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An Economic Diagnosis of Palau Through the Liechtenstein Lens: Moving Up the Value Chain—International Political Economy Strategies for Microstates

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AN ECONOMIC DIAGNOSIS OF PALAU THROUGH THE LIECHTENSTEIN LENS: MOVING UP THE VALUE CHAIN - INTERNATIONAL POLITICAL ECONOMY STRATEGIES FOR MICROSTATES

Dr. Kevin D. Stringer

1. Introduction

By its all-inclusive definition, the Pacific Rim accounts for two-fifths of the world's surface and nearly half of the world's population. By any standard, the nations that encompass the Pacific Rim are dissimilar in many fundamental respects, with differences ranging from culture to political systems to economic orders. [1] They range in category from regional powers like rich and stable Japan to microstates like bankrupt Nauru and volatile Fiji. In particular, the latter category of small, Pacific Island nations faces a number of challenges in the globalized world.

Contrary to the popular image of these as places isolated in time and space, Pacific Island nations, even the microstates, are becoming more firmly integrated into global economic and cultural systems than ever before. This accelerating process is facilitated by improved transport and communication systems, and driven by the global economy's insatiable demand for consumers, raw materials, and cheap labor.[2] Prior to 1989, Pacific Island states could rely on their historic colonial or metropolitan power for aid transfers to prop up their embryonic and often-emaciated economies. Times have changed in the post-Cold War world. For example, the Compacts of Free Association that defined the post-independence relationship between the United States (US) and the Marshall Islands, Federated States of Micronesia, and Palau represent the most spectacular examples of aid-for-security deals in the region, although almost all Pacific Island nations received significant subsidies from external powers.[3] The end of the Soviet threat, and a focus on other regions, particularly Eastern Europe and the Middle East, brought on a more meager era of aid for, and interest in, the Pacific Island states.

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[1] Taken from the essay by Leo Melamed, Foreword to Pacific Rim Futures and Options Markets, 1991, in *Leo Melamed on the Markets* (John Wiley & Sons, 1993), p. 251.
[2] See Gerard A. Finin and Terence Wesley-Smith, "Coups, conflicts and crises: the new Pacific Way?" *Race & Class*, Vol. 42(4), Institute of Race Relations, 2001, pp. 1-16, specifically p. 10.
[3] Finin and Wesley-Smith, p. 10. See also Robert A. Underwood, The Amended US Compacts of Free Association with the Federated States of Micronesia and the Republic of the Marshall Islands: Less Free,

Now, metropolitan countries no longer invite Pacific Island nations to join them as 'partners in progress' or 'allies in the defense of freedom'. Instead, their new message is salvation through economic development.[4] This message requires the receiving nation to develop an appropriate development strategy based upon its geopolitical location, resources, history, culture, and ingenuity. This approach requires innovative and creative thinking and planning. Under this new development regime, a number of Pacific Island governments have been rightly criticized for wasteful spending, ill-conceived policies, poor performance and official corruption.[5] This criticism is justified by the examples of countries that have wasted opportunity through economic mismanagement. Nauru and Tonga are two recent examples. These countries now face a severe challenge in laying out a reasonable strategy for economic growth.

Stewart Firth, of the University of the South Pacific, has summarized the challenge facing Pacific Island nations in an era of globalization:

> The trouble is that the new rules of a globalizing world are being set by people who have little interest in small places or special cases. On the contrary, the whole logic of globalization is to standardize rules so that there are no special breaks for any country whatever its circumstances. Comparative advantage is everything, and if you don't have many comparative advantages, that's bad luck.[6]

David Ricardo (1772-1823) was the English economist who developed the free trade theory of comparative advantage, which stipulates that if each nation specializes in the production of goods or services in which it has a comparative cost advantage and then trades with other nations for the goods in which they specialize, there will be an overall gain in trade, and overall income levels should rise in each trading country.[7] The challenge for most nations is finding their sustainable comparative advantage.

This manuscript focuses on the Pacific microstates since they are these "small places" often overlooked by the rest of the world, but facing the same challenges in the international political economy in an era of globalization. A microstate is defined as a very small, internationally recognized sovereign state. Size in the context of microstates can refer to either physical extent, or

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More Compact? *East-West Center Working Papers*, No. 16, (Honolulu, HI: East West Center Pacific Island Development Series, September 2003), for details to the renegotiated Compacts.

[4] Finin and Wesley-Smith, p. 11.

[5] Finin and Wesley-Smith, p. 11.

[6] "The Pacific Islands and the globalization agenda," *The Contemporary Pacific* Vol. 12, no. 1, Spring 2000, pp. 177-192.

[7] Thomas L. Friedman, *The World Is Flat: A Brief History of the Twenty-First Century* (New York: Farrar, Straus and Giroux, 2005), p. 226. See also David N. Balaam and Michael Veseth, *Introduction to*

population - but usually to both. Regardless of the definition, limited natural and human resources characterize microstates, which makes economic growth difficult. Because they are so small, and often so isolated, the world's microstates are very vulnerable to social, economic and environmental disturbances in the global system. Microstates are dangerously exposed to the vagaries of the global marketplace, including price shifts of their primary exports. Many face the threat of hurricanes, rising sea levels and global climate change. With scant educational and technical capacity, they are in danger of being left behind by a fast-evolving world.[8] In order to overcome these vulnerabilities, microstates need to have a strategic direction and plan for moving up the economic value chain to create a sustainable economy and become more competitive in the global marketplace.

The hypothesis of this manuscript is that in order for Pacific Island microstates to move up the economic value chain and increase global competitiveness, the microstates have to develop value-added economies based upon the real engines of competitiveness, which are science, technology, entrepreneurship, finance, logistics, and education,[9] and diversify away from tourism and extractive natural resource industries. While this may seem contrary to past economic advice for these nations, it is the only way microstates will generate a sustainable economy over a 50-year time frame. Conventional wisdom, defined as the truth associated with convenience, comfort, and simplicity,[10] has held that Pacific Island microstates should focus on tourism given a generally pleasant mixture of sun, sand, and water or else utilize their natural resources, usually fish stocks, to promote their economic development. Intuitively, as microstates are clearly small in geographical size, this fact limits their capacity for tourism growth since an overflow of tourists can overwhelm local infrastructure and spoil or damage the very environment that makes the location attractive for tourism. Extractive industries, specifically mining and fishing, are also not sustainable in the long term, and are environmentally damaging. The decline in Pacific fish stocks and the depletion of Nauru's phosphates are but two examples from a long list.

To partially evaluate this hypothesis, and to gain some insights into how this value chain transformation might be accomplished, this paper will employ a qualitative approach using comparative politics and benchmarking to compare a selected Pacific Island microstate with another microstate that has achieved a higher level of economic development. The aim is to highlight the

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International Political Economy, 3rd Edition (Upper Saddle River, NJ: Pearson Prentice Hall, 2005), pp. 119-120.

[8] See Microstates, Global Policy Forum, http://www.globalpolicy.org/nations/state/microindex.htm, accessed December 10, 2005.

[9] Prof. Stephane Garelli quoted in Frances Williams, "Lower taxes 'not the key' to making countries more competitive," *Financial Times*, May 12, 2005, p. 6.

