour (compared to \$3.5 for the private sector).

Figure 3. Trends in National Government Compensation Spending, FY2015-FY2023

a. National Government Compensation Spending



b. Nominal GDP, Compensation Spending, and other Fiscal Indicators (million US dollars)

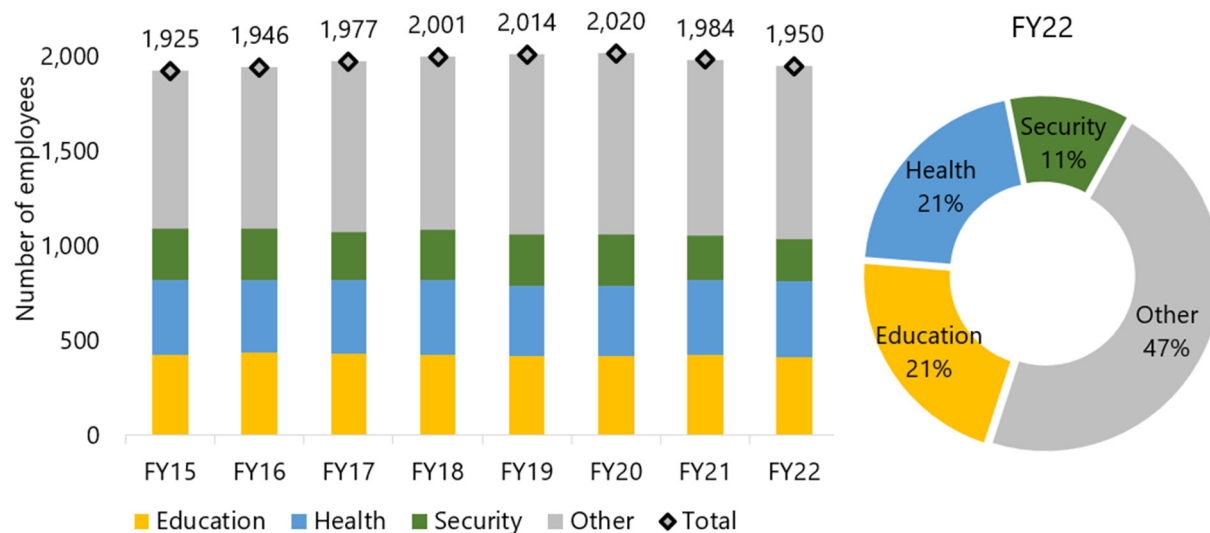


Source: Palauan authorities, IMF staff estimates.

6. National government employment has remained stable at around 16 percent of the working-age population (25 percent when including state governments). Since 2015, the number of workers in the national government has fluctuated between 1,973 and 2,060 employees – this peak, reached in FY2020, has been followed by a fall in headcount, which went back to 1,975 in FY2022. The headcount of state government workers has followed a similar trajectory, going from 954 employees in FY2015 to 1,079 in FY2020, and to 1,004 in FY2022. The working-age population has also been gradually declining, albeit with less variation and a clearer downward trend (see below). These combined trends explain the stability of national government employment over time. The composition of the workforce has also remained broadly unchanged, with education and health each accounting for 1/5 of workers, security for 1/10 and the remainder of employees distributed between other sectors (Figure 4).

7. Overall, the recent trajectory of government compensation spending does not seem to raise fiscal sustainability concerns. Following severe output loss and increase in debt burden during the COVID-19 pandemic, authorities have been implementing important fiscal consolidation reforms to bring the fiscal position back to a balanced level. The introduction of a value-added tax (Palau Goods and Services Tax, PGST) in early 2023 and the (pending) approval of the 2023 Compact Review Agreement (CRA) by the US congress should also generate some fiscal space to accommodate government compensation measures to help attract and retain qualified staff. The financial support under the new proposed CRA would amount to US\$899 million over 20 years, corresponding to annual disbursements of US\$38-44 million (around 16 percent of FY2023 GDP) for budget support, debt relief and infrastructure grants.

Figure 4. Government Workforce Composition, FY2015-FY2022



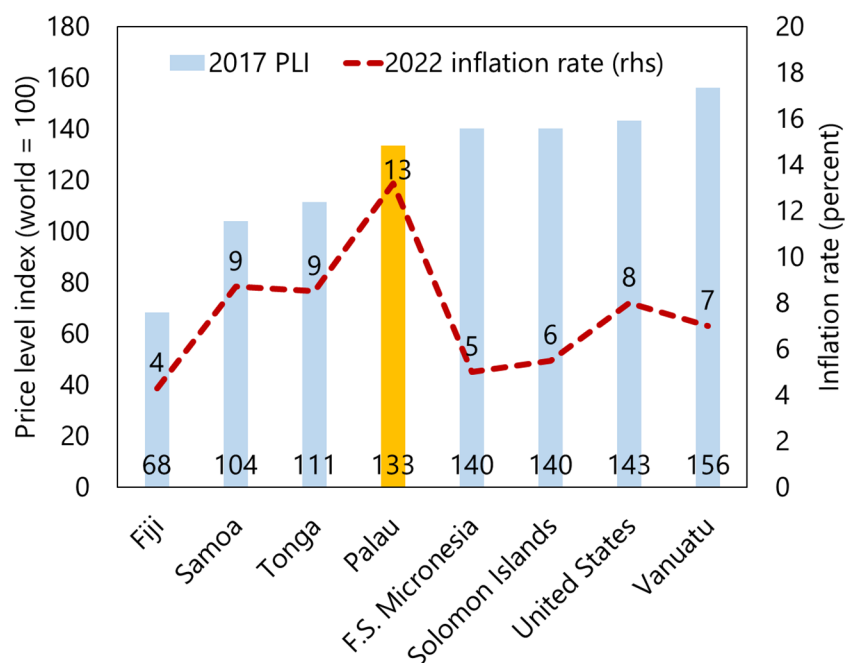
Source: Palauan authorities.

8. Historically high inflation in FY2022 and FY2023 has eroded government employees' compensation. Figure 5 indicates that Palau's 2017 price level index was at the median of PIC peers and only slightly below that of the United States, while recent inflation rate was significantly higher than that of all comparators, adding to the already high pre-pandemic cost of living. Palauan authorities have responded to the increase in inflation by providing targeted subsidies to low-income households and raising government employees' hourly wage by 75 cents across the board in FY2023 and are planning the same increase for FY2024.

9. The rising cost of living is cited as one of the main drivers of emigration. Election absentee registrations in 2020 show that the roughly 2,400 voting-age Palauan citizens living in US states, territories, and other freely associated states⁶ are concentrated in Guam, the Northern Marianas, California, and Hawaii (Figure 6.a). According to the authorities, outward migration flows have significantly grown over the past 3 years driven by the rising cost of living and more limited work opportunities after the pandemic, as well as the relaxing of pandemic-related travel restrictions. As a result, the working-age population has been declining, while the population under 14 and over 65 is increasing (Figure 6.b). This has been impacting recruitment and retention in the government sector, as many employees migrate to competitor markets such as United States and other FAS in search of higher-paying jobs (see below).

⁶ Compared to a total population in Palau of 17,972 in 2020.

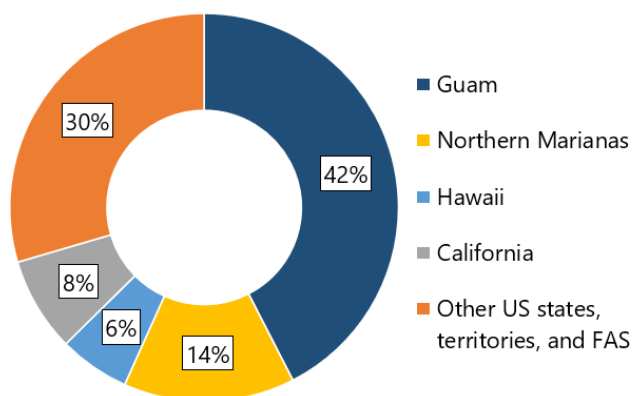
Figure 5. Price Level Indices and Inflation Rate in Palau, PICs, and Comparators, 2022 and 2017



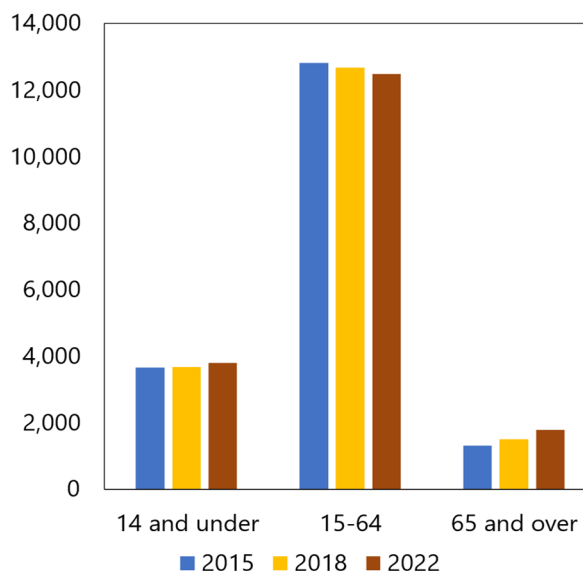
Source: Palauan authorities and IMF staff estimates, World Bank [International Comparison Program](#), IMF World Economic Outlook.
 Note: Price level indices are from World Bank ICP 2017 data.

Figure 6. 2020 Election Absentees and Population Trends, 2015-2022

a. Location of Election Absentees Living in US States, Territories, and FAS, 2020
 (Share of Total Election Absentees)



b. Population Trends, 2015-2022
 (Number of People)



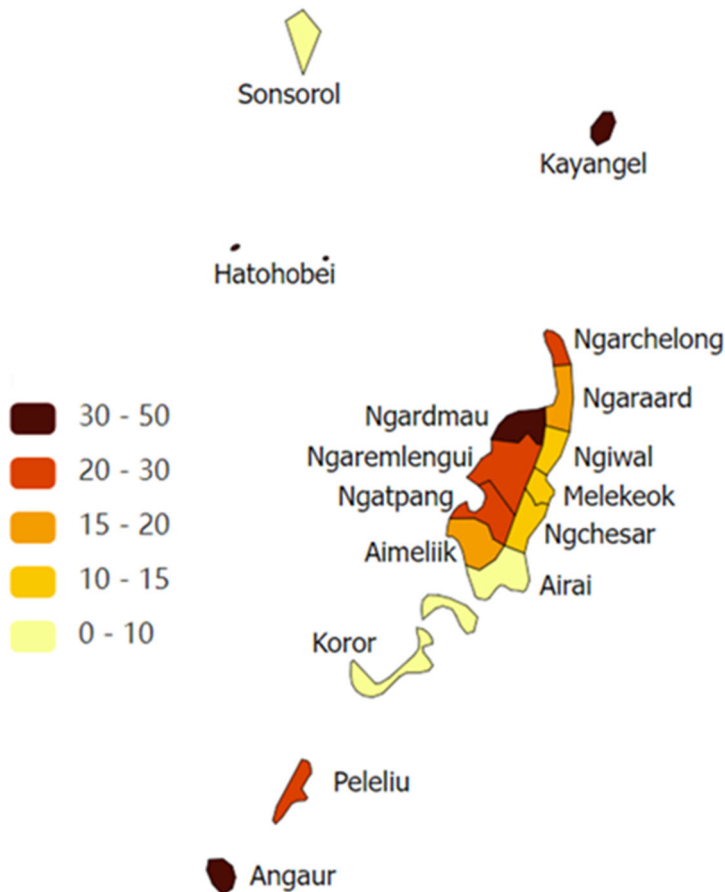
Source: Palauan authorities and UN World Population Prospects.

