

REPUBLIC OF PALAU

HEARING
BEFORE THE
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
ONE HUNDRED TWELFTH CONGRESS
FIRST SESSION

TO

REVIEW S. 343, A BILL TO AMEND TITLE I OF P.L. 99-658 REGARDING THE COMPACT OF FREE ASSOCIATION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF PALAU, TO APPROVE THE RESULTS OF THE 15-YEAR REVIEW OF THE COMPACT, INCLUDING THE AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE REPUBLIC OF PALAU FOLLOWING THE COMPACT OF FREE ASSOCIATION SECTION 432 REVIEW, TO APPROPRIATE FUNDS FOR THE PURPOSES OF THE AMENDED P.L. 99-658 FOR FISCAL YEARS ENDING ON OR BEFORE SEPTEMBER 30, 2024, AND TO CARRY OUT THE AGREEMENTS RESULTING FROM THAT REVIEW

JUNE 16, 2011



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REPUBLIC OF PALAU

THURSDAY, JUNE 16, 2011

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, DC.

The committee met, pursuant to notice, at 10:36 a.m., in room SH-216, Hart Senate Office Building, Hon. Jeff Bingaman, chairman, presiding.

OPENING STATEMENT OF HON. JEFF BINGAMAN, U.S. SENATOR FROM NEW MEXICO

The CHAIRMAN. OK, why don't we get started? Good morning. Welcome to all of our witnesses.

The committee will receive testimony on S. 343, which is the legislation to approve the agreement that was reached last year between the United States and the Republic of Palau.

Senator Murkowski has been delayed with some testimony she's providing in the House, but will be here shortly and asked us to go ahead and proceed.

Palau is one of the United States' closest and most reliable allies. This relationship began in 1944 at the Battle of Peleliu where over 1,700 U.S. servicemen lost their lives. The relationship grew during the 47 years that the U.S. administered Palau under the U.N. Trusteeship.

Today, this close relationship continues under the Compact of Free Association that was entered into force in 1994 and which affirms our nations' shared commitment to democratic principles, economic development, and mutual security.

The agreement to be approved by S. 343 was reached at the conclusion of the joint 15-year review, as called for in the 50-year compact between the United States and Palau.

This agreement would make several modifications to the compact, including an extension of U.S. annual financial assistance on a declining basis until being phased-out in 2025. The \$215 million, or an average of \$15 million annually, would be provided for operations, fiscal consolidation, construction, maintenance, and trust fund contributions. This proposed second term of assistance would be a substantial reduction from the average of \$37 million annually that was provided during the first term of assistance.

The agreement would also enhance accountability by requiring Palau to undertake financial and management reforms, and by authorizing the Secretary of Interior to delay payment of funds if the U.S. determines Palau has not made progress in implementing those reforms.

The Departments of State and Defense have recently written to the committee to underscore the vital role of the compact in meeting the United States' security interests in the Pacific.

The State Department wrote—this is a quotation from their letter. It says, “This right of strategic denial under the compact is vital to our national security,” end quote.

The Defense Department wrote, quote, “Failure to follow through on our commitments to Palau, as reflected in the proposed legislation, would jeopardize our defense posture in the Western Pacific.”

We will insert the full text of these letters from the Departments of State and Defense into our record.

Unfortunately, notwithstanding the close historical ties between the United States and Palau, and the vital role that the compact plays in regional security, the current fiscal and political situation here in the Congress means that this bill cannot move forward without a provision to offset the 10-year, \$194 million increase in mandatory spending that is directed by the bill.

So we look forward to hearing from the Administration witnesses today, specifically on proposals for this offset, and to continue to work with the Administration to consider what options are available, if that becomes necessary.

Before turning to the President as our first witness today, let me call on Senator Murkowski for any statements she would like to make.

[The prepared statement of Senator Bingaman follows:]

PREPARED STATEMENT OF HON. JEFF BINGAMAN, U.S. SENATOR FROM NEW MEXICO

Good morning, and welcome to our witnesses. The Committee will receive testimony on S. 343, legislation to approve the Agreement reached last year between the United States and the Republic of Palau.

Palau is one of the United States' closest and most reliable allies. This relationship began in 1944 at the battle of Peleliu (Pay-lay-loo) where over 17-hundred U.S. servicemen lost their lives. The relationship grew during the 47 years that the U.S. administered Palau under the U.N. Trusteeship. Today, this close relationship continues under the Compact of Free Association which entered into force in 1994, and which affirms our nations' shared commitment to democratic principles, economic development, and mutual security.

The Agreement to be approved by S. 343 was reached at the conclusion of the joint 15-year Review as called-for in the 50-year Compact between the U.S. and Palau. This Agreement would make several modifications to the Compact including an extension of U.S. annual financial assistance—on a declining basis—until being phased-out in 2025. \$215 million, or an average of \$15 million annually, would be provided for operations, fiscal consolidation, construction, maintenance, and trust fund contributions. This proposed second term of assistance would be a substantial reduction from the average of \$37 million annually that was provided during the first term of assistance.

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The Departments of State and Defense have recently written to the Committee to underscore the vital role of the Compact in meeting the United States' security interests in the Pacific. The State Department wrote, “This right of strategic denial (under the Compact) is vital to our national security.” The Defense Department wrote, “Failure to follow through on our commitments to Palau, as reflected in the proposed legislation, would jeopardize our defense posture in the Western Pacific.” I will insert the full text of these letters into the record.

Unfortunately, notwithstanding the close historical ties between the U.S. and Palau, and the vital role that the Compact plays in regional security, the current fiscal and political situation in Congress means that this bill cannot move forward

without a provision to offset the 10-year, \$194 million increase in mandatory spending that is directed by the bill.

I look forward to hearing from the Administration witnesses today, specifically on proposals for this offset, and to continue to work with the Administration to consider other options, if that becomes necessary.

**STATEMENT OF HON. LISA MURKOWSKI, U.S. SENATOR
FROM ALASKA**

Senator MURKOWSKI. Thank you, Mr. Chairman. I do appreciate you holding this hearing on an issue of importance not just to this committee, but to the national security of the United States as a whole.

I was pleased to join with you in introducing legislation to approve the agreement between the governments of the United States and the Republic of Palau following the Compact of Free Association Review.

Mr. President, I welcome you. It was good to visit with you yesterday. We are honored to have you with us this morning.

Palau's history, during and since World War II, is directly linked to the United States. Palau is the site of the Battle of Peleliu, fought between the United States and the Japanese forces for over 2 months with the highest casualty rate of any battle in the Pacific Theater. The U.S. designated Peleliu as a U.S. National Historic Landmark as a result of that horrific battle.

In fact, we've got an Alaskan who visits the area about twice a year, working to clean up and preserve that battlefield. So there's a nice connection there.

I won't go into all of the details of the compact between our 2 Nations, but as a result of the close strategic and economic ties between our countries and our peoples, hundreds of Palauan citizens serve in all branches of the United States Armed Forces. We greatly appreciate their willingness to serve in our Nation's military, in some cases giving their lives to defend our freedom.

Section 432 of the compact provides that after the 15th, 30th, and 40th anniversaries of the compact, the United States and Palau shall formally review the terms of the compact and shall consider the overall nature and development of their relationship, including Palau's operating requirements and its progress in meeting development objectives.

Over the first 15 years of the compact, Palau's voting record in the U.N. has closely mirrored the United States. Palau, along with Israel, votes with the U.S. more times than any other member. Palau has been a steadfast ally of the United States in international forums, support that we should be mindful of and grateful for.

It's also important to recognize Palau's leadership in working with the United States to resettle 6 ethnic Uighurs who were detained at the Guantanamo detention facility. Palau was the first country to offer a future home for these detainees.

Now, turning to the agreement that is before us, the Administration is recommending continued assistance to Palau, but at lower levels. Overall assistance will be less than half of what was made available to Palau in the first 15 years, and accountability measures are included to ensure Palau continues its path toward long-term fiscal and economic stability.

I do concur with the Administration's assessment that the enactment of this bill will "protect the United States' interests and promote the continued well-being of our 2 countries."

Mr. Chairman, I do look forward to working with you to move the agreement forward and for its consideration by the full Senate. But in order for that to happen, as you have noted, the Administration must provide a viable offset for the costs of this agreement.

You and I have sent multiple letters to the Secretaries of State and Interior, as well as the Director of the OMB, requesting a politically workable offset. The realities of the Congress today are that without that offset, we will not be able to enact this important agreement between our 2 nations, and the United States' commitment to our allies in the region will be in question.

That's not a position that I believe any of us wants to be in, so I am hopeful that the Administration witnesses today will be able to provide some hope that a viable offset is there.

With that, Mr. Chairman, I thank you.

Again, welcome the President.

The CHAIRMAN. Thank you very much.

Our first witness today is His Excellency Johnson Toribiong, who is the President of the Republic of Palau.

We had the good opportunity to meet briefly with the President yesterday, and we welcome him before the full committee today.

Please go right ahead and introduce your colleagues, if you would like, and give us any message that you think we need to understand. Thank you.

**STATEMENT OF HON H.E. JOHNSON TORIBIONG, PRESIDENT,
REPUBLIC OF PALAU**

President TORIBIONG. Thank you, Mr. Chairman, Senator Murkowski, distinguished members of the committee. With me today are my Ambassador to the United States, Hersey Kyota, and my Washington-based consultant, Jeffrey Farrow. Behind me are members of my delegation, a member of the House of Delegates, Gibson Kanai; and Senator Alfonso Diaz; and my attorney, Kevin N. Kirk. Also with me is Haruo Wilter, a former Department of Interior staff who is now my financial adviser. So with that, let me begin my presentation.

We also have with me Ambassador Stuart Beck, our Ambassador to the United Nations.

Thank you very much.

Chairman Bingaman, Senator Murkowski, and distinguished members of the committee, thank you for this opportunity for me to address your committee on behalf of the people of the freely associated state of the Republic of Palau regarding S. 343.