[10] See Steven D. Levitt and Stephen J. Dubner, *Freakonomics* (New York: William Morrow, 2005), pp. 89-90 for their explanation of John Kenneth Galbreath's definition of conventional wisdom.

best practices from its example. Given this line of attack, the text is written with the practitioner and policymaker rather than the academic in mind. The methodology of this exercise is to use a comparative approach between an economically advanced microstate and a Pacific microstate to derive some generic economic development "lessons learned" that could be applicable to other Pacific Island microstates trying to move up the economic value chain. While not an all-encompassing study, this paper intends to provoke discussion concerning economic development strategies by using a European microstate as a comparative benchmark to be emulated. The candidate for value chain transformation is Palau, one of the seemingly prosperous Pacific microstates. Yet this surface prosperity conceals a number of economic weaknesses in terms of long-term sustainability. Its comparator state is the European Principality of Liechtenstein. In making the comparison, it should be noted that Liechtenstein was not always a rich country. In fact, until the beginning of the 20th century, Liechtenstein was a very poor country primarily surviving on subsistence agriculture. A modest industrialization process only started in the second half of the 19th century. This process was severely disturbed by both World Wars I and II, and it was only in the post-World War II era that Liechtenstein achieved its economic prominence as a microstate. This achievement came with a clear strategy on developing a high-end economy.

To promulgate and suggest new directions for economic development for Pacific microstates, the fields of comparative politics and business benchmarking will be mixed and employed. Comparative politics as a sub-field of political science is concerned with identifying both similarities and differences between international institutions in a systematic way. This approach enables political scientists to seek out patterns to answer useful questions and to then make informed judgments.[11] Comparative politics is useful in establishing a framework to identify similarities and general patterns among political institutions to understand the political universe.[12] Through comparative studies, political scientists can compensate for the lack of laboratory experiments by comparing political experiences and phenomena in one setting with those in other settings.[13] This possibility is valuable since the variability of human behavior, both individual and organizational, makes it very difficult to enunciate scientific laws in the social sciences. But comparative analysis does enable political scientists to make propositions that have a high probability of being accurate

[11] See Peter Calvert, *An Introduction to Comparative Politics* (New York: Harvester Wheatscheaf, 1993), p. 9 and p. 241.
[12] See Roy C. Macridis and Steven L. Burg*, Introductions to Comparative Politic: Regimes and Change,* 2nd Edition (New York: Harper Collins, 1991), p. 2.
[13] See Frank L. Wilson, *Comparative Politics: An Introduction to Comparative Analysis,* 2nd Edition (Upper Saddle River, NJ: Prentice Hall, 2002), p. 3.

and durable.[14] This discipline can be applied when viewing different nations' economic business strategies.

With a rough comparative framework established between two microstates, the approach is to use benchmarking to extract pragmatic examples of possible development strategies based upon the comparison. The primary assumption is that certain strategies for achieving economic growth might be replicable for another nation. Benchmarking is commonly used in business to evaluate different institutions and their performance in various fields of endeavor. The key elements of benchmarking are simple: at its core, benchmarking is about systematically comparing the performance of operations with a view to stimulating performance improvement by extracting the principles of "best practice" from higher performing operations.[15] It is a rational, structured technique for continuously improving key business processes and practices using, as the driver, comparative measurement against best practice regardless of industry or location.[16] As G. Watson states, "Benchmarking is a continuous search for and application of significantly better practices that lead to superior performance."[17] For this study, the methodology is to fuse the comparative approach found in comparative politics with the deriving "best practice" methodology from benchmarking to provide possible solutions for Pacific Island microstates.

2. General Comparison

The comparison for this paper is between the two microstates Palau and Liechtenstein. Conventional listings by sovereign country size and population generally begin with the Vatican (at 0.44 sq km and 921 inhabitants) and follow in ascending order with Monaco, Tuvalu, Liechtenstein, Palau and others well within the microstate category. A short overview of some general similarities and differences between Palau and Liechtenstein will provide a useful starting point for the evaluation. As with all assessments, the evaluation between these countries is of necessity very general as it cannot take into account all factors - social, economic, historical, and cultural - that bring a country to its current stage if development. This gross comparison will provide a basis for insights into the two states and allow for the economic comparison of the two nations.

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[14] *Ibid.*, p. 4.
[15] See Robert Camp, *Benchmarking: The Search for Industry Best Practices* (Milwaukee, WI: ASQC Quality Press, 1989).
[16] See Sylvia Codling, *Best Practice Benchmarking : A Management Guide* (Aldershot, UK: Gower Publishing, 1995) and Sylvia Codling, *Benchmarking* (Aldershot, UK: Gower Publishing, 1998).
[17] See G. Watson, *Strategic Benchmarking: How to Rate Your Company's Performance Against the World's Best* (New York: Wiley, 1993), p. 4.

The following table provides the general details to the two countries evaluated in this document:

Table 1:

Country	Area (km2)	Population (US Census Bureau July 2005 projection)	GDP in USD mio. (CIA Worldbook 2005)	GDP - Real growth rate in percent (CIA Worldbook 2005)	GDP – per capita in USD
Palau	458	20,303	174 (18)[18]	1	9,000 (600)[19]
Liechtenstein	160	33,717	825	11	25,000

2.1. Similarities

In reviewing the above statistics, both microstates have correspondingly small surface areas, small populations, plus a lack of natural resources. Each state depends heavily on a single strategic partner to whom it outsources parts of its state apparatus, specifically defense and monetary policy. Yet, each state conducts its own foreign policy and maintains a small proprietary diplomatic network. In Palau's case the partner is the United States. Palau gained its independence on October 1, 1994 with the entry into force of the Compact of Free Association with the United States. The Compact of Free Association for the Republic of Palau established Palau as a sovereign nation and ensured a continuation of political, economic, and military links between the US and Palau for the next 50 years. Under the Compact, the US remains responsible for Palau's defense for 50 years. During the first 15 years of the Compact, the US provides up to USD 500 million worth of funds to the Republic of Palau. Palau also uses the US dollar as its national currency, and therefore is dependent on the US for monetary policy, although this dependence can shield its economy from foreign exchange risks arising from currency fluctuations. As a sovereign nation, though, Palau conducts its own foreign relations. Since independence, Palau has established diplomatic relations with a number of nations, including many of its Pacific neighbors. Palau was admitted to the United Nations on December 15, 1994 as its 185th member, and has since joined several other international organizations.

For Liechtenstein, Switzerland is the key strategic partner. Switzerland is responsible for the national defense of Liechtenstein, and in 1980, Liechtenstein and Switzerland concluded a currency treaty with which Liechtenstein – which had already used the Swiss franc as its official currency since 1921 – is included in the currency area of Switzerland, while retaining its currency sovereignty in principle. The Swiss provisions on monetary, credit, and currency policy are therefore applicable

[18] Gross Domestic Product (GDP) estimate includes US subsidy of approximately USD 156 mio. If this were deducted, Palau would have a GDP of only about USD 18 mio. Obviously, the subsidy also skews the GDP per capita.

to Liechtenstein. In foreign affairs, as a sovereign nation, Liechtenstein also maintains its own diplomatic network, on a scale appropriate for its national interests. Additionally, within the scope of an accord concluded in 1919, Switzerland assumes the representation of Liechtenstein interests at the diplomatic and consular level in countries where it maintains a representation and Liechtenstein does not. In such cases, Switzerland acts pursuant to general or specific requests, which it may accept or reject, while Liechtenstein reserves the right to conduct relations with these States directly or to establish its own diplomatic representations. Liechtenstein was admitted to the United Nations on September 18, 1990 as its 160th member and participates in several international organizations.

2.2. Differences

There are a number of differences between the two nations, chief of which include geographical proximity to other countries and markets, the nature of the current economies, and Gross Domestic Product (GDP) figures. Palau, as an island country in the Pacific, is located at a great distance from major world markets and is not integrated into a specific trading bloc. Liechtenstein, in contrast, while landlocked, is locate in the heart of central Europe, and can profit from its participation in the European Economic Area and its proximity to major European trading partners.