Box 1. Employment and Compensation of State Governments in Palau

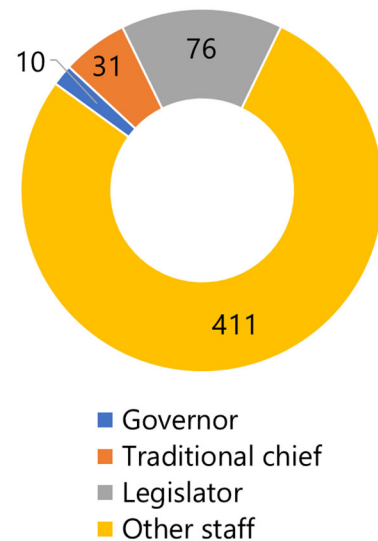
States account for over a third of general government employment in Palau. The country is divided into 16 states, corresponding to traditional municipalities that elect their own legislators and heads of states (e.g., governors or traditional chiefs, elders, and high-ranking clans). In some areas, particularly those more remote, the state government alone employs over ¼ of the working-age population (Box 1 Figure 1). Although states have their own revenue collection (e.g., from fishing permits, vehicle taxes, and tourism), block grants from the national government represent most of their revenue. Payroll data show that around 8 percent of state government staff are governors or chiefs, 14 percent are legislators, but given the lack of information on the remaining 78 percent, who are all classified as “state government staff” (Box 1 Figure 2), the exact functions performed by these employees are unclear. Completing this information could help provide a comprehensive picture of which types of staff work in different levels of government, which would be crucial for informing functional reviews and addressing issues of inadequate staffing.

Box 1. Figure 1. Employment by State Governments, FY2022

a. Share of Working-age Population Employed by State Governments (Percent)



b. State Government Jobs (Number of Employees for all States Excluding Koror)



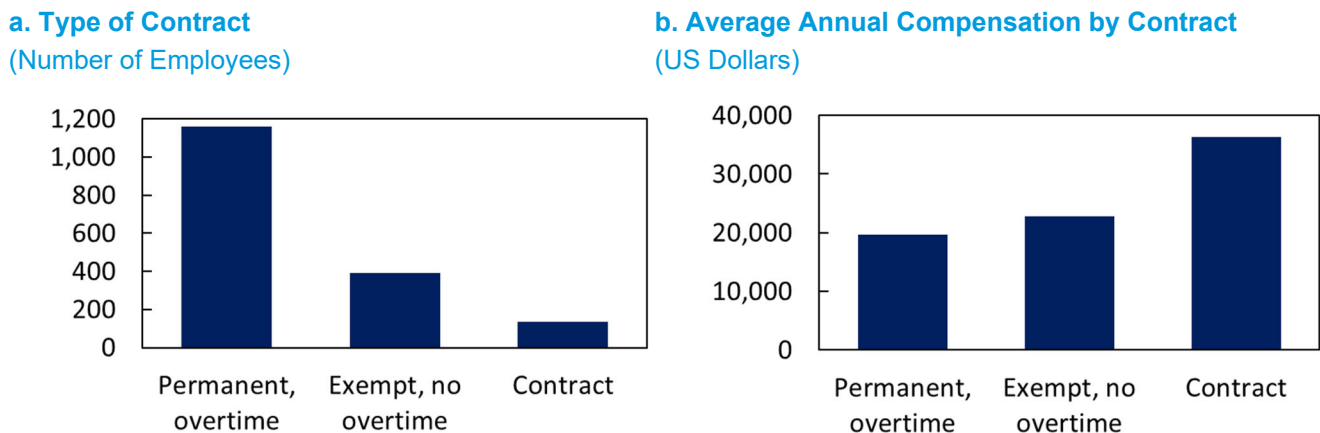
Source: Palauan authorities and IMF estimates.

III. Issues

A. Employment

10. Palau has a multilayered government employment structure. Most government employees in Palau are recruited under a permanent contract (Figure 7), but only Palauans may be hired as permanent government employees. Non-nationals are recruited under fixed-term contracts, usually for one year, to fill positions where no qualified Palauan can be appointed. However, there is no legal provision that requires foreigners to be offered one-year only contracts. Grant-funded positions, fall into a third category of “exempt” employees, who on average benefit from a higher pay level but are entitled to less advantageous benefits (such as paid leave). Most permanent employees are entitled to overtime pay, while most contract and exempt employees are not, resulting in a higher average base wage for the latter two. This situation results in a different treatment of employees working in similar positions. Contract employees are most frequent in the health sector, where skills shortages are more prevalent. Exempt employees are most frequent in the “other sectors” category.

Figure 7. Distribution of National Government Employees and Compensation by Type of Contract

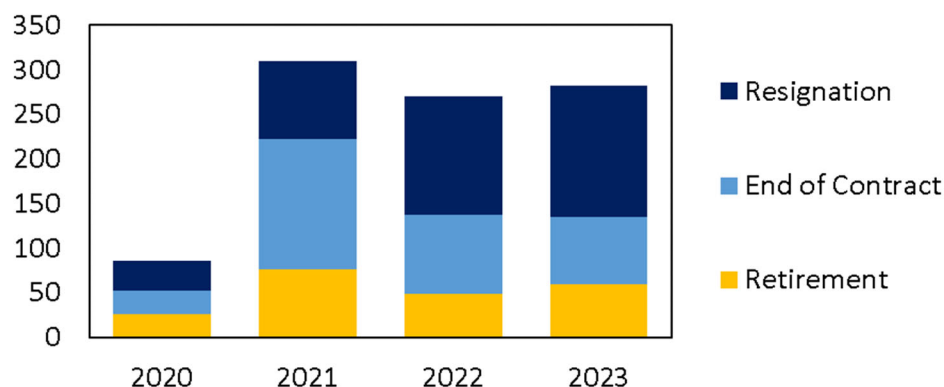


Source: IMF staff calculations based on FY2023 payroll data.

11. Palau’s government has faced significant personnel outflows over the last three years. Between 2021 and 2023, 250 to 300 employees annually have either resigned from their positions, come to the end of their contract, and not started a new one or retired (Figure 8). Those who resigned are, on average, younger and have been employed for a shorter duration as government employees than the average of active government employees. Those who came to the end of their contracts are relatively older; they have been working for the government for 10 years on average, a similar tenure as the average active employee.

Figure 8. Exits from National Government Employment

(Number of Employees)



Source: IMF staff calculations based on payroll data.

12. In FY2022, the education and health sectors were net losers of employees – there were more departures than recruitments – while the rest of government sector, including security, saw relatively balanced flows (Figure 9). Benchmarking the stock of workers in health and education using the IMF Sustainable Development Goals (SDG) costing tools⁷ suggests that in 2020, prior to the outflows, the number of doctors in Palau was too low; the teacher-to-student ratio in 2020 appeared somewhat high, although this should be taken with caution given Palau’s topography⁸, the large outflows of teachers since then, and the increase in the population under age 14 in recent years. Thereafter, Table 1 shows that the net losses in the education sector are concentrated among teachers. Within the health sector, there is by nature more variation among occupations. The net losses are concentrated among registered nurses, coordinators⁹, dental hygienists¹⁰, licensed practical nurses¹¹, and ward supervisors¹². In the security sector, the net losses are less visible. They are concentrated among sergeants and fire fighters.

⁷ [How to Assess Spending Needs of the Sustainable Development Goals: The Third Edition of the IMF SDG Costing Tool.](#)

⁸ It may be inevitable to have schools on the smaller islands serving a disproportionately small number of students.

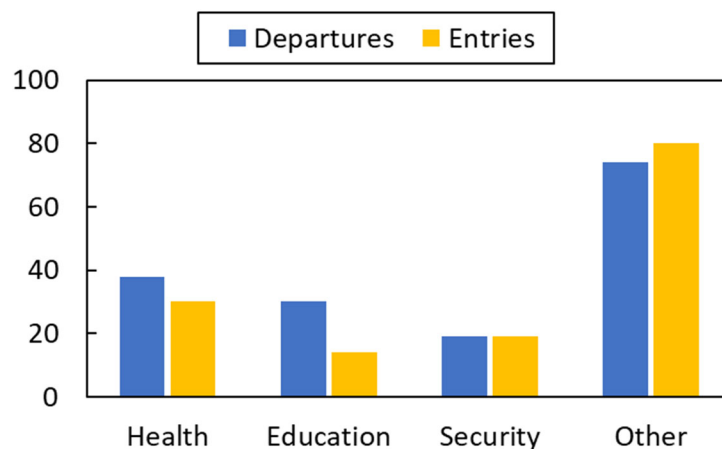
⁹ A health care coordinator works inside medical facilities to help manage patient care. This field aims to provide patients with better care and to help medical facilities operate more efficiently.

¹⁰ Dental hygienists examine patients for signs of oral diseases and provide preventive care, including oral hygiene.

¹¹ A licensed practical nurse (LPN) is a nurse that performs basic medical tasks, including checking vital signs and feeding patients.

¹² A ward supervisor prepares individuals, under the supervision of nursing or medical service administrators, to supervise and coordinate the operations of one or more patient care units in hospitals or other health care facilities.

Figure 9. Departures and Recruitments in National Government
 (Percent of the Average Number of Persons Employed in the Sector Over the Year)



Source: IMF staff calculations based on FY2022 payroll data.