Mr. Chairman, Senator Murkowski, thank you for sponsoring this bill.

This bill is of critical importance to the future of Palau. The people of Palau are most grateful to you for all that you have done to support the United States relationship with Palau, which is a closer relationship than that which the United States has with any other place outside of its territory.

Mr. Chairman, Senator Murkowski, let me first convey our warm greetings from the people of the Republic of Palau and their best wishes for a stronger and more prosperous America.

Palau and our region of the world have been safe, secure, and in peace since the end of World War II thanks to the strong presence of the United States and its leadership in our region.

Mr. Chairman, and distinguished members, having experienced the devastation and horror of one of the bloodiest battles of World War II, Palau is committed to cooperate fully with the United States to preserve and promote peace and security around the world.

Palau is the last trust territory to achieve nationhood under the international trusteeship system. When the Compact of Free Association took effect in 1994, Palau was the only strategic territory in the world which was part of the former Trust Territory of the Pacific Islands because of its strategic importance.

The compact represents Palau's liberation from its colonial past and became the basis of our current political status. The compact was negotiated over a prolonged period of time, and due to concerns of many of our people, it took 2 U.S. laws and 7 referenda supervised by the United Nations over a decade before it was actually approved and took effect on October 1, 1994.

We cherish our unique relationship with the United States, and we'll do all that we can to preserve it.

Under the compact, Palau agreed to give the United States exclusive control over our territory in the Western Pacific, the size of Texas, based upon the United States' desire to preserve its strategic position in our region, as well as Palau's need for the strong defense protection of the United States in our region.

Besides offering our territory to the United States, Palau sends many of its sons and daughters every year to join the United States military to help fight terrorism around the world and defend our freedom. We understand that the cost of freedom and democracy come at a very high price. We know this from the sacrifice made by about 11,000 young Americans who spilled their blood on our soil during World War II, including approximately 2,000 who made the ultimate sacrifice in Palau.

We now observe the same Memorial Day with the United States to honor and remember those who gave their lives for our freedom, including half a dozen of our sons who have made the ultimate sacrifice fighting in Vietnam, Iraq, and Afghanistan for freedom enjoyed by the Americans, its allies, and ourselves.

In the 15th year of our relationship with the United States, Palau and the United States were mandated by section 432 of the Compact of Free Association to review the relationship and Palau's needs for assistance.

The review was concluded on September 3 of last year in Honolulu, when the United States official representative and myself signed the compact review agreement. That agreement now awaits the approval of the U.S. Congress.

I thank you, Mr. Chairman, and Senator Murkowski, for initiating the process for the approval of this agreement.

Chairman Bingaman, Senator Murkowski, Palau is most grateful that through your understanding and support, and those of your

colleagues, the U.S. Congress already has provided financial assistance to Palau for years 16 and 17 of the compact, in line with the compact review agreement, even before that agreement is approved by the U.S. Congress.

Such direct financial assistance has prevented our government from having to reduce the essential public services to our people, especially health, education, and public safety programs and services, below the acceptable minimum standard.

Besides the financial assistance, there are specified economic and budgetary reform measures provided in the compact review agreement, intended to place Palau on the path to economic self-sufficiency over the remaining 35 years of the compact. The compact review agreement is a roadmap for Palau toward economic self-sufficiency.

During the compact review, it became clear that supplemental financial assistance to Palau from the United States was necessary to meet the original expectations of the United States and Palau under the Compact of Free Association.

The trust fund established under the compact in its early years lost about \$60 million of its value between November 2008 and February 2009, when the United States money market suffered substantial losses.

At the time the compact was first negotiated, we were advised that the trust fund would generate a growth of 12.5 percent annually to sustain our government financial requirements from years 15 through 50, but those expectations have fallen far short of the reality.

The assistance provided by the compact review agreement is not only essential, it is prudent. The compact review agreement will require specific reforms for our economic development policy and review and spending practices. Most of the financial assistance is earmarked for public safety, health, education, and the maintenance of infrastructure the United States considers essential, including critical new infrastructure.

The financial assistance is not intended to make Palau more dependent. It is intended to make Palau more and more economically self-sufficient.

The economic and political consequences of this assistance are to make a stronger Palau, and, hence, further strengthen and enhance our relationship under the Compact of Free Association.

Chairman Bingaman, Senator Murkowski, Palau will faithfully honor all of its obligations and responsibilities under the Compact of Free Association, including those prescribed in the compact review agreement. We will honor in every respect our side of the bargain. We are committed to make Palau a prosperous state, not a failed state, in free association with the United States of America.

Because of the extended period of our association with the United States since the end of World War II, Palau has adopted wholly the American values and ideals of freedom, democracy, and the rule of law. This is evident from the fact that Palau has the highest voting coincidence in the United Nations of any United Nations member.

Palau is proud and honored to have a seat in the United Nations and to vote with United States in view of the fact that until 1994

Palau was a ward of the United Nations under the administration of the United States.

Finally, Mr. Chairman, Senator Murkowski, and distinguished members, you are always welcome to visit Palau, some 11 time zones to the west of Washington, DC.

I extend to you a standing invitation to Palau, considered one of the 7 underwater wonders of the world; the world's first shark sanctuary; a place of refuge for political refugees, including 6 Chinese Muslims from Guantanamo Bay; and a place where some of the most historic war memorial monuments are found, the most prominent of which is the one built by the survivors of the Battle of Peleliu atop its rugged ridge known as the Bloody Nose Ridge. On that monument, these words are boldly written, "Lest we forget."

Honorable Senators, Palau shall never forget. We shall always be the most loyal ally of the United States, its true friend in time of peace and in time of war.

Notwithstanding my personal commitment to our relationship, which reflects the sentiments of most Palauans, there are some Palauans who are enticed by the overtures and promises of China, which clearly wants more influence in our islands.

I am concerned that a failure or undue delay in the approval of the agreement will encourage those among us who argue that we should look elsewhere. This will unnecessarily confuse our people.

In closing, let me say that it is my firm belief that the speedy approval of the S. 343 will certainly advance the mutual interest of Palau in the United States now and in the future.

I ask for your favorable action on this bill.

Thank you, and may God bless the United States of America and the Republic of Palau.

[The prepared statement of President Toribiong follows:]

PREPARED STATEMENT OF HON. H.E. JOHNSON TORIBIONG, PRESIDENT,
REPUBLIC OF PALAU

Chairman Bingaman, Ranking Minority Member Murkowski, and Distinguished Members: Thank you for this opportunity to testify on S. 343, the bill introduced by Senators Bingaman and Murkowski to approve the Agreement Between the United States and Palau reached in the 15th Anniversary Review of the relationship between the United States and Palau and Palau's assistance needs required by Section 432 of the Compact of Free Association between our states. I am here to urge its expeditious approval.

Mr. Chairman, I wrote you in February expressing my deep appreciation for your attention to Palau over the years, your sponsorship of this bill, and your leadership in continuing assistance to our islands while the Congress considers the Agreement. I reiterate this appreciation today.

Senator Murkowski, you are also owed Palau's profound gratitude for your leadership regarding the Agreement.

Committee staff members Allen Stayman and Isaac Edwards are as well.

Palau's thanks apply for the letters that the Committee's bipartisan leadership sent United States executive branch officials asking about the importance of the Compact and the Agreement to United States security interests and requesting a proposed amendment to the legislation to provide the budgetary offset that is needed under United States law and congressional rules to enable the legislation to be considered.

In response, the Departments of Defense and State wrote that the legislation is "vital" to United States security, also using words such as "critical," "increasingly important," and "invaluable." In the words of the Defense Department, a failure to pass it would "jeopardize" United States defense—which understands the situation

in Palau. The State Department also wrote that the Department of the Interior has assured that congressional budget requirements would be met.

I hope that the Interior Department makes a proposal for this purpose soon.

To help explain why and why this legislation is needed, I will outline the background of the relationship between the United States and Palau and the Agreement that the bill would approve.

It began with the Battle of the island of Peleliu in 1944 when the United States liberated Palau from Japan in one of the bloodiest battles of World War II. Originally expected to be over in four days, it lasted for more than two months, also resulting in casualties on Angaur and Ngesebus, two other islands of Palau. All told, the United States Armed Forces, consisting of 1st Marine Division, later relieved by the Army's 81st Infantry Division, suffered a total of approximately 9,500 casualties in Palau, including almost 2,000 killed in action.

Through this, valiant Americans liberated Palau from the yoke of colonialism that had weighed heavily on my people for almost 100 years, from the time that the Spanish wrenched freedom from our ancestors, through the era of German rule, and lastly, under the Empire of Japan. Liberation also set in motion events that 50 years later would lead to Palau regaining its sovereignty.

Nevertheless, the gargantuan battle devastated our islands and left our people destitute. Many Palauans were killed. At the end of World War II, fewer than 5,000 Palauans remained alive.

Having taken Palau, the United States governed it; first, under Naval Administration and then as a part of the United Nations Trust Territory of the Pacific Islands. The territory was the U.N.'s only strategic trusteeship at the request of the United States. This made it the only trusteeship subject to U.N. Security Council as well as Trusteeship Council jurisdiction. A Trusteeship Agreement committed the United States to develop Palau socially, economically, and into a self-governing status—but also gave the United States complete control over the islands for which so many Americans had lost their lives and which had tremendous continuing strategic importance to the United States and international peace.

At first, the territory was governed under a policy that closed the islands off from the world, invested little, and only permitted a subsistence economy. As the years went on, however, the United States began to be pressured by the inherent conflict between its obligation to develop Palau into self-government and its desire to maintain military control over a vast, strategic expanse of the Pacific.

The Kennedy Administration's two-pronged solution—continued by succeeding administrations—was, one, to extend substantial assistance, particularly several domestic United States programs, to bind the islands to the United States, and, two, to encourage the idea of free association instead of independence. This status would enable the territory to become self-governing, but retain for the United States full military authority almost as if the islands were United States territory. Compacts of Free Association were negotiated with Palau and two other groups of islands of the Trust Territory.