Palau's economic development level can best be described as that of a hybrid economy with attributes of both developed and developing economies.[20] The essence of Palau's economy is services, mainly tourism and retail.[21] The service sector dominates the Palauan economy, contributing more than 80 percent of GDP and employing three-quarters of the work force. The government alone employs nearly 26 percent of workers. One of the government's main responsibilities is administering external assistance. Chief among the external aid sources is that received under the terms of the Compact of Free Association with the United States. Under this agreement, Palau will receive more than USD 500 million in assistance over 15 years and is eligible to participate in more than 40 US federal programs.

This economic structure contrasts sharply with the equally natural resource poor Liechtenstein. Liechtenstein has a broadly diversified economic structure with significant emphasis on industrial production, with many Liechtenstein companies working in specialized, research intensive market

[19] Adjusted GDP per capita if the US subsidy under the Compact of Free Association is removed.
[20] *Republic of Palau Economic Report* (Honolulu, HI: East-West Center and Bank of Hawaii, April 2003), p. 5.
[21] *Ibid.*

niches, in which they are considered global market leaders.[22] The economy is heavily export oriented with exports to 143 countries, with the main trading partners being the US, Germany, Switzerland, France, Italy, and Taiwan. The public sector share of GDP is relatively small at 7 percent.

With the very different economic structures, Table 1 shows the consequentially large disparity in GDP between the two microstates. This disparity becomes even greater if the US subsidy payments to Palau are removed. Per definition, gross domestic product is a measure of a nation's economic production in a year. It measures only production that takes place within a nation, and is the accepted international measure of national economic performance. In terms of benchmarking, given that a primary goal of economic development is to increase GDP, Liechtenstein could provide an appropriate benchmark for Palau to emulate in terms of possible development strategies.

3. Palau

3.1. Background

The Republic of Palau (or Belau, as it is called locally) is the westernmost group of the Carolines. This small island nation of 20,000 sits in the Pacific Ocean just east of the Philippines and southwest of Guam. Palau's first contact with Westerners began several hundred years ago, when missionaries and whalers stopped or were shipwrecked there. In 1885, Pope Leo XIII asserted Spain's right over the Caroline Islands. In 1899 Spain, in need of cash, sold the Carolines to Germany, which established a semblance of government there. Germany suffered defeat during World War I and the islands were formally passed over to the Japanese. The island of Koror became a sort of Japanese Bermuda for a time, and the Japanese did establish an educational system for the Palauans. After the ravages of World War II, Palau and most of the other islands in the Western Pacific became a trust territory administered by the United States under the auspices of the United Nations. But there were a lot of talented young Palauans who were in the Congress of Micronesia who decided to go it on their own. Through intensive negotiations, a reasonable solution was found.[23] The solution was that the Republic of Palau gained its independence in 1994 after signing a Compact of Free Association with the U.S. that provided funding for 15 years to help the nation develop. The United States provided a certain level of financial assistance and agreed to include Palau in some 40 federal programs for 15 years. Today, the Palauans have close ties with the Chinese government on

[22] Presentation, "Liechtenstein – Industrial location," slide 3, at the official Liechtenstein government site, http://www.liechtenstein.li/en/pdf-fl-multimedia-information-industriestandort-druck.pdf., accessed December 10, 2005.
[23] See Joe Murphy, "Palau: Little Republic That Could," *Pacific Islands Report*, October 18, 2004.

Taiwan, which has provided them with some financial assistance. So has the Japanese government.[24]

3.2. The Economic Challenge

The economy consists primarily of tourism, subsistence agriculture and fishing. The government, which is the largest employer with some 36 percent of the workforce, relies heavily on financial assistance from the United States and other developed countries in Asia. The population enjoys a per capita income twice that of the Philippines and much of Micronesia given the US aid money that flows to the nation.[25] Yet, Palau falls prey to the same economic constraints facing many island nations, including a scarcity of natural resources, geographical isolation, lack of infrastructure, few skilled laborers, and vulnerability to inclement weather. Not only is tourism Palau's main industry, it is Palau's leading private sector income source, with potential for future growth. Long-run prospects for the key tourist sector have been greatly bolstered by the expansion of air travel in the Pacific, the rising prosperity of leading East Asian countries, and the willingness of foreigners to finance infrastructure development. Activity focuses on scuba diving and snorkeling among the islands' rich marine environment, including the Floating Garden Islands to the west of Koror. The number of visitors - 85 percent of whom come from Japan, Taiwan, and the US - reached nearly 67,000 in 1997, more than quadruple the level of a decade earlier. Tourism earned USD 67 million in foreign exchange for Palau in 1996, accounting for roughly half of GDP. Arrivals from Asian countries dropped in 1998 and 1999 due to the regional economic downturn and remained at about 57,000 per year for 2000-2002.

The tourism sector presents the greatest potential for long-run development and growth, especially on the island of Babeldaob, which encompasses 80 percent of the landmass of Palau, and is currently awaiting development money from the US and Japan. Traditionally, Palau has catered to Japanese tourists, but recently, improving relations with Taiwan have brought a surge of Taiwanese tourists as well.[26] Palau is one of the world's top diving destinations, and the Rock Islands is one of the most pristine marine ecosystems in the Pacific. Tourist infrastructure is being built to support this industry, and add to Palau's competitive advantage as a unique destination. However, Palau's limited and fragile ecosystem is the ultimate constraint on how much tourism the country can accommodate.

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[24] *Ibid.*

[25] See the United Nations site http://www.un.org/special-rep/ohrlls/sid/SIDS-states/profiles/palau.htm, accessed December 10, 2005.

Government is Palau's single largest employer and recently accounted for almost a third of the national income.[27] This allocation places a huge drain on the overall economic structure. As P.F. Kluge noted, "There's a relation between the size of a population, the size of the government, the size of the private sector…and the fact that they've been out of balance for fifty years doesn't mean they won't have to pay up eventually. And no one wants that conversation…"[28]

Construction is the most important industrial activity, contributing over 9 percent of GDP. Several large infrastructure projects, including the rebuilding of the bridge connecting Koror and Babeldaob Islands after its collapse in 1996 and the construction of a highway around the rim of Babeldaob, boosted activity at the end of 1990s.[29] Without the construction of public projects, Palau's economy would have been much weaker since the other primary income sources such as exports, including tourism services, have remained at low levels for some time. Yet, Palau's strong construction activity has had little visible ripple effect since the construction workers, who are mostly temporary foreign workers, send their salaries home to their own countries.[30] This situation shows another aspect of Palau's economy. Palau is heavily dependent on foreign workers. To a far greater extent than any other independent Pacific Island nation, Palau has explicitly embraced the notion that "guest workers" are a critical ingredient of its national economic and social development strategy.[31] Some believe that more than 50 percent of the private sector labor force is currently composed of non-Palauan workers.[32] This notion has critical consequences to be addressed later when it comes to maintaining Palau's indigenous talent.