Note: The figure shows the departure (respectively, entry) rate in national government employment. The departure (respectively, entry) rate in FY2022 is measured as the ratio between the number of people employed in a sector and who were marked as inactive (respectively, who were hired) in the payroll data between Oct 1st, 2021, and September 30th, 2022 and the average number of employees in the sector during the period. By convention and construction of the data, persons who worked in two different sectors throughout the year are linked to the latest sector.

13. Many job vacancies remain unfilled. During FY2022, 155 job vacancies were published.¹³ About two-thirds (105) were filled at the end of the fiscal year. These vacancies resulted in more than 500 applications, of which more than 300 were eligible. Vacancies for positions where no eligible applicants were identified include teachers (5 vacancies out of 26 jobs openings), management positions (9 chief positions vacant out of 13 positions, 4 executive director positions out of 7), accountants (3 positions vacant out of 7), financial operations officers, finance planning analyst, (3 positions), business operations (service officer, disaster management) and medical occupations (health care suppliers, dental hygienist). On the other side, positions for cooks, administrative support, police officer trainees, were all filled. The lack of eligible candidate might result of insufficient compensation given higher expectations in terms of certification criteria introduced for some positions such as teachers. Inflexibility in minimal qualification requirements, such as educational requirements without the possibility of substitution by relevant work experience, for instance, can impede the hiring of otherwise skilled candidates.

¹³ Vacancies can be found at [Employment opportunities \(palau.gov.pw\)](https://palau.gov.pw/employment-opportunities).

Table 1. Occupations with the Largest Net Losses by Sector During FY2022
(Number of Employees)

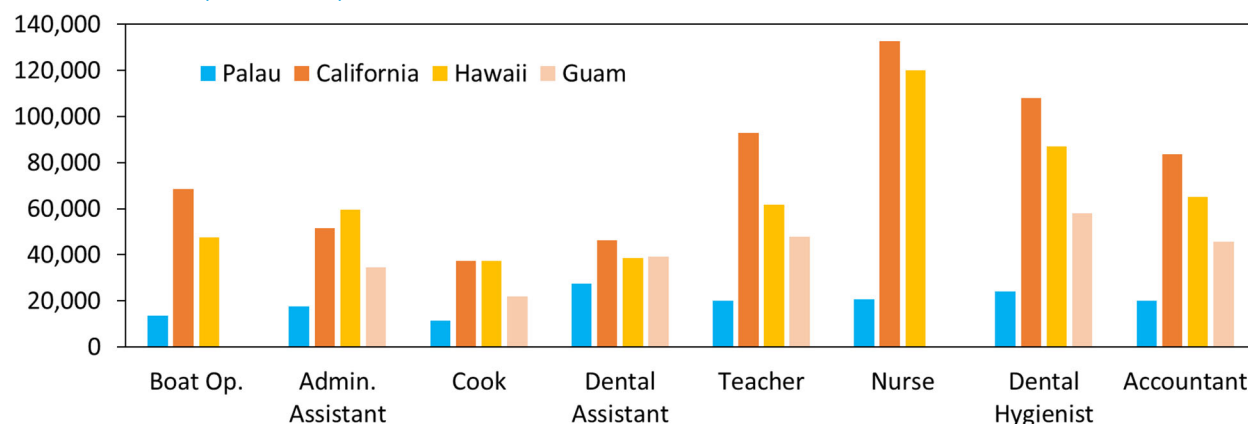
	Number of employees	Departures	Entries	Net entries	Net entry rate (pct)
Health					
Registered nurse	98	14	4	-10	-20
Coordinator	19	3	0	-3	-16
Security guard	8	3	0	-3	-38
Dental hygienist	7	2	0	-2	-29
Licensed nurse	23	2	0	-2	-9
Food preparator	4	2	0	-2	-50
Ward supervisor	11	2	0	-2	-18
Education					
Classroom teacher	405	40	8	-32	-16
Maintenance custodial	6	1	0	-1	-17
Educ. specialist	15	1	0	-1	-7
Data specialist	1	1	0	-1	-100
Budget analyst	2	0	0	0	0
Food preparator	2	0	0	0	0
Cook	24	3	3	0	0
Security					
Admin support	17	3	0	-3	-18
Police - sergeant	29	2	0	-2	-7
Fire fighter	14	4	2	-2	-14
Police airport - lieutenant	4	1	0	-1	-25
Police airport - sergeant	3	1	0	-1	-33
Aviation officer	4	1	0	-1	-25
Others					
Maintenance - ground	78	8	0	-8	-21
Construction inspector	7	4	1	-3	-43
Ex. director	4	3	1	-2	-50
Construction trade	10	2	0	-2	-20
Aviation inspector	1	2	0	-2	-200
Postal service worker	7	2	0	-2	-29

Source: IMF staff calculations based on payroll data, FY2022.

14. The drivers of the net departures from government employment are partly driven by the compensation level, although non-financial factors may also contribute, such as access to health care or education (see below). The Ministry of Human Resources, Culture Tourism and Development is conducting exit surveys to understand the reasons for people leaving and where they go, which is still in progress. However, it is challenging to contact people who have left the government sector, especially in a context of migration.

15. One reason for the vacancies remaining unfilled is that Palauans opt for jobs in main competitor labor markets abroad, typically in California, Guam, or Hawaii. For most positions, the compensation differential with the main competitor labor market is large. Figure 10 illustrates, for some of the occupations discussed above, how the annual compensations compare in Palau, California, Guam, and Hawaii. In most cases, the wages are twice as high at least as the nominal wage in Palau. For occupations with shortages (Nurses, Teachers, Accountant), the gap is even larger.

Figure 10. Median Annual Compensation for Selected Positions in Palau and Main Competitor Labor Markets (US Dollars)



Source: IMF staff calculations based on data from the US Bureau of Labor Statistics and the Palauan authorities.

Notes: Wages in Palau refer to Government employees. Wages for California, Hawaii, and Guam refer to both public and private sectors.

16. Several compounding factors on the labor supply side explain the skills shortage for these positions. In addition to low pay levels, other non-financial factors can discourage people from applying for job positions in Palau. Healthcare provision and lack of educational opportunities resulting from the small size of the country are often mentioned in this respect. In addition, the difficulty of accessing quality and affordable housing and the burden of financial obligations linked to traditional customary obligations¹⁴ also weigh in the decision for workers to apply for positions out of the country (Figure 11).

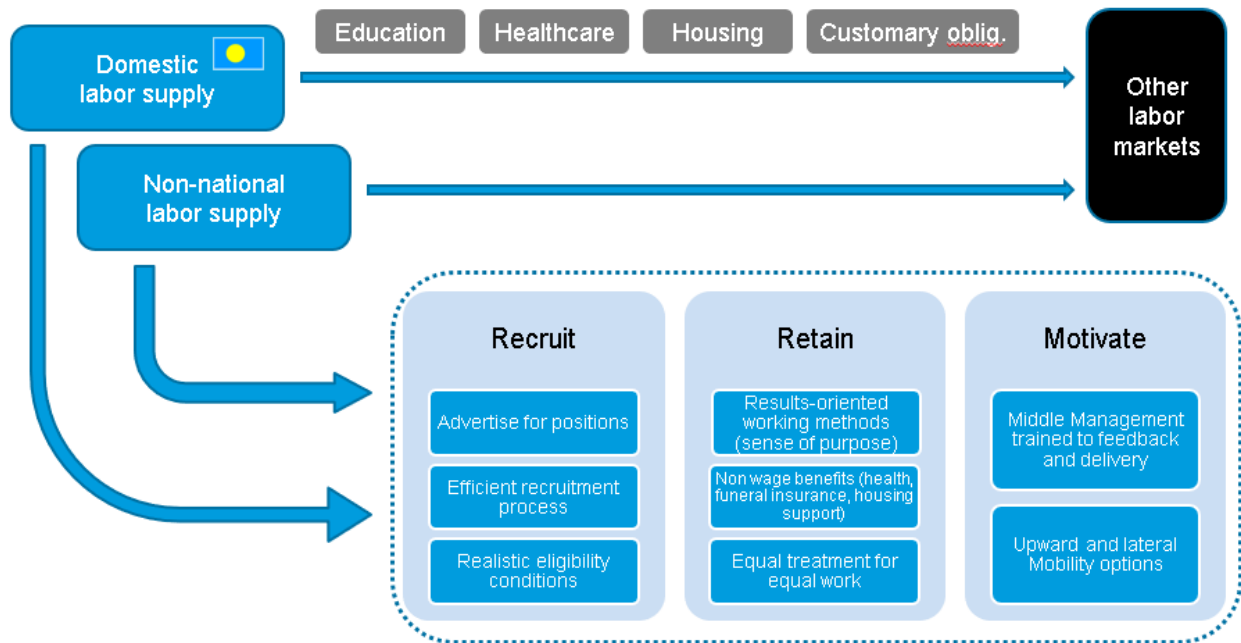
17. On the labor demand side, some organizational bottlenecks in the government sector could also hamper attraction, harm retention and motivation. The great diversity of citizenships among non-Palauan employees, who accounted for 14 percent of national government personnel in FY2023, suggest that the outreach is diversified (Figure 12). However, vacancies should be advertised consistently and prominently to reach a broader audience, instead of recruiting ministries relying on unsolicited applications and word of mouth.¹⁵ There are signs of administrative inefficiencies that can lead to delays in the recruitment process, even leading in some cases to recruiters giving up on selected candidates who cannot be hired for administrative reasons. High requirements on educational attainment can also act as barriers preventing from attracting applicants who could otherwise fit the position based on their work experience. In general, staff retention can be improved when measures are taken to

¹⁴ Traditional informal social schemes, such as expected donations during funerals, represent a heavy financial burden for those contributing. Pooling mechanisms exist that help smoothing the financial burden for those supporting them (see Recommendations).

¹⁵At the time of writing, there are only three vacancies visible online ([Employment opportunities \(palau.gov.pw\)](https://employment.palau.gov.pw)).