The Compact with Palau, which was signed in 1985, ultimately made Palau a nation, but gave the United States the desired control over a strategic expanse of the western Pacific the size of Texas between the Philippines, Guam, and Indonesia, as well as military basing rights for 50 years. In consideration, it also committed to give Palau budgetary, developmental, and program assistance, and permits Palauans to enter and work in the United States, as well as to join the United States Armed Forces as—many do.

The Compact as negotiated was not universally embraced in Palau. It took two United States laws, the second enacted in 1989 addressing concerns of many of our people, and seven referenda in Palau before it was finally approved in our islands.

And then it took years to obtain United Nations Security Council approval because of questions as to whether the Compact's United States military rights were more extensive than can exist in another sovereign nation and inconsistent with the fundamental principle of free association.

Palau finally became a state in free association with the United States on October 1st, 1994.

The Compact specified assistance for 15 years and provides, in Section 432, that subsequent assistance for at least the duration of the 50 years of base rights would be determined in periodic joint reviews of Palau's needs. Some of Palau's needs during Years 15 through 50 of free association were to be met through a trust fund. But the framers of the Compact wisely recognized that more would be needed and Palau's needs could not be projected so far into the future. The reviews were also mandated so that both of our freely associated states could re-evaluate the relationship as a whole on a periodic basis. So, the Compact provides for assessments of our association and of the assistance that Palau needs at the 15, 30, and 40-year

marks. It also commits the United States to act on the needs of Palau identified in the reviews.

The 15th anniversary of the Compact occurred on October 1, 2009. Because the assistance specified in the Compact was to expire September 30, 2009, Palau sought to begin the 15th Anniversary Review in 2008. However, although some United States officials agreed to take steps in this regard, the effort failed.

The process did not get seriously started until early 2009 when I visited new Secretaries Clinton and Salazar. Then, beginning in May 2009, my Compact Review Advisory Group began to meet with a team of United States representatives led by the Department of State.

The Review was protracted due to delays on the United States side. This necessitated a continuation of assistance to Palau for essential government services in Fiscal Year 2010 based on Fiscal Year 2009 funding which you, Mr. Chairman, others, and, then, the United States Administration requested.

Agreement was finally reached last September 3rd after the personal involvement of Secretary Clinton, Assistant Secretary of the Interior Babauta, Deputy Secretary of the Interior Hayes, then Deputy Secretary of State Lew, Deputy Assistant Secretary of State Reed, and others, and constructive work done by all involved with the United States team.

Senior United States officials encouraged me to sign the Agreement last summer so that it could be approved by the United States Congress in time for Fiscal Year 2011 appropriations. Ultimately, however, it was not submitted to you for approval until this past January. This necessitated another continuation of assistance to Palau for essential services based on Fiscal Year 2009 funding, which I appreciate you, Mr. Chairman, urging and Chairman Inouye of the Appropriations Committee insisting upon.

It also resulted in new requirements regarding the Agreement's approval in the United States Congress. The assistance that the Agreement would provide would be considered mandatory appropriations. Last year's PAYGO Act created a requirement that the cost be offset. New House rules require that the offset be in the form of a reduction in other mandatory spending to make the legislation even eligible for consideration—and leaders of the new House majority have made clear that this is important politically as well.

Under the Agreement, Palau would be provided assistance totaling \$215.75 million from Fiscal Years 2011 through 2024—although more than \$13 million of this was already appropriated in the continuing appropriations for Fiscal Year 2011.

The total amount is critical for Palau but it is much less than what was provided during the first 15 years of the Compact. In addition, the Agreement would, in response to demands of the United States negotiators, phase out assistance for essential government services and infrastructure by Fiscal Year 2024, with assistance for government services totally ending in Fiscal Year 2023, a year before the next review.

There are other issues: There is no provision to adjust amounts for inflation as in the Compact and the revised compacts with the other freely associated states; the subsidy for the United States Postal Service would continue even if institutes international rates for Palau delivery; and Palau would have to begin paying for audits the United States wants.

The Agreement would also require mutually and expertly determined substantial Palauan spending and revenue reforms. These reforms will require tough measures but are intended—and needed—to strengthen Palau's budgetary practices and its economy. The reforms would ultimately lessen our islands' absolute need for United States assistance. This will create a stronger, more self-reliant Palau, which is what our islands should be and which would be a better partner for the United States.

Finally, the Agreement would also make changes in United States programs and services in response to requests of various United States agencies in areas including civil aviation, postal service, telecommunications, and weather reporting, amending seven of the Compact's subsidiary agreements. The Agreement would, additionally, amend the Compact to reflect Palau's current practice of issuing machine-readable passports, which enhance United States border security.

Strategic control of Palau and its extensive waters and base rights are not all that are at stake for the United States. Our relationship is based upon our common interests and ideals. For example, year in and year out, Palau votes with the United States in the United Nations more than any other member state. It has stood alone with the United States on key votes, including those concerning Israel and Cuba, despite pressure and entreaties from other nations that have offered friendship.

The Government of Palau's agreement to the request of the United States that we provide a home for Chinese Muslims that the Bush Administration determined it had erroneously detained at Guantanamo is another example of the unmatched

alliance between Palau and the United States. We agreed to provide this sanctuary when no other nation would. Many Palauans had strong reservations, however, and we also did so over the strong objections of the Government of China, which had made economic overtures to our islands. In fact, Palau has provided third-country refuge to more former Guantanamo detainees than any nation other than predominantly Muslim Albania to assist the United States.

And there is no more telling demonstration of the closeness Palau feels to the United States than the record of Palauans serving in the Armed Forces of the United States, which I have been told is at a higher rate than any other state of or associated with the United States. Palauans have fought alongside their American comrades-in-arms in Lebanon, Vietnam, Iraq, Afghanistan, and in other theaters of war, and have given their lives and limbs in this service. Just last month, I attended the funeral of another young Palauan who was killed in the Afghanistan. Three of his siblings continue to serve in the United States Army.

Palau is the United States' closest and most loyal ally. The vast majority of Palauans are happy and proud to be able to help the United States and give back to a nation that has done so much for them.

But there are elements that who would use any failure of the United States to live up to its commitments under the Compact to try to diminish the confidence of Palauans and others in the strong relationship between our freely associated states and to encourage Palau in a different direction.

A failure of the United States Congress to approve this Agreement or an undue delay in assistance which now constitutes 24% of Palau's budget would encourage some—including some in Palau who questioned the Compact even when it was approved—to argue that Palau should move away from the United States and look elsewhere.

And if there is no agreement or an end to essential assistance, many Palauans would insist on an end to the United States military rights under the Compact that the Department of Defense has advised are essential to United States security and for maintaining regional peace.

Already some Palauans are enticed by the new economic power of China, which clearly wants more influence in Palau. We all want greater economic interaction with China, but it should be without compromising the close alliance between Palau and the United States.

I, personally, have a fundamental and enduring commitment to strengthen the relationship between Palau and the United States. This reflects the real desires of the majority of my people. But we will all face a very serious challenge if this Agreement is not approved, and it is simple logic that United States military rights under the Compact and other Palauan support for the United States under the current association could not be expected to continue if the United States does not continue to meet the promise of the Compact.

The relationship will also be significantly—and very unadvisedly—undermined if assistance that the Government of Palau absolutely needs to continue critical services to its people is allowed to lapse even if the Agreement is subsequently approved by the United States Congress. In this regard, United States officials should plan to continue assistance on at least the current basis if they do not act to enable the Agreement to be approved by United States law soon.

The delay in United States action on the Agreement has already led to substantial questions about it being raised by influential leaders of our island. The danger of the growing doubts should be recognized by United States officials. The history of the Compact in Palau should not be forgotten.

I am, however, hopeful that this hearing will be at a catalyst for the United States executive branch and congressional action needed to approve the Agreement, and am confident that Palau will reflect its appreciation for the United States by approving the Agreement.

I respectfully request the Committee to favorably report the bill and lead the Congress in its enactment.

Thank you for your attention and consideration.

The CHAIRMAN. Thank you very much for your excellent statement, Mr. President.

Let me ask a couple of questions. I think on page 5 of your written testimony you say, if there is no agreement or an end to essential assistance by the United States, many in Palau would insist on an end to the U.S. military rights under the compact.

Under the first term of the compact, which ended in 2009, since then, as you pointed out, we have had year-by-year funding. I guess the question would be, what do you think the impact would be on the political debate in Palau if the United States continues to provide assistance at the fiscal year 2009 levels on an annual discretionary basis, rather than going ahead with the legislation we've proposed?

President TORIBIONG. Mr. Chairman, let me answer the last part of your question.

For Palau to seek financial assistance from the United States on a year-to-year basis would be promoting more sense of dependence on the United States. The compact review agreement is a roadmap, through reforms and other assistance, toward economic self-sufficiency, which is the intended goal of the Compact of Free Association.

So I'm concerned that to go from year-to-year will make Palau more dependent on the United States and disregard the long-term goals of the compact.

Regarding the defense rights of the United States in Palau, legally, the United States has that right beyond the terms of the compact until mutually terminated. But politically, the debate will be raging that, since one side is not honoring its obligation, perhaps that justifies seeking modification of the defense and military rights of the United States.

With that, I can defer to my consultant, if he has anything to add to my response.

But all in all, I would say that the compact review is intended to promote the goals of the compact, economic self-sufficiency, a roadmap toward that goal. A year-to-year assistance basis will be to promote more and more a sense of dependency, which we'd like to move away from.

The CHAIRMAN. Very good.

Mr. Farrow, did you wish to add anything?

Mr. FARROW. Just briefly, Mr. Chairman. The President and other leaders of Palau have advised me that a failure to approve the agreement and year-to-year funding on a continuing basis would undermine confidence in the relationship, and, as the President said, lead to people suggesting that the U.S. military rights in Palau should not be continued and that Palau should look elsewhere.