Agriculture is mainly on a subsistence level, the principal crops being coconuts, root crops, and bananas. Fishing is a potential source of revenue, but the islands' tuna output dropped by over one-third during the 1990s. Agriculture and fishing comprise a small share of national income, and the likelihood for growth in this sector is low. The primary reason is Palau's small market, which cannot take advantage of economies of scale that make commercial agriculture financially

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[26] Countrywatch database , updated January 2005.
[27] *Republic of Palau Economic Report* (Honolulu, HI: East-West Center and Bank of Hawaii, April 2003), p. 16.
[28] Discussion with a local Palauan businessman in P.F. Kluge, "Palau: The Age of Barbecue," in *Pilgrims & Natives: Literary and Artistic Journey's*, Edited by Thomas Klein and Roger Schmidt, date and publisher unknown,," pp. 109-110. This source can also be found in P.F. Kluge, "Palau in the Age of Barbecue," *Rendezvous : Idaho State University journal of arts and letters*, Vol. 36, No. 2, Spring 2004.
[29] Countrywatch database , updated January 2005.
[30] *Republic of Palau Economic Report* (Honolulu, HI: East-West Center and Bank of Hawaii, April 2003), p. 10.
[31] See Dean Alegade and Gerard Finin, "Exporting People: The Philippines and Contract Labor in Palau," *The Contemporary Pacific*, Volume 12, Number 2, Fall 2000, pp. 359-370, specifically p. 359.
[32] See citation in Dean Alegade and Gerard Finin, "Exporting People: The Philippines and Contract Labor in Palau," *The Contemporary Pacific*, Volume 12, Number 2, Fall 2000, pp. 359-370, specifically p. 360.

successful.[33] Aside from fish exports, relatively small quantities of garment exports earned Palau a little over USD 9 million in 2001. Critically relevant to the development discussion, apart from garments, handicrafts, local food processing and furniture making for domestic markets, there is no manufacturing in Palau.[34]

In terms of balance of payments, because of Palau's dependence on imports and its narrow export base, the current account balance, lately in perpetual deficit, has widened as project-related capital goods imports have increased and tourist receipts have fallen. The worsening external position suggests that Palau's competitiveness continues to deteriorate. Tourism competitiveness has definitely declined due to Severe Acute Respiratory Syndrome (SARS) and terrorism activity.[35] Palau's trade imbalance is adequately and artificially covered by grants from the United States and other countries.[36]

3.3. Ventures

Bringing the Republic of Palau to its full potential will not be easy, and previous presidents of this Western Caroline island group have not had an easy time with it. But it's a task that President Tommy Remengesau Jr. has been elected to continue to attempt as he leads Palau for the next four years. "I will continue to grow the economy that's required for the survival of the republic," Remengesau said. "We'll continue to concentrate on the tourism industry, the agricultural industry and the aquaculture industry. It's also very possible that Palau can become the financial center of Micronesia and we need to keep working toward that. But we do all of this with the understanding that we need to promote sustainable growth but with a balance that allows us to preserve our island environment and our culture," Remengesau said. "Really, we have one goal - to make Palau a better place to live and really bring Palau to its full potential. I think if we all keep that in mind, then we should be fine," Remengesau said.[37]

President Remengesau's heart is in the right direction, but a number of initiatives proposed to transform the Palauan economy have often led in the wrong direction. The first problem area is the Compact funds. The main economic challenge confronting Palau is to ensure the long-term viability of its economy by reducing its reliance on foreign assistance. The Compact of Free Association

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[33] *Republic of Palau Economic Report 2003*, p. 15.
[34] *Ibid.*, p. 5.
[35] Countrywatch database , updated January 2005.
[36] *Republic of Palau Economic Report 2003*, p. 5.
[37] See Oyaol Ngirairikl, "Remengesau Sets Goals for New Term in Palau," *Pacific Islands Report*, November 10, 2004.

created a trust fund to provide perennial budget support when US direct assistance ends. The value of the trust fund in 2004 was approximately USD 140 million.[38] The United States-Republic of Palau compact agreement funding payments were USD 14.07 million for 2003 and USD 14.21 million for 2004. These compact payments will end after 2009, although Palau is banking on a second compact agreement similar to that negotiated by the Federated States of Micronesia in 2003. Palau reports annually to the United States regarding how these funds are expended. Beyond this US operational support, the Republic of China and Japan are active in providing grant and loan assistance to Palau.[39]

As one writer noted, though, "This is a time when Palau must provide for its future, this is when the Republic needs to make money. But making money is not the same as taking money, which is what they are doing now, taking money from the United States, Japan, Taiwan, Korea, from governments from private investors."[40] According to Senator Yukiwo Dengokl, Palau's leaders are not doing what experts say is necessary to build economic viability. Dengokl claimed Palau's leadership was plundering the compact trust fund instead of building it; squandering money on needless junkets of questionable value; looking to other people for solutions to Palau's problems instead of looking inward; increasing Palau's dependence on foreign labor with its attendant outflow of hard cash; and failing to insure the existence of a new generation of professionals for legal, medical, accounting, and engineering work. He also said that many people are abdicating their responsibility for child rearing and values instruction. "It's enough to make a grown man cry to see how terribly we are failing our children" Dengokl stated. He went on: "Today we see our elders and parents partying, dancing, cutting ribbons, and coloring their hair, and doing whatever it is that seems to be the current fad . . . while our children are left to tend to themselves eating processed foods and watching TV shows that are unsuitable even for delinquent adults, or playing violent videogames that leave them physically and mentally weak."[41]

Unfortunately for Palau, the same money making schemes pop-up year after year, free trade zones, super ports, casinos, garment factories, hotels, new airports, and they all have one element in common: Paluans don't work in them.[42] And they are often poorly thought out, and contrived for short-term revenue gains, rather than long term sustainability. Additionally, tourism is seen as the panacea for the future. Certainly tourism is the foundation upon which Palau must build its

[38] Countrywatch database , updated January 2005.
[39] See Donald R Shuster, "Political Reviews: Micronesia in Review: Issues and Events, 1 July 2003 to 30 June 2004, Palau," *The Contemporary Pacific*, Vol. 17 No. 1, Spring 2005, pp. 173-183.
[40] See P.F. Kluge, "Palau: The Age of Barbecue," p. 111.
[41] See Donald R Shuster, "Political Reviews: Micronesia in Review: Issues and Events, 1 July 2003 to 30 June 2004, Palau," *The Contemporary Pacific*, Vol. 17 No. 1, Spring 2005, pp. 173-183.

economy, but an early diversification will help it weather the vagaries of the tourist trade. The next few paragraphs take a brief look at two of these ventures, both of which are not conducive to moving up the value chain, and the challenges posed to Palau's one sector upon which it can start building a more diversified future.

3.3.1 Energy

In 2004, the grandest plan of all was that of Palau Pacific Energy Inc, which had apparently persuaded many of Palau's political leaders that the chances of oil under the sea floor north of Kayangel Atoll were good. A USD 1.7 billion figure of revenue for Palau had been bandied about, based on annual payments of USD 63 million. This, in turn, was based on the assumption that 250 million barrels of crude could be pumped over twenty-seven years at USD 28 per barrel. Such huge dollar amounts have brought about "oil fever" and generated an argument between President Remengesau and the congress on how to proceed. The congress claimed it had informed itself about the oil exploration and exploitation business and associated environmental issues through consultation visits to Singapore and Texas, but Remengesau took a more cautious approach. The two sides worked out an agreement and signed a joint letter to the World Bank requesting its support for funding an independent feasibility study of oil exploration and an independent analysis of pending Olbiil Era Kelulau (OEK)[43] legislation regarding oil exploration and exploitation. Hopefully with this cautious approach Palau will avoid the financial debacles of the past.[44]

Despite the cautious approach, the direction is still wrong. Oil, as an extractive industry, can bring untold riches to a country, but the central question is how to use the funds properly to develop future sustainability. One only has to look at the Middle East for both positive and negative examples of this challenge. Furthermore, Palau is an archipelago of beautiful islands, with pristine waters famous around the world for providing an unparalleled diving experience. Its waters draw people from around the globe, and thus are an integral component of the Micronesian nation's economy and culture. Since tourism is the "building" foundation, it must not be put at risk.