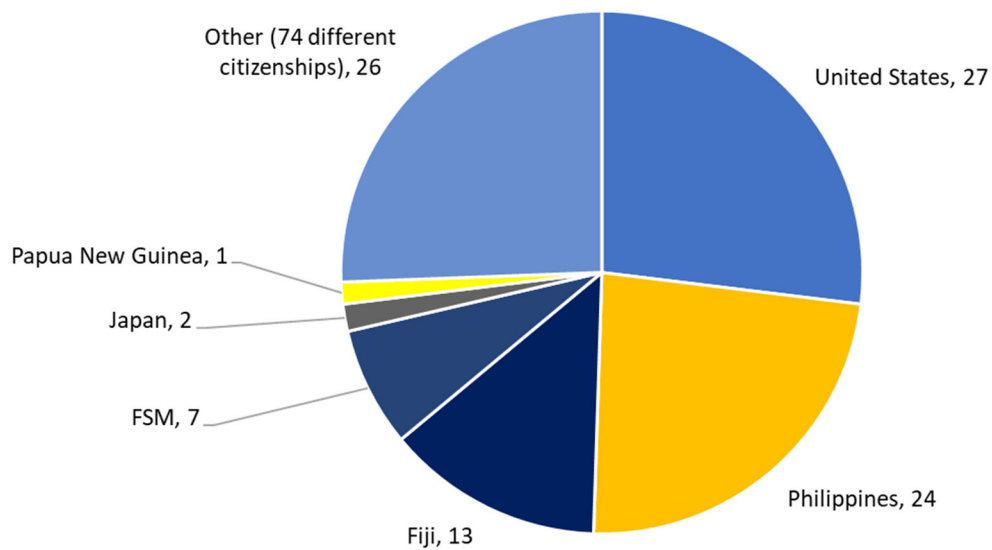
improve the functioning of organizations. This includes accompanying measures for managers (feedback delivery, special support during reorganizations). The access to training is currently very limited, with no clear strategy.

Figure 11. Summary of Non-financial Push and Pull Factors Driving Labor Supply and Demand



Source: IMF staff.

Figure 12. Citizenships of Non-Palauan Workers Employed in National Government, FY2023
(Percent)

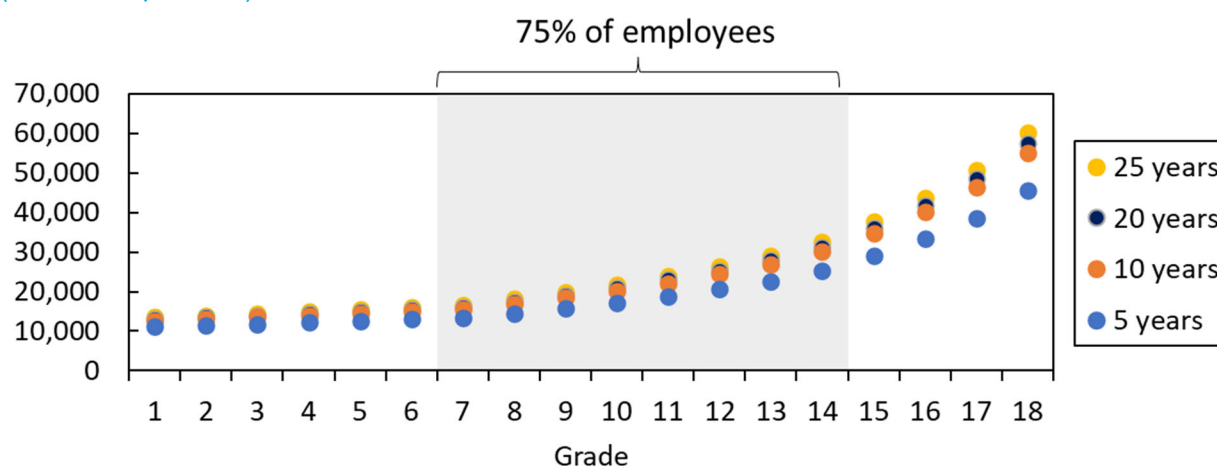


Source: IMF staff calculations based on FY2023 payroll data.

B. Compensation

18. A pay scale determines permanent employees' compensation (Box 2). A grade is attributed to each job position, determining its height in the pay scale. For each grade, ranking from 1 to 18, employees start at step 1, and move up to step 14 - the highest step - as time passes by (Figure 13). It typically takes 30 years to reach the 14th step as it takes longer and longer to reach the next pay level (every year during the first five years, then every second year, until 10 years, and three and four years after).

Figure 13. Wage Level by Grade After 5, 10, 20, and 25 Years of Tenure
(US Dollars per Year)



Source: IMF staff calculations based on FY2023 payroll data.

19. The share of the non-wage component in the overall compensation is modest. Non-wage compensation, which includes differentials,¹⁶ is at most 7 percent of total compensation, which is small compared to many countries. This can be considered a positive feature, as significant non-wage components can make the pay system less transparent and proliferate over time (see Box 2).

20. The pay scale in its current design is very narrow. Someone starting in step 1 for the highest grade (18) earns approximately 4 times as much as someone at the lowest grade (1). At the other end of the spectrum, among those with 30 years of career, someone at grade 18 earns 4.5 times as much as someone at grade 1. All in all, the ratio of the highest pay (grade 18, step 14) to the lowest (grade 1, step 1) is at 6 to 1. It is always challenging to determine an adequate level of earnings inequality, but this ratio appears relatively narrow against some criteria.

21. The government's practice of granting fixed dollar amount wage increases has compressed the wage scale. The National Government Salary and Wage Act of 2006 redesigned the pay system. Subsequent wage increases have been designed as fixed dollar amounts and were granted in FY2014, FY2015, FY2016, FY2023, and FY2024. The government has implemented pay increases of \$0.75 per hour for all grades and steps in FY2023 and FY2024 as part of efforts to increase the minimum wage while limiting the cost of pay increases for those earning more than the minimum wage. This has

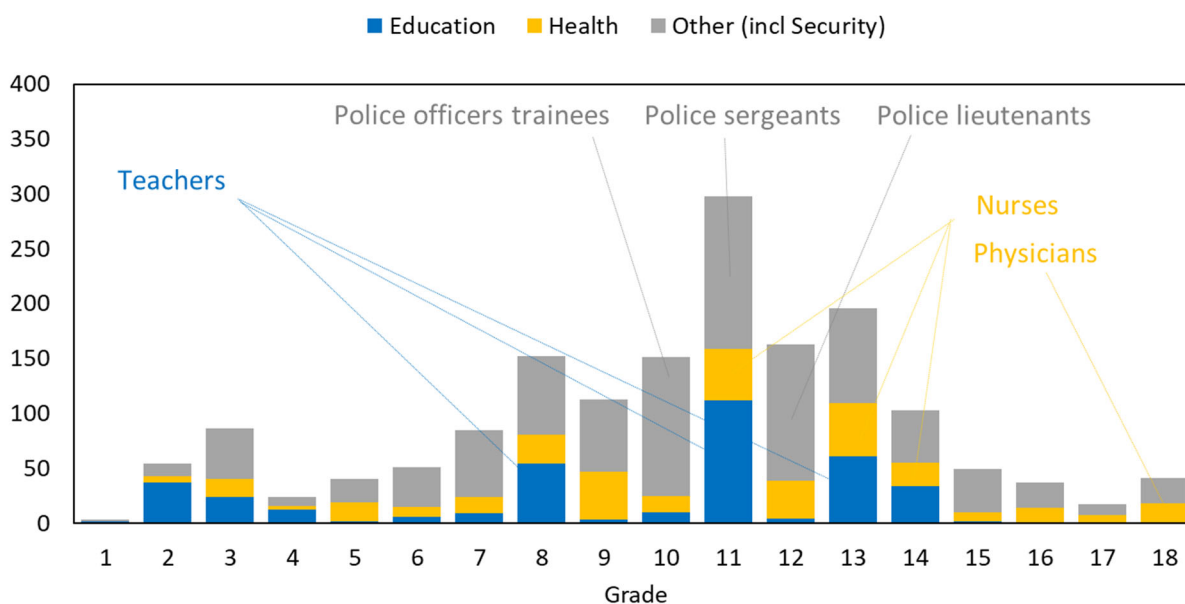
¹⁶ Typically called "allowances" in other countries.

compressed the wage scale relative to what it would have been under fixed percentage increases. The highest wage was at 10 times the lowest pay in FY2006; the ratio decreased to 9-to-1 in FY2014, 7-to-1 in in FY2023, and to 6-to-1 in FY2024.

22. A consequence of the narrow distribution of wages in the pay scale is that the empirical distribution of wages is even more concentrated. The pay scale, established in 2006,¹⁷ relies on a points system across four criteria: educational requirement of the position; knowledge and experience requirement; complexity of work assignment; and supervisory control. Most employees (75 percent) fall in the upper middle grades, I between the 7th and 14th grades (Figure 14). For instance, teachers fall massively in the grades 8, 11 and 13. Registered nurses fall between the 11th and 13th grade. hospital physicians fall in grade 18. Police officers rank into grades 10,11 or 12 depending on their role (trainees, sergeants, lieutenants). The pay compression ratio, which compare the compensation of employees in the 9th decile (10 percent of employees with the largest compensation) to the 1st decile (10 percent of employees with the lowest compensation), is at 2.6, which is very low in international comparison (Figure 15).

23. Excessive pay compression can hinder the recruitment, retention, and motivation of highly skilled professionals. Pay is more compressed when there is a smaller difference between the highest and lowest pay levels. For example, recruiting, retaining, and motivating some highly skilled workers may require relatively high levels of compensation to be competitive with prevailing compensation for these workers in the private sector.