So if they are not certain in the long term about what United States' assistance will be, if it's on a year-to-year basis, then some Palauans would want to have the military commitment that Palau has made to the United States reevaluated and would feel the necessity of looking to other countries for a longer-term assistance package.

So it's important that—and the framers of the compact understood this—it's important that there be a long-term relationship between Palau and the United States on a bilateral basis, and a relationship in which both sides could have confidence for the long term. Thank you.

President TORIBIONG. May I say something?

The CHAIRMAN. Mr. President, sure.

President TORIBIONG. We do appreciate the extension of financial assistance on an interim basis, on the condition that the U.S. Government will honor the compact review agreement.

My concern is the legal integrity and viability of the compact as a treaty between the United States and Palau, were one side to appear not to honor the integrity of that document.

The CHAIRMAN. Very good.

Senator Murkowski.

Senator MURKOWSKI. I just want to follow on this conversation here.

Mr. President, you have suggested that China may show an increasing influence or desire to influence Palau. Perhaps that has something to do with Palau's official recognition of Taiwan. I don't know that.

Mr. Farrow, you have also mentioned that others might be looking to step in and fill that role in terms of assistance.

Are there any other Nations or regions that are looking at Palau now, perhaps hoping to have more influence than they do currently?

President TORIBIONG. As you may know, Palau has diplomatic ties with the Republic of China, Taiwan, 1 of the 20-some Nations which do that. So besides China, the powerhouse of Asia, we've been approached directly by UAE.

The minister of state from Abu Dhabi flew to Palau, invited Palauans to meet with them in Abu Dhabi, with the Arab League. They've been making suggestions that they would like to invest extensively in Palau, but nothing has come from that country as of late, perhaps because of the troubles in the Middle East.

They also said that they insist that we support the position of the Arab world against Israel, which is a very serious issue for us to consider.

Senator MURKOWSKI. It is somewhat sobering to hear that those might be the conditions attached.

Let me ask one more question, Mr. President. The agreement designates \$10 million for a financial consolidation fund to reduce the government payment arrears of Palau that have been accumulated. Can you describe what debts these funds would be used to pay?

President TORIBIONG. Yes. Let me say this, that when I took office in January 2009, Palau was in debt to the vendors and other utilities corporations to the tune of about \$13 million. That has been reduced about \$11 million.

So the \$10 million was estimated to cover all the outstanding deficits, which were incurred over the years. The deficit occurred because our Congress and our previous administration always overestimate the local revenues above and beyond their expenditures.

This year, for the first time, we are ahead of our projection by about 5 to 10 percent. So I hope to be able to put Palau in a position where we live within our means.

One of the conditions in the compact review agreement is a reform on our revenue and spending practices. That's why I call it a roadmap for economic self-sufficiency and economic responsibility.

Senator MURKOWSKI. Thank you, Mr. President.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. President, if you are running a surplus, I'm inclined to ask if we could get a loan from you, but maybe that's inappropriate at today's hearing.

Thank you very much for your excellent testimony.

We do have 4 Administration witnesses now who we wanted to hear from and learn what we can from them.

Let me ask if there's any other statement that you would want to make to the committee before going to the second panel.

President Toribiong I'd just like to express my profound gratitude to both of you, Senators, and to the United States for its generous support and protection of Palau since the end of World War II. We shall always remain your most loyal ally and a friend.

Thank you.

The CHAIRMAN. We congratulate you on the leadership you're providing to your country, and we will do all we can to move this legislation forward. Thank you very much.

Why don't we go ahead with our second panel? I will introduce them as they come forward.

Ms. Frankie Reed is the Deputy Assistant Secretary with the Bureau of East Asian and Pacific Affairs with the U.S. Department of State; Mr. Anthony Marion Babauta, who is the Assistant Secretary for Insular Affairs in the U.S. Department of Interior; the Honorable Robert Scher, who is the Deputy Assistant Secretary of Defense for South and Southeast Asia in the Department of Defense; and Mr. David Gootnick, who is director of International Affairs and Trade with the Government Accountability Office.

So we appreciate all of you being here. We obviously will include your full statements in the record as if read, but if you could give us the short version of your statements and make the main points you think we need to understand in about 5 minutes each, that would be useful. Then Senator Murkowski and I will have some questions.

Ms. Reed, do you want to start? We'll just go across the table that way.

STATEMENT OF FRANKIE REED, DEPUTY ASSISTANT SECRETARY OF STATE, BUREAU OF EAST ASIAN AND PACIFIC AFFAIRS, DEPARTMENT OF STATE

Ms. REED. Thank you, Mr. Chairman, Senator.

Before I begin, I would like to say that in support of this, what I call a partnership, with our very good friends in Palau, I was in Palau over 12 years ago. I'm pleased to say that I returned only several months ago, after signing this agreement in Honolulu. I was heartened to see a very much improved Palau. I'm talking about infrastructure and not just atmospherics, with the good use to which the compact funds have been put.

I'd like to talk to you about the special relationship, this partnership that we have had over the years, a partnership between the Government of the United States and the Government of Palau, in support of S. 343. The proposed legislation nurtures our unique relationship, and it is a small fraction of what we feel it will cost us if we lose the special relationship that exists between the United States and Palau.

For almost 4 decades, from the inception of World War II, Palau was a United Nations Trust Territory under the administration of the United States.

Following lengthy negotiations, the United States and Palau recast their relationship; the result, the Compact of Free Association. It marked Palau's emergence from trusteeship to independence.

Palau is a relatively young state. However, its democratic process is mature and a testament to the strong values of the people of the Pacific. This reinforces the value of the compact as a vehicle for their transition to greater self-sufficiency.

In return, the compact reinforces an important element of our Pacific strategy, that is, the defense of the U.S. homeland. It allows us to carry out very important foreign policy objectives.

The agreement that I signed with President Toribiong in September and the proposed legislation for your consideration addresses the outcome of the review and is a manifestation of the United States following through on its commitments to Palau.

Located in the westernmost point, Palau is a part of a security zone that stretches from California to the Philippines. We paid in blood in World War II to free Palau from Japan, and we fought to counter Japan's control over the region. Palau rebuilt its government upon the principles of democracy, individual rights, and freedom.

The President, Secretary Clinton, and others in this Administration deeply appreciate the historic legacy of the Pacific and the strategic role it plays, particularly in keeping the Pacific Islands allied with the United States.

On controversial issues in multilateral fora, as both of you have so aptly noted, the United States has been able to consistently count on Palau's vote. This is not a small thing. In a number of resolutions in the General Assembly passed over the past year, when the United States was isolated by overwhelming numbers, Palau was at our side.

In 2009, Palau resettled 6 ethnic Uighur detainees from Guantanamo at a time when few other countries were willing to step up. Two hundred (200) Palauan men and women serve in our U.S. military.

Only 2 months ago, a Palauan soldier, Sergeant Sonny Moses, was killed in Afghanistan while serving. I would note, respectfully, that President Toribiong's niece also serves in the U.S. Navy.

A failure to implement the results of the 15-year review would cast significant doubt on the U.S. commitment to the compact relationship. It is crucial that we provide Palau the assistance to which we have agreed, for the smooth continuation of our bilateral relationship.

So I urge you to pass the legislation approving and funding the results of the review. I look forward to ongoing cooperation with the Congress to advance U.S. interests in Palau and the greater Pacific, and our contribution to a secure, prosperous future for the Nations and people of Palau and the Pacific.

Thank you.

[The prepared statement of Ms. Reed follows:]

PREPARED STATEMENT OF FRANKIE REED, DEPUTY ASSISTANT SECRETARY OF STATE,
BUREAU OF EAST ASIAN AND PACIFIC AFFAIRS, DEPARTMENT OF STATE

Chairman Bingaman, Senator Murkowski, and Members of the Committee, I am here today to testify on the importance of our bilateral relationship with Palau as well as to discuss the Compact with Palau and proposed legislation approving the results of the mandated 15-year Compact Review. History has proven that this small Pacific island nation remains indispensable to our national security and other core interests in the Pacific. Current and future challenges convince us we must remain steadfast and true to a thriving relationship that delivers much more than it costs in dollars and cents.

Our Compact with Palau was concluded in 1994. It does not have a termination date and requires a review on the 15-year, 30-year, and 40-year anniversaries. Our two governments worked closely over 20 months of negotiations to conclude the 15-year review last September, which resulted in an agreement I signed with President Toribiong. The legislation now proposed to implement the agreement is the outcome of that review and is the manifestation of the shared commitments between our two governments.

The Palau Compact Review legislation amends Title I of Public Law 99-658 regarding the Compact of Free Association between the Government of the United States of America and the Government of Palau. In formal language, this bill approves the results of the 15-year review of the Compact, including the Agreement between our two governments following the Compact of Free Association Section 432 Review. It appropriates funds for the purposes of the amended PL 99-658 for fiscal years ending on or before September 30, 2024, to carry out the agreements resulting from the review.

Palau has been and continues to be a strong partner with the United States. Its location on the westernmost point of an arc from California to the Philippines creates a security zone that safeguards U.S. interests in the Pacific. That relationship was born in World War II and has been built over the decades since 1945.

TRANSITION TO INDEPENDENCE

Allow me to look back to the end of World War II. In 1947, the United Nations assigned the United States administering authority over the Trust Territory of the Pacific Islands, which included Palau and island districts of Micronesia that we had liberated from Japanese occupation. During that period, the United States built roads, hospitals and schools and extended eligibility for U.S. federal programs in the Trust Territory. In the following years, the trustee islands sought changes in their political status. Palau adopted its own constitution in 1981, and the governments of the United States and Palau concluded a Compact of Free Association that entered into force on October 1, 1994. The Compact fulfills our solemn commitment to Palau's self-governance in accordance with the freely expressed wishes of the Palauan people. The Compact also provides for an important element of our Pacific strategy for defense of the U.S. homeland and allows us to carry out important foreign policy objectives.