This is why Palau President Tommy Remengesau Jr. did the right thing by sending the Palau National Petroleum Act back to the legislative branch with recommendations. Both houses of Palau's Olbiil Era Kelulau passed the legislation, which would create a national energy agency that would lead efforts to drill for oil about 12 miles northwest of Kayangel state. They cite geological

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[42] See P.F. Kluge, "Palau: The Age of Barbecue," pp. 95-117, specifically p. 109.
[43] The OEK is Palau's Congress.
[44] See Donald R Shuster, "Political Reviews: Micronesia in Review: Issues and Events, 1 July 2003 to 30 June 2004, Palau," *The Contemporary Pacific*, Vol. 17 No. 1, Spring 2005, pp. 173-183.

surveys that say the area is a "potential oil site." Florencio Yamada, a delegate of Kayangel state, was one of the primary authors of the legislation. He said, "We won't know how much oil is there until we drill." But that's not an acceptable position when drilling could result in a potential environmental disaster, which would wreak havoc on Palau's waters and thus its tourism industry. There needs to be a much more deliberate and careful approach toward any potential oil exploration in Palau.

Remengesau's chief of staff, Billy Kuartei, wanted an independent company with expertise in the field to conduct a study that looks at the viability of oil drilling and details the environmental dangers that may occur. This isn't much to ask before proceeding with something that could ruin Palau's marine ecosystem. While the discovery and production of oil would, in all likelihood, be an economic boon for Palau, the government and its citizens must be aware of any potential hazards. The positive must be weighed against the negative to make a truly informed decision. Drilling for oil in Palau is not a decision that should be lightly or haphazardly made. Remengesau recognized that; Palau's legislators need to do the same.[45]

3.3.2 Free Trade Zone

Another project was the creation of a free trade zone in Ngardmau. The free trade zone aims to create job opportunities for Palauan citizens and boost the economy through attracting new investors. According to the proposed law, companies that establish manufacturing operations in Ngardmau will get exemptions from import tax on capital equipment and raw materials and partly finished goods to be used in manufacturing. The exemptions will serve as an incentive to businesses in the free trade zone. The area needed for the zone is at least 14 square kilometers. The Committee on Resources, Commerce, Trade and Development chaired by Senator Lucius Malsol endorsed the passage of the bill. The measure provides for the establishment of the Ngardmau Free Trade Zone Authority, a public corporation governed by a board of 11 directors. The authority will be tasked to determine what types of businesses are appropriate within the trade zone. The authority will draft regulations for the zone, including environmental rules.[46]

According to the Senate panel, the non-collection of import tax revenue by the government during the period of the exemption will be offset by an increased tax base in terms of gross revenue taxes collected from the zone's businesses, and the wage and salary taxes collected from additional workers and Palauan workers. The increased sale of goods and services to companies in the zone is

[45] See Pacific Daily News, "Oil and Palau Don't Mix," *Pacific Islands Report*, September 9, 2004.

also expected to boost the country's economy, the committee said. "(The) committee firmly believes that this (bill) will form the basis for the introduction and growth of the new businesses and industry that would be highly favorable to the development of our economy," the committee report said.[47] While a noteworthy development, a free trade zone in and of itself does not generate value. What sort of businesses should invest in Palau? What sectors might find Palau attractive? These questions seem not to be answered in the current literature on this free trade zone.

3.3.3 Tourism

As mentioned earlier, Palau's main comparative economic advantage currently lies in developing specialty tourism.[48] Palau's attractiveness in recent years as international tourist destination is largely attributable to its small size, lack of industrial development, and unspoiled natural beauty. The post-independence decision to make Asian-led tourism the engine of Palau's economic growth during the 1990s has resulted in both a construction boom fueled by foreign capital and a burgeoning service sector composed primarily of Filipino contract workers.[49]

The Palau that Ambassador Stuart J. Beck, Palau's permanent representative at the United Nations first encountered in 1977 had a high commissioner, a flag, a golf course, lots of scuba diving and no phones. The country he represents today is busy turning itself into a tourist spot for vacationing Asians and replacing its shantytown capital city on its most populous island, Koror, with a new capital on its largest island, Babeldaob. The jungle site has yet to be cleared, but the completed government building, a spanking white, domed replica of the United States Capitol, already stands in its midst. "As China and the Asian middle class grows, Palau will be their Bermuda," Mr. Beck said. "Taiwanese who want to get married on a tropical island already think of Palau as a hot destination."[50]

President Remengesau added that the strengthening of the tourism industry would be continued through promotion of additional markets and diversified tourism activities. The president said that aside from diving, Palau should go into sport fishing, and golf and eco-tourism activities and will also look into the potential of the "Silver Hair" town concept. "We must maximize the benefits we receive from tourism and ensure that these benefits are distributed to the broadest number of

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[46] See Bernadette H. Carreon, "Palau Creates Free Trade Zone to Boost Business," *Pacific Islands Report,* September 15, 2003.
[47] *Ibid.*
[48] *Republic of Palau Economic Report* (Honolulu, HI: East-West Center and Bank of Hawaii, April 2003), p. 5.
[49] *Republic of Palau Economic Report* (Honolulu, HI: Bank of Hawaii Economics Department, 1997), p. 4.

Palauans. We must develop new marketing options and improve government support and programs for tourism," Remengesau said. The president said since the Babeldaob Compact Road and National Capital will be completed next year, economic opportunities in the areas of agriculture and aquaculture must be developed in the area. He also emphasized the development of the country's natural resources and international corporate and banking sectors.[51]

Yet tourism is a shaky house to build one's economy on. Economic and financial difficulties in Japan and Taiwan can adversely affect the entire Pacific. The Western Pacific, in particular Palau, primarily depends on Japan and Taiwan for tourist dollars.[52] Given this challenge, Palau should determine the specific types of visitors, as the focus of its development strategy. One suggestion put forward by Dr. Wali M. Osman, in his report on Palau's economy, was for Palau to maintain its major market mix of visitors from Japan, Taiwan, and the US while adding other markets such as Korea to diversify. Reliance on 3-4 markets rather than one or two would reduce the risks of tourist traffic fluctuations. The ultimate goal is for Palau to strengthen its comparative tourism advantage by becoming a specialty market by attracting small masses of higher per capita spenders.[53] Yet even with such a strategy, Palau's' overdependence on the vagaries of the tourist trade makes for a weakly sustainable economy over a long period. Moreover, larger world events like terrorism, pandemics, SARS, rising oil prices for airline fuel, and the Asian downturn can all have a strong impact on a tourist based economy. Palau's expeditious diversification beyond this cornerstone sector will help its development path during the next 50 years. To think innovatively on how this diversification path might look, a fellow microstate, Liechtenstein, provides some comparative insights.[54]

4. Liechtenstein

4.1. Background

Liechtenstein is a unique, but little known microstate success story in modern Europe. Achieving full international sovereignty in 1806, Liechtenstein is one of Europe's senior states with no natural resources beyond a hard-working and entrepreneurial population. As a poor, agrarian country, well

[50] See Warren Hoge, "If you Care about Palau, This is a Good Place to Be," *United Nations Journal*, July 10, 2005, p. 4.
[51] See Bernadette H. Carreon, "Remengesau Promises Quality in Palau," *Pacific Islands Report*, February 2, 2005.
[52] *Republic of Palau Economic Report* (Honolulu, HI: East-West Center and Bank of Hawaii, April 2003), p. 9.
[53] Ibid., pp. 17-19.
[54] The Liechtenstein government portal at http://www.liechtenstein.li/ provides a wealth of official information to the country, history, and economy.

into the 20th century, Liechtenstein struggled to feed a population of only about 8,000 inhabitants. When population exceeded this size, there were repeated waves of emigration.[55] The economic crisis of the 1920s, and a devastating flood of the Rhine River laid a poor foundation for sustainable economic development. Since the 1940s, low taxes, liberal regulation, small government, and innovation have helped to transform it from an agrarian backwater into one of the most advanced high technology industrial countries in Europe. Its high tech manufacturing companies are important providers of employment to the indigenous population and offer as many jobs abroad as at home.[56]

