



Highlights of [GAO-08-732](#), a report to congressional committees

Why GAO Did This Study

The Compact of Free Association between the Republic of Palau and the United States entered into force on October 1, 1994, with the U.S. interest of promoting Palau's self-sufficiency and economic advancement. The compact and its related subsidiary agreements provide for a 15-year term of economic assistance. In fiscal year 2009, the two governments must review the terms of the compact and related agreements and agree on any modifications. The Department of the Interior (DOI) has primary responsibility for oversight of Palau's use of compact funds. GAO was requested to report on (1) the provision of compact and other U.S. assistance to Palau in fiscal years 1995-2009; (2) Palau's and U.S. agencies' efforts to provide accountability over Palau's use of federal funds in 1995-2006; and (3) Palau's prospects for achieving economic self-sufficiency. GAO reviewed Palau's compact annual reports, financial statements and internal control reports for fiscal years 1995-2006, as well as other compact-related documentation. GAO interviewed officials from the U.S. and Palau governments and conducted fieldwork in Palau.

What GAO Recommends

GAO recommends that the Secretary of the Interior direct the Office of Insular Affairs to formally consult with the government of Palau regarding Palau's financial management challenges and assist Palau in building financial management capacity. DOI and Palau agreed with GAO's recommendations.

To view the full product, including the scope and methodology, click on [GAO-08-732](#). For more information, contact David Gootnick at (202) 512-3149 or gootnickd@gao.gov.

COMPACT OF FREE ASSOCIATION

Palau's Use of and Accountability for U.S. Assistance and Prospects for Economic Self-Sufficiency

What GAO Found

For fiscal years 1995-2009, U.S. aid to Palau is expected to exceed \$852 million. Compact direct assistance will account for 48 percent of U.S. assistance; this assistance provides general budgetary support for Palau's government operations, including initial investment in a trust fund intended to provide annual distributions of \$5 million in 1999-2009 and \$15 million in 2010-2044. Compact federal services such as postal, aviation, and weather services will account for about 3 percent of assistance, and construction of a road, finished in 2007, will account for 17 percent of assistance. Palau's receipt of federal programs, providing services such as education grants and community health care, will account for approximately 31 percent of assistance.

Single audit reports for fiscal years 1995-2006 show that Palau has made progress in its financial accountability through improvements in the timeliness and reliability of its financial statements. However, the reports show that Palau has persistent internal control weaknesses over financial reporting and over compliance with laws and regulations governing federal grants. According to Palau officials, inadequate capacity in financial accounting resources and expertise limits Palau's ability to address these weaknesses in a timely way. These weaknesses put at risk Palau's ability to sustain its progress in financial accountability and to operate a major federal program according to applicable requirements. Palau met most compact and subsidiary agreement accountability requirements. However, although DOI used single audit reports and Palau's compact annual reports to monitor Palau's use of compact funds, DOI's oversight was lacking in some matters.

Palau's prospects for economic self-sufficiency depend on four key factors:

- **Levels of continued U.S. assistance.** Given the \$10 million scheduled increase in Palau's annual trust fund withdrawals in fiscal year 2010, the expiration of \$13.3 million in compact direct assistance will likely reduce Palau's national government revenues by less than 4 percent. However, future levels of discretionary federal programs—estimated at \$11.9 million in 2009—could have a more significant fiscal impact. Also, unless compact federal services are extended, Palau will lose services funded by U.S. agencies estimated to cost almost \$1.6 million in 2009.
- **Availability and value of trust fund distributions.** Palau's trust fund can distribute \$15 million per year for 35 years if it earns a compounded annual return of at least 8.1 percent, a rate lower than the average earned thus far. However, market volatility could lead to the trust fund's depletion after 2016. Moreover, inflation will cause the distributions to lose value over time.
- **Fiscal reform.** To reduce its reliance on trust fund financing, Palau will require fiscal reforms to increase revenues and decrease expenditures.
- **Private sector growth.** Palau will need to improve its business environment by addressing problems with its foreign investment climate; financial system; and land, labor, and commercial policies that currently discourage private sector growth.