PALAU'S SUPPORT OF THE UNITED STATES

Mr. Chairman, the United States paid dearly in blood in WWII to free Palau. It is a story that every American should understand and that generations before us have seen as creating a sacred trust to remember and honor.

Rising from those ashes, with the strong and steady support of the American people, Palau rebuilt its infrastructure and modeled its government upon the principles of democracy, human rights, and fundamental freedoms. President Toribiong recently signed an Executive Order designating the last Monday of May Memorial Day in Palau, an official holiday. On this day, the people of Palau honor those who paid the ultimate sacrifice to defend the freedom and democratic principles we all enjoy today. On May 30, President Toribiong and our U.S. Ambassador to Palau laid wreaths on the grounds of the WW II monument in Peleliu State. More than 2,000 American soldiers lost their lives and more than 10,000 were wounded in the Battle of Peleliu, one of the bloodiest battles of WW II. Palau remains a strong reliable partner and continues to share our values through these historic ties.

The United States can count on Palau to vote with us on controversial issues in multilateral fora. On a number of important resolutions in the General Assembly over the past year, Palau stood by us and provided critical votes. For example, Palau has voted with the United States on controversial resolutions related to Israel 100 percent of the time and on human rights issues, 93 percent of the time. Palau's overall voting coincidence with us is at 87 percent.

Although Palau is a steadfast and committed friend of the United States, China, the Arab states, Cuba and others are actively courting Palau, and the other Pacific island nations, as they seek to build influence in the region. The United States must maintain and strengthen its relationship with Palau by maintaining our strong friendship and upholding our commitments as set forth in the Compact.

The results of the 15-year Compact Review as reflected in the subsequent legislation nurture our unique relationship. By supporting the Compact Trust Fund, the United States contributes to Palau's development and secures our security interests. Our contribution represents a vital link between our two countries. Implementation of the results of the Compact review sends a reassuring signal to Palau and others in the Pacific region and beyond that the United States follows through on its commitments, in good times and in difficult times. These are indeed difficult times for us. However, it is essential to our long-term national interests to make sure that the United States remains true to its identity as a Pacific power. Meeting vital interests more than six decades ago, the United States invested blood and treasure. Today, it remains in our strategic, political and economic interests to nurture Palau's young democracy, support its development, and increase its self-sufficiency.

U.S. Defense Interests in Palau

Mr. Chairman, the United States and the people of the Pacific have fought side-by-side. Our identity as a "Pacific power" was, in many ways, forged on the beaches of the Pacific during World War II.

The importance of our special relationship with Palau is most clearly manifested in the U.S. defense posture in the Asia-Pacific region, which forms a north-south arc from Japan and South Korea to Australia. Maintaining U.S. primacy in the Pacific depends on our strong relationship with the Freely Associated States of Palau, the Marshall Islands and the Federated States of Micronesia, which along with Hawaii, Guam, the Commonwealth of the Northern Mariana Islands, American Samoa and the smaller U.S. territories comprise an invaluable east-west strategic security zone that spans almost the entire width of the Pacific Ocean.

Additionally, critical security developments in the region require the United States' sustained presence and engagement, particularly given the range of U.S. strategic interests and equities in the Western Pacific. Essential elements of our presence include the Reagan Ballistic Missile Defense Test Site on U.S. Army Kwajalein Atoll and disaster relief operations throughout the region. This posture will become increasingly important as regional powers become increasingly active and seek to supplant U.S. military leadership and economic interests in the region. Following through on our commitments to Palau, as reflected in the proposed legislation, buttresses our defense posture in the Western Pacific.

Palau does not maintain its own military forces, but under the terms of our Compacts, their citizens are eligible to serve in the U.S. Armed Forces. And they do. Palauan citizens volunteer in the U.S. military at a rate higher than in any individual U.S. state. Approximately 200 Palauan men and women serve in our military today, out of a population of about 14,000. Palau is indeed a strong partner who punches well above its weight. We are grateful for their sacrifices and dedication to promoting peace and fighting terrorism. Palau has deployed soldiers for U.S. coalition missions and participated in U.S.-led combat operations in the world's most difficult and dangerous places. Since 9/11, at least six Palauans lost their lives in combat.

Just this year, Sgt. Sonny Moses was killed in Afghanistan while serving with his comrades providing computer training to Afghan citizens. Sgt. Moses was the youngest of eight children of Mr. and Mrs. Sudo Moses and when his body came to Palau for burial, three of his siblings came home in U.S. uniform. Of the family of eight, four chose to serve in the United States military. And during the motorcade for his procession to the Capitol the streets of Koror were lined with citizens waving U.S. and Palauan flags. This sad occasion shows just how close the ties between the United States and Palau truly are.

President Toribiong's niece and Minister Jackson Ngiraingas' son both serve in the U.S. Navy. The son of Minoru Ueki, Palau's Ambassador to Japan, serves in our army. Palau Paramount Chief Reklai has a daughter and son in the Army. Palau's Ambassador to the United States Hersey Kyota has two adult children serving in the Armed Forces. He has several nephews serving in the Army and Marine Corps. Similarly, many other Palauan sons and daughters of other government officials and of ordinary Palauan citizens served honorably in U.S. military units over the past decades and most recently in Afghanistan and Iraq.

The Compact and our continued commitment to Palau, as manifested in the proposed legislation, will reinforce an important element of our Pacific strategy for defense of the U.S. homeland. As you will hear from Deputy Assistant Secretary of

Defense Robert Scher, the U.S.-Palau Compact includes provisions that close Palau to the military forces of any nation, except the United States. The United States enjoys access to Palauan waters, lands, airspace, and its Exclusive Economic Zones (EEZ), a vital asset for our defense and security needs. Our relationship with Palau allows the United States to guard its long-term defense interests in the region.

Beyond Defense Interests

The importance of our strong relationship with Palau extends beyond defense considerations. Palau works closely with the U.S. to detect and combat international crime and terror. In 2009, Palau resettled six ethnic Uighur detainees from Guantanamo at a time when few other countries were willing to step up. Palau was the first island partner to sign the U.S. Coast Guard ship rider and ship boarding agreements that bolster law enforcement in the vast Pacific region.

Our people-to-people ties continue to grow. Since 1966, more than 4,200 Peace Corps Volunteers taught English, offered life skills education, and supported economic development, education, capacity building, and marine and terrestrial resource conservation in Palau and in the two other Freely Associated States. Today approximately 55 Peace Corps volunteers serve in Micronesia and Palau.

THE ADMINISTRATION'S PACIFIC STRATEGY

Mr. Chairman, the President, Secretary Clinton, and others in this Administration deeply appreciate the historic World War II legacy of the Pacific and the strategic role it plays, particularly in keeping the Pacific Islands allied with the United States. Today, we find ourselves in a tumultuous global political environment that calls for wisdom and long-term strategic vision. An investment in Palau today will help to ensure Palau will continue to stand with us as a staunch, dependable, democracy tomorrow.

Palau is important, but why enact the U.S.-Palau Legislation now?

Palau's stable government is modeled on our own. Palau shares our vision on important international goals for human rights and democracy. The maturity of the democratic process in as relatively young a state as Palau is a testament to the strong values of the people of the Pacific and reinforces the value of the Compact as a vehicle for their transition to greater self-sufficiency.

Palau was the first insular area, including the U.S. territories, to get a clean audit opinion on the government's financial statements. Public facilities are in good repair, and Palau puts a great deal of care into maintaining a pristine environment, especially by addressing critical areas of energy, water, sewer, and transportation. They understand the importance of continuing efforts to operate within a balanced budget.

We must remain true to our commitment to the people of Palau. The bottom line is that Palau is an irreplaceable and loyal partner, who shares our interests in preserving regional and international security. Failing to affirm the results of the 15-year review of the Compact with Palau is not in our national interest. We appreciate the interest and leadership of this Committee in considering this legislation promptly and hope both the Senate and the House will pass it this session.

Although the Department of the Interior is responsible for implementing and funding the Compact programs, I would like to say a few words about the assistance package resulting from the 15-year review. The direct economic assistance provisions of the Compact expired on September 30, 2009. The outcome of the 15-year review resulted in an assistance agreement that provides \$215.75M to Palau over the next 14 years and enables Palau to transition to reliance on a \$15 million a year withdrawal from its trust fund; instead of the \$13 million in direct assistance and \$5 million from its trust fund that it has come to rely on. The assistance package included in the legislation, which provides approximately \$215 million to Palau divided over the next 14 years, reflects an effort to ease Palau off of U.S. direct economic assistance as it continues to grow and reform its economy. As a result of the Compact review, Palau will have continued eligibility for a wide range of Federal programs and services from agencies such as the U.S. Postal Service, federal weather services, the Federal Aviation Administration, the Department of Agriculture, and Health and Human Services.

If the bilateral agreement between our two countries is not implemented, the trust fund would be unable to provide a steady outlay of \$15 million a year from now until 2044, which was the intended purpose of the Compact negotiators in the 1980s. The Trust Fund suffered considerable shrinkage as a result of the recent global financial crisis. For the smooth continuation of our bilateral relationship, it is crucial that we provide Palau the assistance agreed to in the Compact review.

Mr. Chairman, in closing I would like to emphasize that Palau, a small island country far away in the Pacific, was our protectorate and is now our ally. The people of Palau are woven into the American fabric, serving with distinction and honor in our military and living and working beside us in the United States. Thanks to its geography, Palau is a unique outpost in our security arc in the Pacific. It is a place America liberated with its blood and that now helps us protect the western flank of our homeland. The economic center of gravity continues to shift to the Asia Pacific, and the vital importance of a stable, increasingly prosperous and democratic Palau to U.S. interests in this dynamic region continue to grow.