4.2. Current Economic Situation[57]

Liechtenstein is country with approximately 34,000 inhabitants, with 29,000 available jobs. A special characteristic of Liechtenstein's national economy is it's comprehensive diversification. The primary sector of the economy, agriculture and forestry, accounts for little more than 1 percent of the total workforce. Industry and the trades sector account for 44.8% of the jobs. The service and commercial economy's share is around 54%. In terms of GDP, about 40% of GDP is covered by added value in industry and manufacturing, 30% in the financial services sector, 25% in general services, and the remainder of 5% in agriculture and households.[58]

The secondary sector is highly diversified. Liechtenstein's industry does not manufacture cheap mass products, but only high-tech goods. Liechtenstein has no other option. It does not fulfill the basic prerequisites for the sale of mass products on a competitive scale. On the one hand, Liechtenstein has no natural raw materials, which would favor the foundation of a basic industry or heavy industry in Liechtenstein. On the other hand, the wage level in Liechtenstein is too high to make labor-intensive manufacturing processes appealing. Furthermore, the government takes no steps to spur the economy or promote exports with subsidies or aid.

Liechtenstein's main products lie in the field of mechanical and apparatus engineering. This field is illustrated by fastening and mounting systems for construction, steel mills and shipyards, vacuum

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[55] See Dr. Hubert Büchel, Director of the Office of Economic Affairs, "Liechtenstein – An Example of Economic Freedom and a Free Market Economy," official report, Vaduz, June 2003.
[56] See David Beattie, *Liechtenstein: A Modern History* (London: IB Tauris & Co Ltd., 2004) for an excellent English language overview to Liechtenstein's economic development.
[57] See Dr. Hubert Büchel, Director of the Office of Economic Affairs, Vaduz "Is their anything special about Liechtenstein's national economy," official report, Vaduz, June 2003.
[58] See Liechtenstein Economic data, Portal of the Principality of Liechtenstein, http://www.liechtenstein.li/en/eliechtenstein_main_sites/portal_fuerstentum_liechtenstein/fl-wuf-wirtschaft_finanzen/fl-wuf-wirtschaftszahlen/fl-wuf-wirtschaftszahlen-wertschoepfung.htm, accessed November 21, 2005.

technology products, optical and electronic thin-film products, electronic systems, measuring and testing instruments, and heat generating and heat recovery systems. A further field is chemistry and ceramics, which includes products ranging from the manufacture of dentures and accessories for dental technology to lacquers, paints and crystal gems.[59] The tourist and catering sector are not as important as they are believed to be. This branch of industry only accounts for about 5 percent of the country's total jobs. The banking sector is however, more important accounting for 8 percent of total employment and as stated earlier, 30 percent of the GDP. Liechtenstein can be considered a financial center in its own right, with specializations in trusts, domiciliary companies, and private banking.

4.3. Strategies That Worked

For Liechtenstein, there is to some extent a natural concentration on high value added sectors, without special national planning and support, given the lack of raw materials, scarcity of labor, and scarcity of land.[60] Enterprises are forced to be entrepreneurial, as they have to face competition abroad without special state support. Its small home market means that the country must achieve success in foreign markets. The success of Liechtenstein's industry is demonstrated by its exports increasing in the last decade by about 80 percent. In Liechtenstein's special circumstances, the production structures are almost automatically oriented towards specialized market niches. The manufacture of these niche, high tech products calls for constant and intensive research and development work, and highly educated and motivated personnel.[61] This concentration on high tech manufacturing for exports and to a lesser extent banking illustrates that Liechtenstein's success and position high on the economic value chain revolves around the real engines of competitiveness, which are the aforementioned areas of science, technology and niche industries, entrepreneurship, finance, logistics, and education.[62]

Examples of this successful strategy abound. In the logistics field, the Austrian based crystal company, Swarovski runs its main production and logistics center in Liechtenstein. Hoval, based in Vaduz, is one of the leading manufacturers of boilers and ventilation systems in the world. Hilti, headquartered in Schaan, Liechtenstein is the global market leader in fastening technology. It

[59] See Dr. Hubert Büchel, Director of the Office of Economic Affairs, Vaduz "Is their anything special about Liechtenstein's national economy," official report, Vaduz, June 2003.
[60] See Dr. Hubert Büchel, Director of the Office of Economic Affairs, "Liechtenstein – An Example of Economic Freedom and a Free Market Economy," official report, Vaduz, June 2003.
[61] See Dr. Hubert Büchel, Director of the Office of Economic Affairs, Vaduz, "Overview: Liechtenstein's History and Economy," speech to the US Congressional Visit to Liechtenstein, International Management and Development Institute, Vaduz, February 21, 2004.

employees 1,500 person in Liechtenstein and 14,500 abroad. A more detailed case, exhibiting a combination of science, technology, and unique niche positioning is the company Ivoclar Vivadent.

Since its founding in 1933 in Schaan, Liechtenstein, Ivoclar Vivadent has evolved into a leading international manufacturer of high quality dental materials for preventative, restorative and prosthetic dentistry. In addition to being a leader in product innovation it is the recognized leader in quality esthetic dental materials. Dental laboratories and dentists in over 100 countries throughout the world use its products. Its focus is to provide product systems for the success of the laboratory technician, the success of the dentist and the satisfaction of the patient. Ivoclar Vivadent AG is an innovative enterprise with one of the largest research and development centers in the dental industry offering a convenient system solution for every requirement in the dental office and dental laboratory. It has global orientation, but local presence. As a global player, the company is present in almost all the markets in the world with its own subsidiaries in 17 countries in Europe and overseas. At the headquarters in Liechtenstein, 120 employees in research and development alone are working on ensuring high quality products.[63] This company clearly profits from the Liechtenstein concentration on education, investment in human capital, and seeking niche production capabilities.

Under the headings of education and entrepreneurship, and to build the human capital element, Liechtenstein founded a Competence Center for Small and Medium-Size Businesses under the direction of the Liechtenstein University of Applied Sciences to support its high value economy. This center advises young entrepreneurs, coaches self-employed persons, researches business cycles and trends, and provides an interface between business and science.[64] Liechtenstein further places heavy emphasis on vocational education, which feeds its industry, and participates in research and development activities with regional Swiss, German, and Austrian partners. For finance and banking, Liechtenstein offers specialized courses to maintain its excellence as a financial center. All of these efforts fuel its high tech, niche export economy. This microstate model, adapted to Palau's unique situation, could provide a better path for future development than previous proposals.

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[62] Prof. Stephane Garelli quoted in Frances Williams, " Lower taxes 'not the key' to making countries more competitive, *Financial Times*, May 12, 2005, p. 6.
[63] See the Ivoclar Vivadent website for company details at http://www.ivoclarvivadent.com/Secure30/ivoclar.jsp?xml=ivoclar:/data/portal.xml&xsl=ivoclarsheets:/sheets/portal2.xsl&language=EN&portal=com, accessed December 10, 2005.
[64] Presentation, "Liechtenstein – Industrial location," slide 3, at the official Liechtenstein government site, http://www.liechtenstein.li/en/pdf-fl-multimedia-information-industriestandort-druck.pdf, accessed December 10, 2005.

5. Prescriptions and Ideas:

The strategies for a microstate in terms of value creation and moving up the economic value chain approximate those found in the corporate world. Microstates may even resemble corporations in certain characteristics given their small size. Microstates, like corporations, must consider:

- Finding a niche or comparative advantage for driving their economy
- Diversifying in business activities to avoid over dependence on global factors that might influence the economy negatively
- Creating a value proposition for would be commercial markets and partners
- Branding and positioning in the world market so that the microstate is identified with a clear value proposition.