Figure 14. Distribution of Workers and most Frequent Occupations by Grade
(Number of Employees)

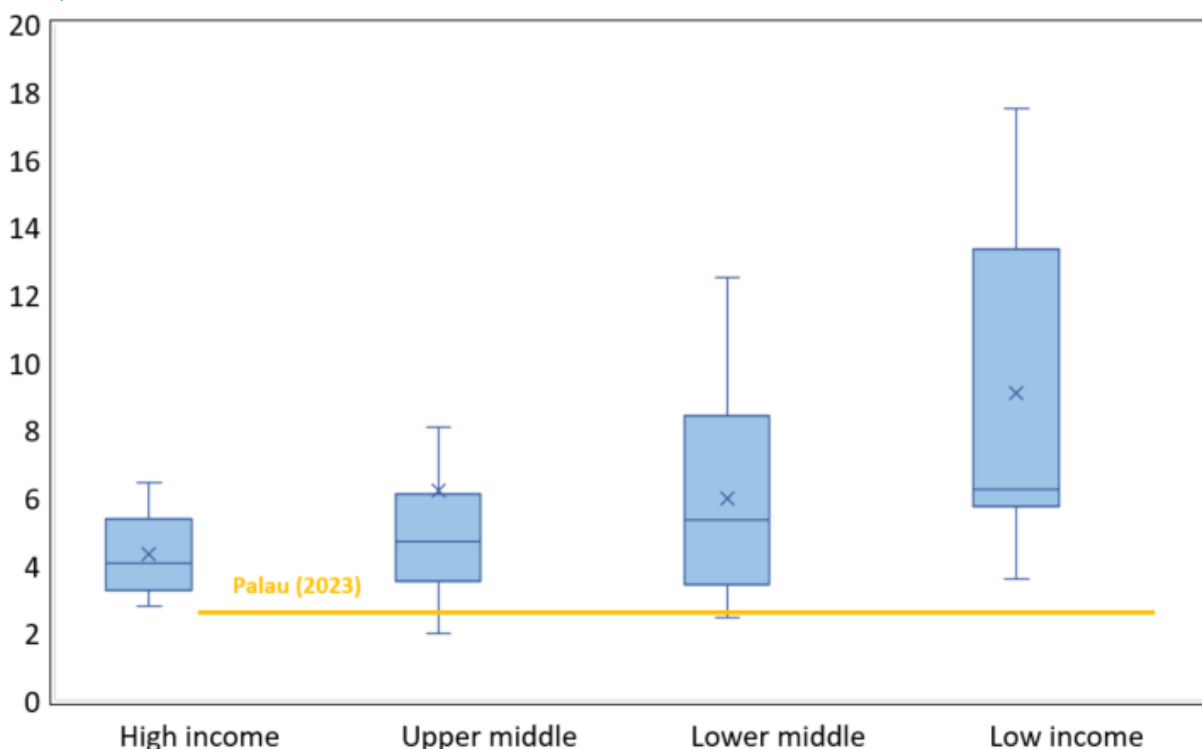


Source: IMF staff calculations based on FY2023 payroll data.

¹⁷ See Executive Order 238 Establishing a New Position Classification System.

Figure 15. Government Pay Compression in Palau and other Countries

(Ratio)



Source: IMF staff calculations based on FY2023 payroll data and World Bank Bureaucracy indicators.

Note: Pay compression is defined as the ratio between the 9th and 1st decile.

Reading Note: In Palau, the ratio between the compensation of 10 percent government employees with the highest compensations and the compensation of the 10 percent government employees with the lowest compensation is at 2.6. It compares to a median of 4 in high income countries and 4.7 in upper middle-income economies.

24. The compensation of nurses and teachers (relative to clerks) is lagging in Palau, while police officers and doctors (relative to clerks) are more in line with international standards. Figure 16 illustrates how much some occupations, such as doctors, nurses, police officers and teachers earn by comparison to a reference occupation (office clerk) in other countries in the region, in the world or other small and micro-states.

- Doctors earn on average three times as much as clerks in Palau. This is close to the average in most countries. In some countries, such as Singapore, or the US, the ratio is much above, while in some others (which sometimes also face skills shortages in the health sector), it is significantly lower.
- Nurses in Palau earn at 1.12 times as much as office clerks. This is a lower bound compared to many countries in the South Asia and Pacific Area. For instance, in Malaysia, Indonesia, Philippines or Singapore, it is approximately twice as much.
- Police officers earn on average as much as clerks in Palau, which is close to the situation in most countries. Only in New Zealand, Australia or Singapore do police officers earn significantly more than office clerks would.

- Teachers earn on average 1.1 times as much as a clerk in Palau. It would be closer to 1.7 in the selected countries in South Asia and Pacific; 1.3 in other selected advanced economies; and 1.4 in other selected small and microstates. Some countries with good educational outcome, such as Singapore or Taiwan reward teachers about twice as much as clerks. However, in some other countries with good performance in their education systems, such as Finland or Korea, the ratio is not necessarily much higher. This suggest that while the pay level matters in driving performance, it is not the only criteria to consider.

25. The positive compensation premium for government employees is unlikely to suggest that the workers turn away from the Palauan private sector given the duality of Palau’s labor market.

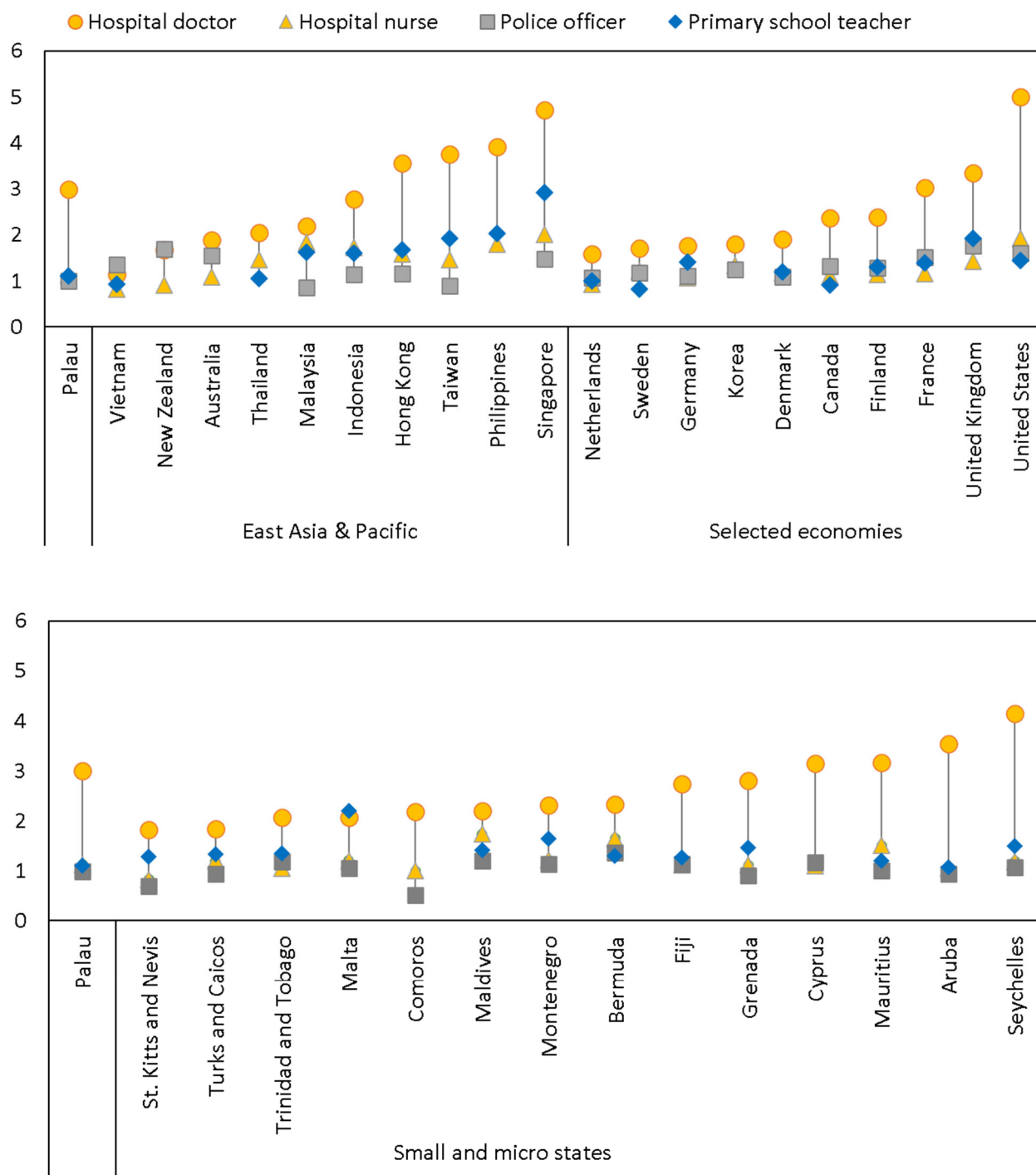
IMF staff estimates based on the 2013/2014 Palau Household Income and Expenditure Survey indicate that public-sector employees¹⁸ in Palau earn a compensation premium of 21 percent relative to the private sector in Palau. This estimate controls for education levels and other individual characteristics.¹⁹ It is difficult to determine how this estimate has evolved since the Survey was conducted. However, a still-positive value for the compensation premium would not necessarily be a concern in Palau, as it would be in other countries. The Palauan government faces competition from the US for workers more than from the Palauan private sector, while the Palauan private sector relies to a greater degree on workers from neighboring countries who cannot freely move to the US.

¹⁸ The Survey does not distinguish between employees of the different levels of government and state-owned enterprises.

¹⁹ Methodological details can be found in Gupta, S., Coady, D., Fouad, M., Hughes, R., Garcia-Escribano, M., Curristine, T. & Soto, M. (2016). Managing Government Compensation and Employment-Institutions, Policies, and Reform Challenges. Policy Papers, 47.

Figure 16. Pay Compression Ratio by Occupation in Palau and Selected Countries

(Multiple of Annual Pay Compared to an Office Clerk)



Source: IMF staff calculations based on FY2023 payroll data and World Bank Bureaucracy indicators.

Notes: The compression pay ratios by occupation compare the average compensation of a given occupation (e.g., teachers) to a reference occupation, office clerk (proxied by administrative assistants in Palau).

Reading Note: In Palau, Doctors' compensation is 3 times as high as the compensation of the reference occupation (office clerk). In Singapore, it would be five times as high.

Box 2. Base Wage, Non-wage Component: How to Design Compensation Policy?

In most countries, government compensation comprises a base wage, determined according to a pay scale and non-wage components. The base wage would ideally represent the bulk of an individual's total compensation package. It is determined by pay scales that define fundamental pay levels for specific job roles, grades, and steps within an organization. Pay scales maintain consistency, transparency, equity, and visibility over future earnings. They ensure that employees with similar qualifications and job responsibilities receive comparable compensation. Pay scales provide visibility on earnings over time, as rules determine at which pace employees will move up the scale. They are a tool for the government to manage promotions, training needs, and implement strategic planning. There are usually two ways of moving up the pay scale ladder: passage of time and promotions. The pace of climbing the pay scale and the magnitude of the increases allow compensation to increase with age and job tenure.

The matching of occupations to a pay scale is a heavy, in-depth exercise, which requires a detailed assessment. On one side, pay scales need to reach a sufficient granularity to capture the heterogeneity of various occupations and universality/equity to streamline some horizontal equity among employees with similar characteristics but in different domains. When too precise, it makes it difficult for managers to adapt a job to changing circumstances, such as the introduction of new tasks, technology or working methods. On the other hand, if too broad, it may not give enough room to differentiate pay according to job characteristics, which may affect employer attractiveness. It may also make it harder to manage career paths.