I hope that my testimony today, coupled with that of my colleagues from the Department of the Interior and the Department of Defense, has given you a more robust and complete picture of the key role played by the Compact in not only cementing our partnership with Palau, but also in serving the interests of the United States.

I look forward to working with you and other Members of Congress to secure and advance U.S. interests in Palau by passing the legislation implementing the results of the Compact review.

Thank you again for giving me the opportunity to testify before you today and to clarify the importance of this legislation. I look forward to answering your questions.

The CHAIRMAN. Thank you very much.
Mr. Babauta, go right ahead.

STATEMENT OF ANTHONY M. BABAUTA, ASSISTANT SECRETARY OF THE INTERIOR, INSULAR AFFAIRS, DEPARTMENT OF THE INTERIOR

Mr. BABAUTA. Thank you very much.

Chairman Bingaman and Ranking Member Murkowski, I am pleased to be here today to discuss S. 343. My written statement has been submitted for the record, and my statement today will focus on the financial assistance components of the new agreement with Palau for which the Department of the Interior will be responsible.

The department and the Government of Palau have been partners since 1951. Consistent with the provisions of the 1994 Compact of Free Association, Palau has exercised its sovereignty in accordance with the principles of democracy and in a firm alliance with the U.S.

The compact has proven to be a very successful framework for U.S.-Palau relations. The goals of the first 15 years of the compact have been met: The trusteeship was terminated; Palau's self-government was restored; a stable democratic state was established; third countries were denied military influence in the region of Palau; and with U.S. financial assistance, a base for economic growth has been provided.

The original financial terms and conditions of the compact have been fully implemented by the U.S. and Palau. The U.S., through the department, has provided over \$600 million of assistance, including \$149 million used to construct the 53-mile road system on the island of Babeldoab, and \$38.7 million for health care and education block grants.

Palau has made strong economic gains under the compact, and its growth in real terms has averaged just over 2 percent per year.

The U.S. and Palau agree that prospects for continued economic growth rely on 4 key factors: the viability of the compact trust fund and its ability to return \$15 million annually; the implementation of fiscal reforms to close the gap between Palau's revenues and expenditures by shrinking its public sector and raising revenue; the

promotion of increased foreign investment and private sector growth; and, the continuation of certain U.S. assistance, including access to U.S. Federal domestic programs and services.

The agreement extends U.S. assistance in declining annual amounts through fiscal year 2024. The total of direct financial assistance to Palau under the agreement is \$229 million, although \$13.1 million of that amount has already been appropriated for direct economic assistance by congressional action in fiscal year 2010 and \$13 million in fiscal year 2011.

Under the agreement, in 2011, the U.S. is to provide Palau \$28 million and the amount will decline every year thereafter. The declining amount of assistance is intended to provide an incentive for Palau to develop other sources of local revenue and serves notice that the Palauan Government has agreed that it will need to make systemic adjustments to its government in order to live within those same resources.

The agreement contains 5 categories of financial assistance to Palau.

Direct economic assistance in amounts starting at \$13 million in 2011, declining to \$2 million by 2023 for education, health, administration of justice, and public safety. The timing of direct assistance payments is conditioned on Palau's making certain fiscal reform efforts.

Mutually agreed upon infrastructure projects, which will provide \$8 million in grants for 2011 through 2013, \$6 million in 2014, and \$5 million in 2015 and 2016.

The infrastructure maintenance fund is a trust fund with both U.S. and Palau contributing. It will be established to be used for maintenance of capital projects previously financed by the United States.

Fiscal consolidation fund: The U.S. will provide grants of \$5 million each in 2011 and 2012 to help Palau reduce its debt.

Trust fund: The agreement increases the size of Palau's trust fund directly and indirectly to bolster the likelihood that the trust fund will yield payments of up to \$15 million annually through 2044.

The U.S. and Palau will work cooperatively on economic reform. The agreement requires the 2 governments to establish an advisory group to recommend economic, financial, and management reforms.

Palau is committed to adopting and implementing such reforms. Palau will be judged on its progress in such reforms as the elimination of operating deficits, reduction in annual budgets, reducing the number of government employees, implementing meaningful tax reform, and reducing subsidies to public utilities.

Palau's progress in implementing reforms will be addressed at annual bilateral economic consultations.

The agreement also continues to provide other U.S. services and grant programs, including U.S. Postal Service, the National Weather Service, and the FAA.

The Palau compact legislative proposal does have PAYGO costs. These costs are included in the President's budget along with a number of legislative proposals with PAYGO savings. Some proposals that fall under this committee's jurisdiction include net receipt sharing, which takes into account the costs of managing Fed-

eral oil and gas leases before revenues are shared with States; termination of payments for reclaiming abandoned coal mines to States that are already certified as having cleaned up all of their priority sites; and production incentive fees of non-producing Federal oil and gas leases.

Each example by itself could provide more than enough savings to offset the cost of the Palau compact. These proposals are also viable. Net receipt sharing, for example, has been enacted for 4 years through annual appropriations language.

The Administration looks forward to continuing our partnership with Palau. The department is proud of the positive advancements our assistance to Palau has provided over the last 15 years and looks forward to the progress that we anticipate will be made over the next 15 years.

Thank you, Mr. Chairman, Senator Murkowski.
[The prepared statement of Mr. Babauta follows:]

PREPARED STATEMENT OF ANTHONY M. BABAUTA, ASSISTANT SECRETARY OF THE
INTERIOR, INSULAR AFFAIRS, DEPARTMENT OF THE INTERIOR

Chairman Bingaman and members of the Committee on Energy and Natural Resources, I am pleased to be here today to discuss S. 343, a bill that would amend Public Law 99-658 and approve the results of the review of fifteen-years of the Compact of Free Association between the Government of the United States and the Government of the Republic of Palau (ROP). My colleagues from the Departments of State and Defense will discuss the importance of the United States—Palau relationship as it relates to national security and our policies in the Pacific. My statement today will focus on the financial assistance components of the new agreement with Palau for which the Department of the Interior will be responsible.

THE UNITED STATES—PALAU RELATIONSHIP

The Department of the Interior and the Government of Palau have been partners since 1951, when the Navy transferred to the Department of the Interior the administration of the United Nations Trust Territory of the Pacific Islands. Since the end of World War II, Palau has emerged from its status as a war-ravaged protectorate to become a sovereign nation and member of the world community. Consistent with the provisions of the 1994 Compact of Free Association, Palau has exercised its sovereignty in accordance with the principles of democracy and in a firm alliance with the United States.

The Compact of Free Association has proven to be a very successful framework for United States—Palau relations. The goals of the first fifteen years of the Compact have been met: the trusteeship was terminated; Palau's self-government was restored; a stable democratic state was established; third countries were denied military influence in the region of Palau; and with United States financial assistance, a base for economic growth has been provided.

The original financial terms and conditions of the Compact have been fully implemented by the United States and Palau. The United States, through the Department of the Interior, has provided over \$600 million of assistance including \$149 million used to construct the 53-mile road system on the island of Babeldoab and \$38.7 million for health care and education block grants. Most of the funding, \$400 million, was expended on activities defined under Title Two of the Compact, which included general government operations, energy production, communications, capital improvements, health and education programs and establishment of the Compact Trust Fund.

The Compact Trust Fund was an important feature of U.S. assistance. Capitalized with \$70 million during the first three years of the agreement in the 1990s, the objective of the trust fund was to produce an average annual amount of \$15 million as revenue for Palau government operations for the thirty-five year period fiscal year 2010 through fiscal year 2044. The fund also generated \$5 million in annual operational revenue for Palau since the fourth year of the agreement, totaling \$60 million for the years 1998 through 2009.

Palau has made strong economic gains under the Compact of Free Association. Its growth, in real terms, has averaged just over 2 percent per year. Palau's govern-

mental services are meeting the needs of its community. Palau has taken control of its destiny and is moving in the right direction.

COMPACT REVIEW

As both the United States and Palau began the required Compact section 432 review several years ago, each side took pride in the growth evident in Palau. However, the review, which examined the terms of the Compact and its related agreements and the overall nature of the bilateral relationship, also focused attention on several important issues. The United States and Palau agreed that prospects for continued economic growth relied on four key factors: 1) the viability of the Compact trust fund and its ability to return \$15 million a year; 2) the implementation of fiscal reforms to close the gap between Palau's revenues and expenditures by shrinking its public sector and raising revenue; 3) the promotion of increased foreign investment and private sector growth, and, 4) the continuation of certain United States assistance, including access to United States Federal domestic programs and services.

From the perspective of the United States, the viability of the Compact Trust Fund was of paramount concern. The economies of Pacific islands are always fragile; their size, distance from markets and relative lack of resources make growth a perennial problem. Although Palau has some relative advantages in contrast to other Pacific island countries, the Compact Trust Fund was established with the intention of providing a relatively secure revenue base for Palau's government through fiscal year 2044. As the 15-year review began, Palau's trust fund, which had earned roughly 9 percent annually since its inception, had suffered significant losses. As GAO reported in 2008, it was uncertain that the trust fund could pay \$15 million annually to the Government of Palau through fiscal year 2044.

COMPACT AGREEMENT

The condition of the Compact Trust Fund, the need for fiscal and economic reforms, and the goal of strengthening conditions for private sector growth became the focus of the bilateral review. I believe that the Agreement Between the Government of the United States of America and the Government of the Republic of Palau Following the Compact of Free Association Section 432 Review (Agreement) that arose from the 15-year review, and which is embodied in S. 343 will address these concerns, maintain stability, promote economic growth and increase the progress already made under the Compact of Free Association.

The Agreement extends United States assistance, in declining annual amounts, through fiscal year 2024. The total of direct financial assistance to Palau under the Agreement is \$229 million, although \$13.1 million of that amount has already been appropriated for direct economic assistance by congressional action in fiscal year 2010 and \$13 million in fiscal year 2011.