For Palau, President Tommy E. Remengesau, Jr. has set out the priorities of this young Republic very clearly in his recently published Statement of Purpose:

> *". . . Palau must establish a clear framework to become self-sufficient in order for the People of Palau to gain the benefits of a free and democratic society that had so long been denied to them."*[65]

This self-sufficiency can only come with a clear and coherent strategy for moving up the economic value chain. This requirement necessitates that Palau look to a reasonable benchmark to find ideas and prescriptions for achieving this. As noted in the paper, the fellow microstate of Liechtenstein could be one such development benchmark. Translated into action, Palau must change its development strategy and transform its economy. The strategy should shift the economy from a service-based economy, with a large government sector, to a high end, export based economy with a smaller government. This change would mean moving beyond the tourism and fishing sector foundation of today into commercial areas that focus on education, logistics, and technology and niche industries.

Small economies like Palau's that depend heavily on overseas capital, skills, and income flow (such as tourist arrivals and spending) tend to be stagnant. Because small economies like Palau can exert little pressure on large economies, implementing economic policies to diversify

[65] Quoted from Palau's Statement of Purpose, 2005. See also the website of Palau's Mission to the United Nations, http://www.palauun.org/, accessed December 10, 2005.

sources of capital, skill, and income flows would help maintain flexibility.[66] In fact, states with transformative aspirations are, almost by definition, looking for ways to participate in leading sectors and to shed lagging ones.[67]

5.1. Education ideas

With few natural resources, Palau could plug into the electronic, globalized world by providing high-end services to corporations. Liechtenstein does this by having a high tech industry supported by a center of competence for entrepreneurs and the necessary technical education in the school system. Adapting these concepts to the Pacific environment, since Palau sits at a cultural and geographical nexus between the US and Asia, Palau could capitalize on its connections with Japan and Taiwan to become the linguistic center of competence for Japanese - English or Chinese - English translation. Corporations have a tremendous need for document translations and bilingual capabilities. By establishing an educational center to develop this skill base, Palau could create a knowledge-based industry in cooperation with US, Japanese, or Taiwanese commercial partners, and provide young Palauans with educational training that would keep them from emigrating.

This focus on specialized education has its precedent already in another Pacific Island microstate. In an undertaking with global reach, the Tuvalu Marine Training Institute (TMTI) offers scores of young Tuvaluan men instruction in the skills necessary to staff commercial cargo ships worldwide. Each year young Tuvaluan men compete to be part of an entering class of 40 to 60 cadets who receive international accredited classroom and practical instruction in seamanship. Over the years TMTI has a successful history of maintaining a special relationship with German shipping firms that employ some 450 TMTI graduates. This high degree of satisfaction with the Tuvalu maritime workers employed around the globe is essential given the paucity of other employment opportunities, particularly for young men lacking high school degrees. More recently some workers have pursued higher education and are becoming officers. It is estimated that the maritime workers send home remittances in excess of USD 5 million per year.[68]

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[66] *Republic of Palau Economic Report* (Honolulu, HI: East-West Center and Bank of Hawaii, April 2003), p. 11.

[67] See Robert Gilpin, *The Political Economy of International Relations* (Princeton, NJ: Princeton University Press, 1987).

[68] See Gerard A. Finin, Small is Viable: The Global Ebbs and Flows of a Pacific Atoll Nation, *East-West Center Working Papers*, No. 15, (Honolulu, HI: East West Center Pacific Island Development Series, April 2002), pp. 21-22.

5.2. Logistics ideas

The sea is a part of the soul of any island state. Shipping could provide a gateway for economic diversification and movement along the value chain. Is there a specialized niche for Palau here? Could Palau become the producer of high-end items for the world's growing private luxury yacht fleet? This multi billion-dollar market shows steady growth. In terms of national players, the Italian industry, which took over the No. 1 ranking from the United States in 2000, widened its lead over second-ranking United States with a 6.4 percent increase over 2003. With 189 total projects, Italy now commands a 37.3 percent share of the world's large-yacht production. The United States saw its 17 percent global market share in 2003 slip to 15 percent in 2004. The Netherlands also saw its global market share erode this year, from 11.4 percent to 9.7 percent. The biggest gainers in the 2004 national rankings, however, are Greece and Denmark, neither of which appeared in the top-10 rankings in 2003. Greece, with eight current orders averaging more than 225 feet, jumped from virtually a nonexistent yacht order book to eighth in this year's rankings. This is due to the strength of Neorion, which is building four mega-charter yachts between 280 feet and 300 feet in length. Denmark, which last year was 13th, jumped to ninth place due to orders for Royal Denship, which markets for a consortium of Danish shipyards. In other national changes, New Zealand and Taiwan each jumped up a place, to fifth and sixth respectively, while Germany slid back two places, to seventh from fifth. Both Australia and Turkey also slid back, to 10th and 11th respectively in the rankings.[69] Through an extended commercial diplomatic network, manned by high quality honorary consuls, Palau could seek out partners for possible entry into this luxury shipping sector.

As a role model, a Mediterranean microstate has effectively integrated the shipping sector into its economy. Shipping activities represent 4% of Monaco's annual turnover. Shipping has become a true economic power in full expansion; in 1990 it numbered 48 enterprises, 144 in 1994 and more than 170 in 1998. This industry employs more than 1,300 people. The largest of the international shippers have offices in the Principality of Monaco.[70] Another example is Panama. Although not a microstate, it has made shipping into a mainstay of its economy. With more than fourteen thousand ships and 85 million in gross tonnage registered, Panama boasts the biggest merchant fleet in the world. Panama's consulates worldwide accept registry applications, and the government collected

[69] See Showboats Survey: Megayacht Construction on the Rise, http://www.dockwalk.com/issues/2003/november/megayacht1.shtml, accessed December, 10, 2005.
[70] See the official government website, The Principality of Monaco, http://www.monaco.gouv.mc/PortGb, accessed June 16, 2005.

5% of its federal revenues from ship registration fees and annual taxes in 1995, and another USD 50 million or so from maritime lawyers, agents, and inspectors.[71]

5.3. Technology and niche industries ideas

Since diving and pristine water are central Palauan qualities, instead of just focusing on diving tourism, with its seasonal fluctuations, Palau could partner with manufacturers of diving and specialized underwater equipment. What prevents Palau from manufacturing components of diving equipment for export? "Made and tested" in Palau should certainly be of interest to major diving concerns. Rather than just focusing on the necessary and critical Asian relationships, why doesn't the government of Palau, through an extended commercial diplomatic network made up of qualified and competent honorary consuls[72], approach companies like Air Liquide, the world leader in industrial and medical gases and the owner of the Aqualung diving equipment business. Or what about initiating contacts with Draeger, a worldwide German firm that produces a large line of closed circuit systems for diving apparatus and respiratory protective equipment. Could Palau's work force be of interest to these firms? Palau would do well to study how Liechtenstein has positioned itself in developing light manufacturing facilities for specialized or high-value component production. Such an opportunity could link environmentally sound, export-oriented growth to Palau's beautiful diving setting.