Non-wage components (for instance, night work allowances) can allow differentiation of compensation according to job and employee characteristics; however, they can complicate the compensation system, limit transparency, and hinder employee mobility. Non-wage compensation typically covers five broad categories: job, task, labor market adjustment, housing, and commuting. They can be a way of rewarding scarce skills (labor market adjustment), an example often mentioned by governments aiming at attracting health or education workers to underserved regions. It can also be a way of compensating for risks taken in some jobs, for instance personnel sent to dangerous areas, or encouraging certain behaviors, such as using public transit instead of driving.

The purpose of the non-wage compensation needs to be carefully anchored to the strategic medium-term objectives of government employment, in particular whether the focus is to recruit, retain or motivate employees. For instance, a given country aiming at motivating the workforce and increase performance might consider getting rid of education-related allowances as they create no incentives to *motivate* the workforce. Another country wanting to *recruit* more skilled workers, might consider education-related bonuses as a channel to differentiate the pay level in a targeted manner. In any case, bonuses and allowances should be introduced with parsimony and strategic purposes, and regularly re-assessed to avoid creeping.

Source: How to Set Compensation for Government Employees, C. Thévenot and S. Walker, IMF, forthcoming and The Public Sector Pay System in Israel, OECD, 2021. <https://doi.org/10.1787/3b6ad37f-en>.

IV. Reform options

A. Role of the Employment and Compensation Committee (ECC)

26. The ECC—formed by Presidential Directive No. 23-60—is an excellent first step toward strengthening the management of government employment and compensation in Palau. Co-chaired by the Minister of Finance and the Minister of Human Resources, Culture, Tourism, and Development, the ECC has been tasked with developing a medium-term strategy on behalf of the government. Its mandate should include establishing medium-term objectives not only for the overall size of the government workforce but also for its composition. Likewise, its mandate should include establishing objectives not only for average levels of remuneration but also for the remuneration of those positions for which recruitment and retention are most problematic. Box 3 provides examples from other small island states on use of similar committees in promoting efficient and cohesive public service delivery.

Box 3. Employment and Compensation Committees in Selected Small Island States

Employment and compensation committees (or commissions) play a crucial role in shaping and maintaining efficient and cohesive public service systems. The following examples offer insights into the organization of such commissions in selected small island states.

In **Tonga**, the Public Service Commission is a five-member body run by a chief executive and led by a chairperson. It meets weekly and acts as an advisor to the Prime Minister on all human resource issues. With jurisdiction over 16 ministries and 4 agencies, it sets hiring procedures and salary standards. The Ministry of Finance is responsible for allocating resources for personnel costs across line ministries. The Commission is responsible for developing performance standards, advising the government on public service management, overseeing employment policies, ensuring adherence to policies, and recruiting and training personnel.

In the **Seychelles**, the Department of Public Administration is under the office of the President. It sets guidelines for public service salaries and is responsible for workforce management in collaboration with the National Human Resource Development Council. Line ministries are responsible for job creation, but positions are assigned to salary grades by the Department of Public Administration. A Public Service Salary Review Committee meets biweekly and reviews the country's salary structures every five years.

In **Fiji**, the Public Service Commission—supported by the Ministry of Civil Service—gathers the permanent secretaries from the line ministries to set remuneration for positions within the budget as approved by the Parliament, establishes recruitment standards, and defines salary bands for all 26 ministries. A Job Evaluation Committee—made up of accredited evaluators—conducts job evaluations.

In **Kiribati**, the Public Service Office establishes pay levels for the public sector. Individual line ministries propose the creation of new positions, but the Public Service Office holds final authority over their approval.

In the **Maldives**, the Civil Service Commission sets salaries and benefits for all public service employees. The Commission comprises five members chosen by the President who serve for 5-year terms.

Box 3 Table 1. Compensation of Employees Indicators in Selected Small Island States, Latest Available Values

Country	Compensation spending (% of GDP)	Compensation spending (% of total expenditure)	Government employees (thousands)	Government employees (% of working-age population)
Palau	15.8	36.7	14.9	29.9
Tonga	14.6	29.9	9.9	15.7
Seychelles	10.8	30.6	11	17.8
Fiji	9.0	27.7	38.3	6.6
Kiribati	38.6	30.3	9.7	12.7
Maldives	10.9	24.9	67.7	18.2

Source: IMF FAD Government Compensation and Employment Dataset.

27. The establishment of medium-term objectives will provide an essential framework for making year-to-year decisions based on resource availability as part of the budgeting process.

This approach to managing employment and compensation has three key advantages. Most importantly, it provides greater fiscal flexibility by enabling changes to be shaped by year-by-year resource availability without sacrificing strategic medium-term human resource management objectives. Fiscal flexibility is particularly important for smaller economies, such as Palau's, which are highly vulnerable to exogenous economic shocks. In addition, it enables changes in employment and compensation policies to be made in a planned and incremental manner, thereby providing the opportunity for the authorities to modify their strategy in response to changing human resource needs, lessons learned, and evolving challenges with recruitment and retention. Finally, it enables changes in the composition of the government workforce to be made gradually based on attrition, rather than retrenchment which is typically contentious.

28. The ECC should establish clear medium-term objectives for the size and composition of the government workforce. In developing its medium-term strategy, the ECC should consider launching a program of government-wide functional reviews to identify areas of functional overlap in the government sector and to prioritize essential government services. Such functional reviews should rely, as needed, on outside sectoral experts with the active participation of the Bureau of Human Resources within the Ministry of Human Resources, Culture, Tourism and Development (MHRCTD). The overarching objective of functional reviews is to *right-size* the government workforce—expanding employment where needed and reducing employment where appropriate—to improve spending efficiency. Once completed, functional reviews should provide the basis for making planned changes in the staffing of ministries, departments, and agencies. The ECC—rather than the individual line ministries—should have final authority to amend their establishment lists.

29. The scope of the ECC’s functional reviews should include considering the merger of some state functions into the national government. In the view of the mission, some of the services provided by the state governments could be provided more efficiently by the national government without compromising delivery. Potential candidates include park policing, road maintenance, garbage collection, and vehicle registration (the requirement to register vehicles at both the state and national levels, for example, serves no apparent purpose). In pursuit of right-sizing government employment, the merging of certain functions under the national government will help overcome the diseconomies of scale inherent in their delivery by even smaller individual state governments. In addition, such mergers could create valuable fiscal space for larger increases in government compensation or for other expenditure priorities. Palau’s Constitution does not appear to allocate any specific functions to the states and provides that “[a]ll governmental powers not expressly delegated by this Constitution to the states nor denied to the national government are powers of the national government.” Mobility protocols could be created to facilitate personnel movements between state and national governments as functions are merged.

30. The ECC’s medium-term objectives for the size and composition of the government workforce should respect evolving human resource needs. When amending establishment lists, the ECC should consider gradual changes driven by: (i) technology that could facilitate changes in the modalities by which some public services could be provided; (ii) climate change mitigation and adaptation (iii) demography that will impact the demand for certain public services (e.g., as the number of children declines, fewer teachers may be needed; similarly, as the population ages, the demand for healthcare services will rise); and (iv) net emigration that may force changes in the mix of public services the government needs to provide in the future.

31. The ECC should also establish clear medium-term objectives for the evolution of remuneration for government workers. Its strategy should address two separate, but related, challenges. The first is the need to adjust government pay levels to preserve their purchasing power in the face of inflation. While the mission does not recommend the automatic indexation of government wages—because it deprives the authorities of essential fiscal flexibility—the mission does recommend *percentage* increases in government wages in line with inflation provided that the fiscal space exists to do so. The second is the need to adjust wage levels *differentially* for those positions for which recruitment and retention is most problematic. Targeted increases in compensation, as will be discussed further below, are a fiscally more efficient mechanism for addressing issues with staffing than are across-the-board increases. To the extent possible, the ECC’s strategy for making differential wage adjustments should be driven by recruitment and retention data. Such data should be systematically collected and analyzed. The endorsement of broad orientations by the ECC could help the Government to communicate the decisions and ensure their acceptability.

B. Compensation Policies Should Advance Human Resource Objectives

32. When designing and implementing medium-term reforms to government compensation policies, the ECC should be guided by lessons learned from international experience. International experience with the management of government compensation spending suggests that:

- ***Changes in compensation policies must be consistent with overall expenditure priorities and be designed to fit within an allotted fiscal space.*** This is true for both the short and medium terms.

Because compensation spending cannot easily be adjusted in response to exogenous events that impact resource availability, changes in compensation should generally be introduced incrementally—and with a degree of caution. Once implemented, pay increases are typically binding, except in countries in extreme fiscal duress.

- ***The mechanism by which compensation is increased is important, because it drives behavioral responses on the part of workers.*** Categorically, there are three mechanisms for increasing pay levels for government workers:
 - *Compensation can be increased by a flat amount* (e.g., 0.50 per hour for all workers). While such an approach—when applied to workers in the private sector—might be defensible on the grounds of poverty alleviation, it is not generally justified for government workers who earn significantly more than the minimum wage. Increasing compensation by a flat amount has the disadvantage of increasing wage compression (i.e., a measure of the relative wages of high-earners vis-à-vis low-earners).²⁰ While wage compression varies from country to country, very high levels of wage compression—such as already exist in Palau—make it difficult to recruit and retain higher-skilled workers. Typically, such difficulties are readily observable in recruitment and retention data.
 - *Compensation can be increased on a percentage basis.* This is the approach taken by most countries when adjusting government compensation over time. Often, such increases are referred to as “cost-of-living adjustments” (or COLAs). Provided they are proportional to the rate of increase in compensation observed among private sector workers, percentage increases in compensation have little impact on behavioral incentives because they: (i) preserve relative levels of compensation between the government and the private sectors for workers of similar qualifications and experience; and (ii) preserve the pay differentials earned across pay grades within the government sector.
 - *Compensation can be increased on a differential basis.* Differential changes in compensation are typically used to address issues in the recruitment or retention of specific positions—or sectors—of the government workforce. Differential changes should be implemented within the existing compensation framework, whenever possible, and should be shaped by evidence in the form of recruitment and retention data.
- ***While the size of the government workforce—and levels of compensation—represent a fiscal tradeoff, the tradeoff can be made easier to manage through right-sizing.*** As discussed above, the use of functional reviews is the best way to identify nonessential positions and areas of operational overlap among ministries, departments, and agencies. For smaller countries, which suffer from diseconomies of scale, centralizing some elements of public service delivery is essential to improving the efficiency of public services delivery. Right-sizing can be accomplished through attrition, but only if it is done in the context of a medium-term staffing strategy. In practice, this means filling only vacancies deemed essential such that, over time, nonessential positions are eliminated. The ECC should have the final authority to approve (or disapprove) the filling of any vacant positions

²⁰ Flat increases in compensation increase wage compression because they increase wages for low-income workers more on a percentage basis than they do for high-income workers.

and to make changes to the staffing complements of all ministries, departments, and agencies. Positions deemed noncritical—and left unfilled—should be struck from their establishment list to discourage rehiring in the future.