Under the Agreement, in 2011 the United States is to provide Palau \$28 million (of which \$13 million is the aforementioned direct assistance), and the amount will decline every year thereafter. The declining amount of assistance is intended to provide an incentive for Palau to develop other sources of local revenue and serves notice that the Palauan government has agreed that it will need to make systemic adjustments to its government in order to live within those same resources.

The Agreement contains five categories of financial assistance to Palau.

Direct economic assistance

The Agreement provides for direct assistance for education, health, administration of justice and public safety, in amounts starting at \$13 million in 2011, declining to \$2 million, the last payment, in 2023. The timing of direct assistance payments is conditioned on Palau's making certain fiscal reform efforts. If the United States government determines that Palau has not made meaningful progress in implementing meaningful reforms, direct assistance payments may be delayed until the United States Government determines that Palau has made sufficient progress on the reforms.

Infrastructure projects

Under the Agreement the United States is to provide grants to Palau for mutually agreed infrastructure projects—\$8 million in 2011 through 2013, \$6 million in 2014, and \$5 million in both 2015 and 2016. The Agreement does not name any projects.

Infrastructure maintenance fund

Under the Agreement, a trust fund will be established to be used for maintenance of capital projects previously financed by the United States, including the existing Compact Road. From 2011 through 2024, the United States government will con-

tribute \$2 million annually and the Palau government will contribute \$600,000 annually to the fund. This will protect crucial United States investments in Palau that significantly contribute to economic development.

Fiscal consolidation fund

The United States will provide grants of \$5 million each in 2011 and 2012 to help the Palau government reduce its debt. United States creditors must receive priority, and the government of Palau must report quarterly on the use of the grants until they are expended. This fund will also simplify needed economic adjustments to Palau's fiscal policies.

Trust fund

The Agreement increases the size of Palau's trust fund directly and indirectly to bolster the likelihood that the trust fund will yield payments of up to \$15 million annually through 2044. First, the United States will contribute \$3 million annually from 2013 through 2022 and contribute \$250,000 in 2023. Second, the government of Palau will delay withdrawals from the fund, drawing \$5 million annually through 2013 and gradually increasing its withdrawal ceiling from \$5.25 million in 2014 to \$13 million in 2023. From 2024 through 2044, Palau is expected to withdraw up to \$15 million annually, as originally scheduled. Under the Agreement, withdrawals from the trust fund may only be used for education, health, administration of justice and public safety.

CONTINUING COOPERATION

The United States and Palau will work cooperatively on economic reform. The Agreement requires the two governments to establish an advisory group to recommend economic, financial and management reforms. Palau is committed to adopting and implementing reforms. Palau will be judged on its progress in such reforms as the elimination of operating deficits, reduction in its annual budgets, reducing the number of government employees, implementing meaningful tax reform and reducing subsidies to public utilities.

Palau's progress in implementing reforms will be addressed at annual bilateral economic consultations. If the government of the United States determines that Palau has not made significant progress on reforms, the United States may delay payment of economic assistance under the Agreement.

The Agreement also continues to provide other United States services and grant programs, including the United States Postal Service, the National Weather Service, and the Federal Aviation Administration. The Postal Service moves mail between the United States and Palau, and offers other related services. Palau maintains its own postal service for internal mail delivery. The National Weather Service reimburses Palau for the cost of operating its weather station in Palau, which performs upper air observations twice daily, as requested, for the purpose of Palau's airport operations and the tracking of cyclones that may affect other United States territories, such as Guam. The Federal Aviation Administration provides aviation services to Palau, including en-route air traffic control from the mainland United States, flight inspection of airport navigation aids, and technical assistance and training.

The proposed legislation will also allow the continuance of other Federal program services currently available to Palau under separate authorizing legislation, including programs of the Departments of Education and Health and Human Services. The general authorization for Palau to receive such services was created by the Compact, but individual program eligibility has been created by specific laws that include Palau as an eligible recipient.

The Palau Compact legislative proposal does have PAYGO costs. These costs are included in the President's Budget along with a number of legislative proposals with PAYGO savings. Some proposals that fall under this Committee's jurisdiction include:

- Net Receipt Sharing, which takes into account the costs of managing Federal oil and gas leases before revenues are shared with the States;
- Terminate payments for reclaiming abandoned coal mines to states that are already certified as having cleaned up all of their priority sites; and
- Production incentive fees on non-producing Federal oil and gas leases.

Each example by itself could provide more than enough savings to offset the costs of the Palau Compact. These proposals are also viable; Net Receipt Sharing, for example, has been enacted for four years through annual appropriations language.

The Administration looks forward to continuing our partnership with Palau. The Department of the Interior is proud of the positive advancements our assistance to

Palau has provided over the last fifteen years and looks forward to the progress that we anticipate will be made over the next fifteen years.

The CHAIRMAN. Thank you very much.
Mr. Scher, go right ahead.

STATEMENT OF ROBERT SCHER, DEPUTY ASSISTANT SECRETARY OF DEFENSE, SOUTH & SOUTHEAST ASIA, DEPARTMENT OF DEFENSE

Mr. SCHER. Thank you. Mr. Chairman, Senator Murkowski, thank you for the opportunity to appear before you today to discuss the importance of the Palau Compact Agreement.

In short, our compact with Palau, coupled with our compacts with the Federated States of Micronesia and the Republic of the Marshall Islands, is a critical arrangement that enables DOD to maintain access and influence in the Asia-Pacific region.

Passage of S. 343 is critical to allowing the department to continue to benefit from the security arrangement afforded by the compact.

Today, I'd like to take the opportunity to discuss the importance of Palau and the compact to preserving national security interests in the Asia-Pacific region. As noted, I have submitted a fuller statement for the record but will mention just the highlights here briefly.

Let me begin by discussing Palau in the context of regional security environment of the Western Pacific. Palau lies at a pivotal crossroads in the Pacific, an area near critical sea lines of communication and rich fishing grounds. It is also located directly in the so-called "second island chain" from mainland Asia, close to all of the major East and Southeast Asian powers.

Our strategic interests and equities are expanding and shifting more toward the Asia-Pacific region. Having Palau as a strong partner in the Pacific is increasingly important to maintaining military as well as political and diplomatic leadership in this quickly evolving strategic environment.

We must take note of critical security developments in the Pacific that require the department's sustained presence and engagement.

Broadly speaking, countries such as China, Russia, and, as you heard, some Arab Nations are actively courting the Pacific Island states, challenging the security status quo in the region, and increasing their economic, diplomatic, and military engagement with the island states.

These critical security developments require sustained U.S. presence and engagement in the region.

Our relationship with Palau under the compact would be reinforced with the passage of this legislation and would ensure that the United States has the unique advantage to deny other militaries access to Palau.

For these reasons, it is imperative that the U.S. Government sustain our commitment to Palau.

The region's lack of political and security infrastructure has given rise to a trend of growing transnational crime, which underscores the importance of continued DOD and U.S. Government engagement in the Western Pacific.

With this in mind, the department seeks to develop creative ways to remain strategically engaged in the region. Recognizing that Palau has no military and only limited law enforcement capabilities and resources, the department's engagement with Palau primarily focuses on helping them develop maritime security and humanitarian assistance capabilities.

I would also be remiss if I did not highlight, as my colleagues have done, the extraordinary service of Palauans in the U.S. Armed Forces and their individual contributions to U.S. security.

Under the provisions of the compact, Palauans are able to serve in the Armed Forces and, in fact, Palauans serve in the Armed Forces in impressive numbers. Currently, at least 200 Palauan men and women serve on active duty in the U.S. Armed Forces.

Sadly, 5 Palauans have been killed in action and numerous others have been wounded fighting on the battlefields in Afghanistan and Iraq. Their sacrifice in the defense of the United States homeland and U.S. security interests cannot go unnoticed.

Furthermore, as also noted, in 2009, Palau stepped up to offer resettlement to 6 Uighur detainees from Guantanamo Bay at a time when other countries were hesitant to take these individuals.

Together with the 2 other compact states, the Federated States of Micronesia and the Republic of the Marshall Islands, Palau forms part of an important security zone under exclusive U.S. control that, along with Guam and the Commonwealth of the Northern Mariana Islands, spans the entire width of the Western Pacific.

Palau's location makes it an important part of U.S. strategic presence in this region.

In conclusion, U.S. power projection in the Asia-Pacific region will continue to be essential to our national security interests, and the U.S.-Palau compact is a strategic asset for that presence in the Western Pacific.

Loss of the defense rights and exclusive access granted to the United States under the compact would adversely affect U.S. national security.

Our relationship with Palau is unique and reliable. Passage of the proposed legislation approving the results of the 15-year compact review would ensure this important security agreement continues and would reassure Palau of our sustained commitment to the Nation and its people. Further, it would reinforce our shared interests in regional and global security.

I urge you to support the continued security agreement the United States has developed with Palau over the years and ask for your support of the proposed legislation.

Thank you.

[The prepared statement of Mr. Scher follows:]

PREPARED STATEMENT OF ROBERT SCHER, DEPUTY ASSISTANT SECRETARY OF
DEFENSE, SOUTH & SOUTHEAST ASIA, DEPARTMENT OF DEFENSE

INTRODUCTION

Members of the Committee, thank you for the opportunity to appear before you to discuss the importance of the Palau Compact Agreement. Since its enactment in 1994, the Compact has served as an important foundation for our security strategy in the Asia-Pacific region, providing the United States with critical access, influence, and strategic denial of access to other regional militaries. Our Compact with Palau, coupled with our compacts with the Federated States of Micronesia (FSM) and the

Republic of the Marshall Islands (RMI), has enabled DoD to maintain critical access and influence in the Asia-Pacific region. Passage of S. 343, a bill to amend Title I of PL 99-658 regarding the Compact of Free Association between the United States and Palau, is vital to allowing the Department to continue to benefit from the security arrangement afforded by the Compact. Today, I would like to take the opportunity to discuss the importance of Palau and the Compact to preserving U.S. national security interests in the Asia-Pacific region.