5.4. What Not to Do

Palau should not pursue any venture in the direction of becoming an offshore financial center. Unlike Liechtenstein, Palau does not have a comparative advantage here. This thought should be discarded for a number of reasons. For one, Palau lacks the expertise and specialist skills needed to have a viable financial center. Palauan expertise in trusts, complex investments, and tax advice is limited. Second, Palau has no brand in providing financial services. It will always be associated, rightly or wrongly, with more poorly regulated island offshore financial centers. Third, it cannot compete against established centers like Cayman Islands, Cyprus, and Guernsey and Jersey, which have established franchises in the increasingly sophisticated world of asset management and private banking. Lastly, given the aforementioned obstacles, Palau brings little value added services to a banking customer compared to an established center. Competition in terms of tax rates, tax

[71] J. Morris, " 'Flags of Convenience' Give Owners a Paper Refuge: Banners Don't Always Represent a Nation – and They Can Mean a Way Around Shipping Regulations," *Houston Chronicle*, August 21, 1996. cited in Ronen Palan, *The Offshore World* (Ithaca, NY: Cornell University Press, 2003), p. 53.

sheltering, and banking secrecy, is no longer sufficient, as other, more established centers already offer these features.

5.5. Human capital must be addressed

Palau is distinctive in terms of the percentage of citizens who, despite a growing domestic economy, are migrating to the United States. The export of Filipino workers from the Philippines to Palau appears to have encouraged the departure of Palauan workers seeking better wages and opportunities.[73] The 1999 implementation of a minimum wage law that explicitly excludes foreign workers provides further evidence of a divide that gives legally sanctioned incentives for the private sector to hire less expensive, non-Palauan employees.[74] The heavy dependence on temporary workers has raised serious concerns in Palau regarding whether this trend may already have compromised the country's capacities for self-reliance. Has Palau as nation become too heavily dependent on non-Palauans?[75] It's cheaper to hire a foreign college graduate than a Palauan with a high school degree. That's the problem, what are Palauan's going to do?"[76]

As one writer noted in his monograph on Palau, "We are going through a quiet kind of decline, an ambience of confusion and chaos…All these foreign workers are a good and bad thing…The good part is its cheap labor. But in its consequences, it's not cheap."[77] The critical issue is, "Palauans don't work enough. We drive a car, drink coffee, read newspapers and call it work. People come from all around the world to be on our beaches…This is the Age of Barbecue."[78] In the end, human talent and capital is everything for development in Palau and its sister microstates. The fewer natural resources your country or company has, the more you should dig inside yourself for innovations to survive.[79] For example, Taiwan is a barren rock in a typhoon-laden sea, with virtually no natural resources – nothing but the energy, ambition, and talent of its own people – and today it has the third largest financial reserves in the world.[80] With the funds provided by the

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[72] Like the consular model other small countries use, these honorary consuls would be non-Palauan individuals, resident in the countries where Palau would seek to establish trade relations and explore new commercial relationships.
[73] See Hiashi Endo, "The Meaning of Palauan Population Movement: An Analysis of Life Histories" In *Contemporary Migration in Oceania*, eds. Kenichi Sudo and Shiji Yoshida, (Osaka: Japan Center for Area Studies: National Museum of Ethnology, 1997), pp. 25-44.
[74] Dean Alegade and Gerard Finin, "Exporting People: The Philippines and Contract Labor in Palau," *The Contemporary Pacific*, Volume 12, Number 2, Fall 2000, pp. 359-370, specifically p. 364.
[75] Ibid., p. 367.
[76] Discussion with a local Palauan businessman in P.F. Kluge, "Palau: The Age of Barbecue," pp. 109-110.
[77] Discussion with John Ngiraked, in P.F. Kluge, "Palau: The Age of Barbecue," pp. 113-114.
[78] Discussion with Johnson Toribiong in P.F. Kluge, "Palau: The Age of Barbecue," p. 114.
[79] Thomas L. Friedman, *The World Is Flat: A Brief History of the Twenty-First Century* (New York: Farrar, Straus and Giroux, 2005), p. 131.
[80] Ibid., p. 263.

Compact as the start up capital to develop its human talent and high value, export orientated enterprises, Palau has the chance to move up the development value chain. Any other use of this money is a form of social welfare and wastage.

5.6. Conclusions

This monograph takes issue with the statement of James Tsai, Chairman of the Fong Kuoi Fishery Group and a leading member of the Taiwan Tuna Association, who stated to *Pacific Magazine* that countries like Palau should focus on an economy of natural resources, which are generally extractive in nature.

> It is very obvious that the populations of the South Pacific nations are tiny compared to Taiwan's. So it would be difficult to develop heavy industries, and most consumer products are imported. So I think if we want to establish a working relationship with South Pacific island countries, the best way is to focus on their natural resources.[81]

Reliance solely upon these natural resources over a 50-year horizon could lead to economic disaster. As Palauan Ambassador Beck stated:

> The period leading up to such a catastrophe is upon us. Palau must rely on the maintenance of its extraordinary reefs and waters, its unparalleled biodiversity, to attract tourists. Without these assets, it will be unable to develop a sustainable economy, to create jobs, which will allow its children to live and work in their homeland. The other pillar of Palau's development is its fisheries. For countless generations, our people have relied on their waters for their sustenance. Now, foreign fishing fleets, which have denuded the waters proximate to their own harbors, have come to the Pacific and threaten to do the same. The very food chain is threatened by new fishing practices, which, though in their infancy, have begun to damage Pacific seamounts in ways, which the scientific community deems alarming.[82]

All Pacific microstates need to look carefully at revenue schemes that revolve primarily around the selling of fishing licenses, leasing of internet domains, selling postage stamps, and leasing their extended air space for satellites. The governments need to be cautious in building such potentially short term, volatile and tenuous income flows into their longer-term expenditure plans. Rather they should take a 50-year view and look to a value model like that of Liechtenstein.

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[81] See Graham Norris, "Fishing and Diplomacy: James Tsai On Taiwan's Pacific Influence," *Pacific Magazine*, May 2004.

[82] Statement by H.E. Mr. Stuart Beck, Ambassador Extraordinary and Plenipotentiary/ Permanent Representative of Palau at The General Debate of the Sixtieth Session United Nations General Assembly, New York, 22 September 2005.

With these statements in mind, the Palauan government has to take a conscious decision to seek global economic opportunities in the same vein as Liechtenstein, a once poor, agrarian microstate a mere 70 years ago. The path to moving up the economic value chain lies in developing, in small steps, export oriented, value added industries and services for the globalized world. This approach would prevent the "brain drain" of Palau's "best and brightest" to emigration, and would provide a self-sufficient and independent economy for when the Compact Funds are expended. As one recent article on business process offshoring and outsourcing stated, "Companies, which develop niches and emerge regional leaders, could, over a period of time, develop strengths to allow them to directly compete with entrenched monopolies. A similar scenario is expected to unfold over the next few decades in the outsourcing business as countries develop and position their strength on the global offshoring front."[83]

In the business world, good advice often comes from careful and innovative networking. Given that both Liechtenstein and Palau maintain control of their own foreign affairs and have diplomatic missions in some of the same international bodies, why do they not start a dialogue at the state level between themselves to discuss development strategies? Rather than take advice from a superpower like the United States or regional powers like Japan or Taiwan, Palau might seek counsel from another microstate that certainly understands the unique development problems confronting one of its peers. This exchange might result in a useful cross-fertilization of ideas and knowledge between two microstates and engender even possible investment opportunities.

One hoped for outcome of this paper is that this type of comparative methodology might also help other Pacific Island microstates besides Palau to look pragmatically at microstate peers for innovative development ideas. In addition to Liechtenstein, Monaco, San Marino, and Andorra have all moved up the economic value chain in various manners over the past 60 years. Their examples might provide new development ideas and paths for not only Palau, but also for microstates such as Tuvalu, Kiribati, Federated States of Micronesia, Nauru, and Marshall Islands.

[83] See K. Yatish Rajawat, "India Lacks Academic Courses in BPO," *The Economic Times*, 19 Nov 2005.