- ***Non-wage benefits can also shape the incentives for workers to join or remain in the government workforce.*** Such benefits can include internship programs, training and education courses, retirement savings provisions (i.e., pensions), health insurance coverage, and other benefits.

33. Categorically, three options are available to the authorities for making differential changes in levels of compensation to target ongoing issues with recruitment and retention. To the extent possible, changes should be implemented incrementally to enable them to be modified in response to lessons learned, new data on patterns of recruitment and retention, and evolving human resource needs. The three options include:

- ***Job reclassification:*** positions can be assigned to a higher grade in the wage table when the resulting pay increase is perceived to be commensurate with the additional compensation required to improve recruitment and retention. If the increase in pay is too large, then the reclassification may be perceived as unfair by other workers in the government, and it will be more costly than was necessary. This option has the advantage of being targeted, but it cannot be implemented incrementally.
- ***Applying differential percentage adjustments to individual pay grades:*** this option is recommended for addressing issues with recruitment and retention driven primarily by pay compression. For individual positions, this approach is only somewhat targeted, making it fiscally less efficient. If done incrementally—e.g., by providing higher percentage increases for higher grades each year for a period of several years—retention data can be used to measure the efficacy of prior adjustments. To preserve the integrity of the wage table, however, the compensation of a lower grade should not be increased to the point where it overlaps with a higher grade, so there are practical bounds for the degree to which this option can be deployed.
- ***Offering supplements or other pay enhancements outside of the wage table to workers in particular jobs or sectors.*** This option for adjusting compensation is highly targeted—and, therefore, fiscally efficient—but should be deployed with restraint because it decreases the share of total compensation attributable to wages and salaries (which is generally discouraged because it reduces transparency) and because it can engender demands from other government workers for similar increases in compensation. It is, however, inherently incremental because pay supplements can be gradually increased until they improve recruitment and retention sufficiently to meet human resource objectives.

C. Fiscal Forecasting Should Shape the Policy Dialogue

34. To support the ECC in developing its medium-term objectives, the mission constructed an employment and compensation projection model. The Microsoft Excel-based model and a user's manual were delivered to the authorities, and staff from the Ministry of Finance (MOF) were trained in its use. The model separates the workforce into sectors—education, health, security, and everyone else—and relies on individual-level payroll data to create distributions for the number of *workers-by-age*, their

mean *wages-by-age*, and their mean *allowances-by-age*.²¹ The three distributions are used to reproduce spending in the first year of the projection horizon (FY2023) as recorded in the budget.²² The distributions are then projected forward over a medium-term horizon based on policy assumptions and other input variables. The role of the projection model is to facilitate an informed policy dialogue by enabling the authorities to: (i) evaluate the implicit tradeoffs between employment and remuneration; (ii) assess the fiscal implications of potential changes in government employment and remuneration policies; and (iii) tailor packages of reforms to attain medium-term fiscal targets.

35. The mission used its forecasting model to create a baseline projection for central government compensation spending. The mission’s baseline assumes that: (i) government employment will remain fixed at the same level as it was in FY2023 (per the authorities’ intentions) and (ii) average compensation for all workers will be increased on a *percentage* basis in line with the lagged rate of inflation,²³ in addition to the estimated 2 percent annual rate of increase attributable to longevity-related pay increments embedded in the structure of the government’s wage table. Values for inflation and nominal and real GDP growth were sourced from the IMF Staff Report for the 2023 Article IV Consultation. Compensation spending is expressed relative to GDP, chosen as a proxy for the magnitude of the government’s fiscal resources.

36. Under these assumptions, national government compensation spending as a share of GDP is expected to decline from 18.2 percent in FY2023 to about 16.5 percent by FY2026.²⁴ After FY2026, spending as a share of GDP is expected to remain roughly stable. Spending as a share of GDP declines initially because real GDP is assumed to grow strongly between FY2024 and FY2026, as Palau’s economy recovers from the pandemic. The spending stabilizes from FY2027 because real GDP is assumed to grow at about the same rate as the magnitude of the longevity-related pay increments embedded in the structure of the government’s wage table (Table 2). The longevity-related pay increments are of the same magnitude as anticipated long-term productivity growth in Palau’s economy. Consequently, relative remuneration between the public and private sectors for workers of similar qualifications and experience will remain roughly stable, provided that government compensation is increased on a percentage basis in line with inflation.

Table 2. Compensation Spending and Macroeconomic Assumptions

	FY23	FY24	FY25	FY26	FY27	FY28	FY29
Compensation Spending (Percent of GDP)	18.2	17.9	16.8	16.5	16.4	16.5	16.5
Nominal GDP (\$US Millions)	268.3	313.5	357.5	377.0	392.4	406.2	421.7
Nominal GDP Growth Over Prior Year (Percent)	8.9	16.9	14.0	5.5	4.1	3.5	3.5
Real GDP Growth (Percent)	0.8	12.4	11.9	3.5	2.0	1.5	1.5
Inflation (Period Average in Percent)	13.0	5.9	2.2	2.2	2.3	2.3	2.3

Source: IMF staff estimates.

²¹ “Allowances” in this report refer to all forms of nonwage remuneration, such as “differentials”, excluding the government’s contributions as an employer for pensions and healthcare.

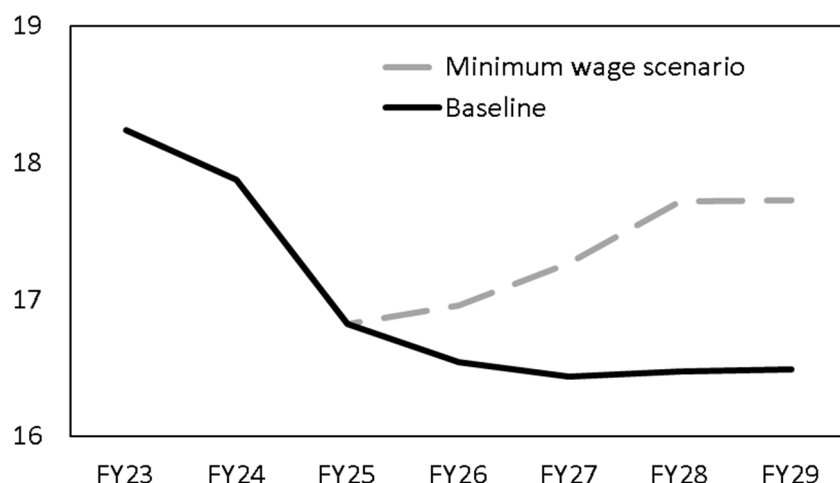
²² Some scaling of the distributions for *workers-by-age*, mean *wages-by-age*, and mean *allowances-by-age* was required as compensation spending as recorded in the budget never aligns exactly with payroll data because of the reclassification of some expenditure and for other reasons.

²³ Meaning that wages in any given year will be adjusted upward based on the observed rate of inflation from the prior year.

²⁴ 16.5 percent is roughly equivalent to pre-pandemic levels.

37. The mission’s baseline anticipates the emergence of fiscal space that could be used to address ongoing issues with recruitment and retention. However, this fiscal space is not a given. Increasing compensation by fixed dollar amounts to continue raising the minimum wage will reduce the fiscal space available to decompress the pay scale and/or target increases at positions for which recruitment and retention are most problematic. Figure 17 illustrates this risk by showing the evolution of compensation spending under the assumption that wages for all national government workers are increased further by \$0.50 per hour in FY2026, FY2027, and FY2028, mirroring the impact on pay resulting from the increases enacted in FY2023 and FY2024. In addition, should Palau suffer from another global shock—such that the economy fails to bounce back from the pandemic as is envisaged under the mission’s baseline projection—government compensation spending relative to GDP could rise, rather than fall, from its current level. It merits noting that another global shock will not only push spending upward relative to GDP, but it will depress revenue, as well.

Figure 17. Compensation Spending
(Percent of GDP)



Source: IMF staff estimates.

Note: The minimum wage scenario assumes wages for all national government workers are increased by \$0.50 per hour in FY2026, FY2027, and FY2028, mirroring the impact on pay resulting from the increases enacted in FY2023 and FY2024.

D. Increasing Compensation Within a Fiscal Constraint

38. The forecasting model developed by the mission should be used to evaluate the fiscal and distributional consequences of any proposed changes to compensation policies. The ECC will need to rely on the model to ensure that the fiscal consequences of its policy recommendations are consistent with overall expenditure priorities and will fit within the allotted fiscal space. This notably applies to developing medium-term targets for average levels of compensation for government workers and for setting remuneration of those positions for which recruitment and retention are most problematic. To illustrate the utility of the model in facilitating a dialogue on compensation policies, four scenarios for increasing government pay are discussed below.

39. All four scenarios assume that the authorities will choose to hold national government compensation spending as a share of GDP at 18.2 percent as it was in FY2023. The increase in

compensation attributable to the tenure-related increments embedded in the government wage scale—which the mission estimates to be about 2 percent per year—is close to the authorities’ estimates for the long-term real GDP growth rate. Therefore, if the wage table is adjusted on a percentage basis (as recommended), once Palau’s economy recovers from the pandemic, then the increase must be capped at the rate of inflation to prevent compensation spending from rising ever higher as a share of GDP. This means that real pay for government workers can only rise by about 2.0 percent per year, on average, over the long term. Individuals not receiving a step increase²⁵ will not receive an increase in their real pay but, if across-the-board percentage increases are awarded in line with inflation, the purchasing power of their compensation will always be preserved.

- **Flat increases in hourly wages:** holding compensation spending as a share of GDP at 18.2 percent (while maintaining the other assumptions in the baseline scenario) will enable wages to be increased on a fixed dollar per-hour basis for all workers by the amounts shown in Table 3. The consequence of this policy, however, will be to compress compensation for government workers even further than it already is. This will inevitably aggravate existing challenges with the recruitment and retention of workers for positions in the higher grades of the wage table.
- **Percentage increases in hourly wages with fixed employment:** if wages are increased using percentage increases (the recommended mechanism for increasing compensation across-the-board), pay compression will remain unchanged. Table 3 provides estimates for the percentage increases that can be feasible, while still holding compensation spending as a share of GDP at 18.2 percent, under the assumption that the size of the national government workforce remains fixed.
- **Percentage increases in hourly wages with a reduction in the size of the workforce:** if the number of national government workers can be gradually reduced from 1,976 workers (in FY2023) to 1,776 workers (in FY2029), a reduction of about ten percent, the percentage increases in compensation that can be afforded, while still holding compensation spending as a share of GDP at 18.2 percent, will be higher (Table 3). This illustrates that the *right-sizing* of government employment through a program of targeted attrition can create greater fiscal space for across-the-board increases in compensation. Roughly speaking, to accomplish a ten percent reduction in the size of the national government workforce, the mission estimates that only four of every five vacancies can be filled each year between FY2024 and FY2029. The increases in real pay resulting from this policy will be roughly double, on average, what is already provided by the tenure-related increments embedded in the government wage table.
- **Differential increases in wages:** to reduce the degree of compression in the government wage table, percentage increases can be applied differentially across grades. To illustrate the fiscal impact of such a policy, Table 3 provides estimates for feasible percentage increases under the assumption that wages for grades 1-10 are increased by only the rate of inflation, while wages for grades 11-18 are increased at the highest rate consistent with maintaining compensation spending at 18.2 percent of GDP.²⁶ Grades 11-18 were chosen because they include all teachers and most front-line

²⁵ This can occur either because they have not worked for enough years to be eligible or because they have reached the highest step in their grade.

²⁶ The percentage increases for grades 11-18 would vary by year and amount to 19.5 in FY2024, 16.9 in FY2025, 4.5 in FY2026, 3.1 in FY2027, 2.1 in FY2028, and 2.1 in FY2029.

healthcare workers which are the most problematic positions to fill and are subject to the highest rates of employee turnover. The rationale for providing increases for grades 1-10 in line with inflation is to preserve the purchasing power of compensation for workers not eligible for a step increase in any given year. Workers in grades 1-10 who are eligible for a step increase will receive a roughly 2 percent increase in the real value of their wages, on average, in those years. Figure 18 illustrates the impact of such a policy on compensation compression. Overall, compensation compression increases from 4.4 in FY2023 to 5.9 in FY2027.

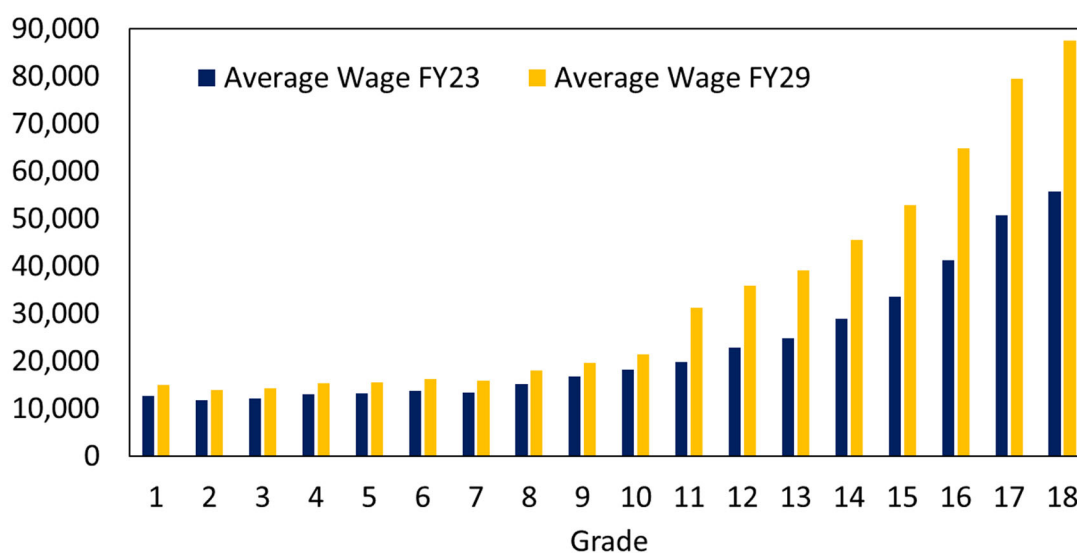
Table 3. Increasing Compensation Within a Fiscal Constraint

	FY24	FY25	FY26	FY27	FY28	FY29
Compensation Spending (Percent of GDP)	18.2	18.2	18.2	18.2	18.2	18.2
Sustainable Flat Increases (in USD per hour)	1.59	1.52	0.53	0.41	0.31	0.33
Compensation compression	3.7	3.3	3.2	3.1	3.0	3.0
Sustainable Increases - Fixed Employment (in percent)	15.1	12.5	3.9	2.9	2.1	2.2
Compensation compression	4.4	4.4	4.4	4.4	4.4	4.4
Sustainable Increases - Reduced Employment (in percent)	17.3	14.6	5.8	4.7	3.8	3.9
Compensation compression	4.4	4.4	4.4	4.4	4.4	4.4
Sustainable Average Differential Increase (in percent)	15.1	12.5	3.9	2.9	2.1	2.2
Compensation compression	5.0	5.7	5.8	5.9	5.9	5.9

Notes: for the purpose of this illustration, wage compression is defined as the ratio of the *average* compensation paid to workers in the highest grade relative to the *average* compensation paid to workers in the lowest grade. Wage compression can also be defined using the wages earned by the top- and bottom earners or by other metrics. Regardless of the metric chosen, compression will be reduced when wages are adjusted by a larger percentage for higher-paid workers than for lower-paid workers. Source: IMF staff estimates.

Figure 18. Average Annual Compensation by Grade

(US Dollars per Year, Sustainable Average Differential Increase Scenario)



Source: IMF staff estimates.

E. Additional Structural Reforms and Measures

40. In addition to preparing a medium-term strategy, as was discussed above, the ECC and other decisionmakers should consider additional, but related, structural reforms and measures to improve human resource management.

41. Ensure that vacancies are consistently and prominently advertised online. The authorities indicated that there is currently a widespread practice of recruiting ministries relying on unsolicited applications and word of mouth.²⁷ Vacancies should be consistently and prominently advertised online to reach a broader audience (both inside and outside of Palau) and ensure a transparent and competitive recruitment process. It would be helpful for hiring ministries' websites to include a link to the central ROP Employee Self-Service recruitment portal.

42. Developing initiatives to identify and address Palau's future human resource needs. The ECC should start by commissioning a study to identify any essential skills that are currently in short supply in the government workforce—or could become so over the medium-term as a result of turnover and retirement. The ECC should then take steps to address those shortages. This will likely require developing initiatives to achieve the following.

(i) Recruit more foreign workers to fill critical vacancies. This may require harmonizing the terms of their employment and structure of their compensation to more closely align them with the terms and compensation for domestic workers. Such a harmonization could include issuing longer-term (or open-ended) contracts to foreign workers and considering the waiving of the 30-day waiting period for non-Palauans to apply for critical vacant positions.

(ii) Expand the labor supply by increasing labor market participation, for instance by encouraging more Palauan women to enter the labor market.

(iii) Train and retrain the government workforce and expand educational programs to better align available human capital with the government's human resources needs.²⁸ This could include retraining workers previously employed in functions that have been identified as redundant.

43. Strengthening human resource management. The ECC should start by commissioning a study of the processes and procedures followed by the Bureau of Human Resources to ensure that unnecessary steps are eliminated, to remove undue discretion on the part of their staff, and to ensure that the line ministries have appropriate input. An intake program should be developed to educate new ministers and supervisory staff about human resource management. This could be performed by staff from the Bureau of Human Resources or by point-of-contact persons and HR staff within the individual line ministries under the supervision of—and with the support of—the Bureau. Based on the findings of the study discussed above, the ECC should also commission a review of the Bureau of Human

²⁷At the time of writing, there are only five vacancies visible online, although some are for several positions ([Employment opportunities \(palaugov.pw\)](#)).

²⁸Recent progress made in online training options since Covid could be harnessed to access new forms of training. See for instance The Potential of Online Learning for Adults: Early Lessons From the COVID-19 Crisis, OECD, 2020. Moreover, massive open online courses (MOOCs) from leading universities around the world are available on multiple online platforms including Khan Academy, Coursera, EdX, and Udacity. These could be integrated into in-person, on-campus learning and help reinforce training in highly sought-after fields.

Resources' enabling legislation and regulations—and make recommendations for their amendment—to ensure that the Bureau's processes and procedures advance Palau's human resources needs. Such a review would improve the ability of the Bureau to support the line ministries and to respond to changing labor market conditions and demands.

44. Taking advantage of existing initiatives. Securing qualified staff to provide essential services in Palau demands innovative approaches. The ECC should (i) survey existing programs across the national government and within the state governments to identify those programs that are most effective in addressing human resource needs and (ii) promote their adoption across the government sector. Many of these initiatives were discussed previously. Of particular importance are initiatives to: (i) encourage younger Palauans to enter government service through internships and apprentice programs; (ii) expand opportunities for higher education with in-country programs designed to support the government's human resource needs; (iii) recruit foreign workers into government service through fellowship programs; (iv) recruit young professionals from abroad, even temporarily, through programs such as the Overseas Development Institute (ODI) fellowship, Teach for America, and the US Peace Corps.

45. Gradually raising the retirement age for government employees from 60 to 65, in line with the authorities' stated intentions and IMF recommendations. Raising the retirement age is justified on actuarial grounds,²⁹ but it will also slow the loss of valuable human capital from the government workforce.

46. Addressing housing shortages would benefit all, including current or prospective government employees, and reduce the barriers to working in Palau. Avenues could consider improvement of infrastructures to some parts of the land that could be built. This would require fostering cooperation nation-wide, including between states and national governments to unlock access to land. Initiatives that have been implemented to help young people with accommodation during their education or at the beginning of their career are promising. Attention should then be paid to ensure that young people can move smoothly to more permanent housing once they enter adult life.

47. More openly discussing the financial burden created by customary social obligations. The unplanned and significant expenses of customary social obligations—which are primarily attributable to funerals for extended family—can be as high as several months of salary. These obligations can create severe financial stress, lead to excessive indebtedness, and encourage younger Palauans to emigrate. Emigration, in turn, shrinks the labor supply from which the government (and private sector) can recruit new workers. Some initiatives encourage the ex-ante pooling of resources through an insurance mechanism—such as the scheme implemented by the Koror State Government (with optional regular contributions deducted from paychecks), or test and learn solutions developed in Samoa by the United Nations' Pacific Financial Inclusion Programme and insurance companies.³⁰

²⁹ See [IMF Country Report No. 23/430](#).

³⁰ <https://www.uncdf.org/article/5808/making-funeral-insurance-accessible-to-samoans-for-the-first-time>.