PALAU'S CONTRIBUTIONS TO AMERICAN AND GLOBAL SECURITY

Let me begin by discussing Palau in the context of the regional security environment in the Western Pacific. The Pacific Islands region is sparsely populated, physically isolated, and geographically widespread. However, Palau lies at a pivotal crossroad in the Pacific, an area near critical sea lines of communication and rich fishing grounds. It is also located directly in the so-called "Second Island Chain" from Mainland Asia, close to all of the major East and Southeast Asian powers. With our strategic interests and equities expanding in shifting more toward the Asia-Pacific region, having Palau as a strong partner in the Pacific is increasingly important to maintaining military, as well as political and diplomatic, leadership in this quickly evolving strategic environment.

We must take note of critical security developments in the Pacific that require the Department's sustained presence and engagement. Broadly speaking, countries such as China, Russia, and the Arab states are actively courting Pacific Island States, challenging the security status quo in the region, and increasing their economic, diplomatic, and military engagement with the island States. These critical security developments require sustained U.S. presence and engagement in the region. Our relationship with Palau under the Compact would be reinforced with passage of this legislation and would ensure the United States the extraordinary advantage to deny other militaries access to Palau. For these reasons, it is imperative that the U.S. Government sustain this advantage.

Since the Compact of Free Association between the Government of the United States of America and the Government of Palau went into effect in 1994, the United States has taken full responsibility for the security and defense of Palau. This unique security arrangement has created a steadfast and reliable partner that helps the United States advance its national security goals in the region.

PALAU IN THE REGIONAL SECURITY CONTEXT

I would also like to highlight the extraordinary service of Palauans in the U.S. Armed Forces and contributions to U.S. security. Under the provisions of the Compact, Palauans are able to serve in the U.S. Armed Forces. In fact, Palauans serve in the U.S. Armed Forces in impressive numbers. Sadly, five Palauans have made the ultimate sacrifice, and numerous others wounded, fighting on the battlefield in Afghanistan and Iraq since 9/11. Their sacrifice in the defense of the U.S. homeland and U.S. and Coalition security interests should not go unnoticed. Furthermore, in 2009, Palau stepped up to offer resettlement to six Uighur detainees from Guantanamo Bay at a time when other countries were hesitant to take these individuals.

Most notably, our commitment to the Compact with Palau allows the Department to leverage Palau's strategic geopolitical position to sustain U.S. security interests in the region. The United States exercises full authority over and responsibility for the security and defense of Palau, an arrangement similar to those that we have with the Federated States of Micronesia and the Republic of the Marshall Islands. With this authority and responsibility, the United States is entitled to military access to the lands, water, and airspace of Palau and retains the right to deny such access to the military forces of other nations. Our current security arrangement affords us expansive access, which will be an increasingly important asset in the defense and security interests of the United States in the Asia-Pacific region in coming years. The Department recognizes the strategic value of the Compact, and we hope to continue to utilize it to serve our national security interests.

U.S.-PALAU DEFENSE RELATIONS

We have growing national security interests and equities in the Western Pacific, a region that is traditionally overlooked and undervalued. Together with the two other Compact States, the Federated States of Micronesia and the Republic of the Marshall Islands, Palau forms part of an important security zone under exclusive U.S. control that spans the entire width of the Pacific when we include Hawaii and the U.S. territories, Guam and the Commonwealth of the Northern Mariana Islands. Palau's location makes it an important part of the U.S. strategic presence in the Asia-Pacific. The Palau Compact affords us strategic positioning in a country with

a unique geopolitical position in the Asia-Pacific. The region's lack of political and security infrastructure has given rise to a trend of growing transnational crime, which underscores the importance of continued DoD engagement in the Western Pacific. With this in mind, the Department seeks to develop creative ways to remain strategically engaged in the region. Recognizing that Palau has no military and only limited law enforcement capabilities and resources, the Department's engagement with Palau primarily focuses on helping them develop maritime security and humanitarian assistance capabilities.

First, maritime security has been one of the most fruitful areas of cooperation between our two nations. DoD sends mobile training teams to Palau to help train local security personnel in maritime security-related matters. Palau's EEZ is part of the Pacific's richest fishing grounds and has traditionally faced serious problems with foreign exploitation of the fishery resources. Large numbers far-ranging fishing vessels from other Pacific nations threaten encroachment. Japan, China, Taiwan, and the United States participate in a highly competitive multi-million dollar tuna industry. The Department is currently reviewing ways to use existing DoD assets and cooperative mechanisms to enhance maritime domain awareness in the region.

To combat illegal fishing, the U.S. Coast Guard has entered into a shiprider agreement with Palau, which enables Palauan security officials to embark on transiting U.S. Coast Guard vessels to conduct maritime patrol of its enormous, under patrolled Exclusive Economic Zone (EEZ). This kind of shiprider agreement allows the U.S. Coast Guard to play a more active role in developing partner law enforcement capacity of the island States. In addition, we are cooperating with Japan, Australia, Palau, the Marshall Islands, and Micronesia to bring to fruition the Sasakawa Peace Foundation's \$10 million initiative to support maritime surveillance in all three Compact States.

Second, the Department's humanitarian programs have been very well-received in island communities. These programs primarily focus on the removal of explosive remnants of war from the World War II era, humanitarian projects, and prisoner of war/missing in action operations. DoD's 12-person Civic Action Team maintains a rotational presence in Palau, conducting small-to medium-scale humanitarian and civic action projects in the health, education, and infrastructure areas. Especially notable are the large-scale, multinational, pre-planned humanitarian missions, the U.S. Air Force's Pacific Angel and U.S. Navy's Pacific Partnership, which include medical and engineering projects in remote regions that are conducted in close coordination with local communities. In the summer of 2010, more than 1,900 Palauans were treated, 14 community service projects were completed, and more than 1,000 man hours spent across the three states of Koror, Peleliu and Angaur when USS BLUE RIDGE (LCC-19) stopped in Palau as part of Pacific Partnership 2010. Also, the longest running humanitarian campaign in the world, Operation Christmas Drop, which provides air-dropped supplies to the people of the remote Micronesian islands each December, celebrated its 58th anniversary in December 2010 and continues annually to assist the remote islands of Palau. These humanitarian missions are evidence that the Department's engagement in Palau extends well beyond traditional security parameters.

CONCLUSION

In conclusion, U.S. power projection in the Asia-Pacific region will continue to be essential to our national security interests. The U.S.-Palau Compact is a strategic asset for U.S. presence in the Western Pacific, an increasingly important region. Loss of the defense rights and exclusive access granted to the United States under the Compact would adversely affect U.S. national security. Our relationship with Palau is unique and reliable. Passage of the proposed legislation approving the results of the 15-year Compact Review would ensure this important security agreement continues and would reassure Palau of our sustained commitment to Palau and its people and of our shared interest in regional and global security. I urge you to support the continued security agreement the United States has developed with Palau over the years and ask for your support of the proposed legislation.

The CHAIRMAN. Thank you very much.

Mr. Gootnick, go right ahead. Tell us what GAO's view on this situation is.

STATEMENT OF DAVID GOOTNICK, DIRECTOR, INTERNATIONAL AFFAIRS AND TRADE, GOVERNMENT ACCOUNTABILITY OFFICE

Mr. GOOTNICK. Thank you, Mr. Chairman and Ranking Member Murkowski.

Thank you for asking GAO to participate in this hearing. I will be returning to some of the economic provisions under the agreement.

As has been stated, the 1994 compact provided 15 years of economic assistance. It also established the trust fund, built the Compact Road, and provided U.S. postal, weather and aviation services.

Importantly, the compact established the basis for discretionary U.S. Federal programs, such as Head Start, community health centers, Pell Grants, the airport improvement program, special education, and numerous others.

Taken together, compact funds, in-kind services, such as delivery of the road, and U.S. program assistance since 1994 is valued at roughly \$850 million.

My written statement, which I'll briefly summarize, describes, first, the funding and conditions as outlined in the September 2010 agreement; second, the impact of the agreement on Palau's trust fund; and, third, projected Palau Government revenues under the agreement.

Regarding future economic assistance, the agreement will provide \$250 million, as has been said, with a steady annual decrement, from roughly \$28 million in 2011 to \$2 million in 2024.

About half of this assistance would directly support government operations and be directed to specific needs, such as health, education, and public safety.

Along with these funds, an advisory group would be appointed and tasked to make recommendations for economic, fiscal, and management reforms. The agreement cites reductions in the national budget, in government employment, and in operating deficits, as well as tax reform, as examples of meaningful reforms. The U.S. may delay funding conditioned on progress of these reforms.

The agreement also provides \$40 million for mutually agreed infrastructure projects. Projects must have land title, budgets, and certified scopes of work to receive funding.

Also, a maintenance fund is established and designated to be used for U.S.-financed capital projects, principally the Compact Road and the international airport.

The agreement also provides \$10 million toward Palau's debt. It prioritizes U.S. creditors for repayment and requires U.S. concurrence of the debts to be paid.

Finally, the agreement provides an additional \$30 million to the trust fund. It requires Palau to reduce scheduled trust fund withdrawals by \$89 million. It directs disbursements to health, education, justice, and public safety.

The agreement also extends the framework to continue discretionary Federal programs.

Regarding the trust fund, the additional U.S. contributions and the delay in scheduled withdrawal, as provided in the agreement, will markedly improve the fund's prospects. In 2009, we reported that the trust fund would require an annual return above 10 per-

cent to yield its proposed withdrawals through 2044. However, under this agreement, the trust fund would need only 4.9 percent to yield its new schedule of withdrawals. This is well below the 8.2 percent it has earned to date.

Last, regarding projected Palau Government revenues under this agreement, to offset the steady decline and budget support from 2010—excuse me, from 2011 through 2024, estimates prepared for the Government of Palau project a growing reliance on trust fund withdrawals and domestic revenues, and continued access to Federal programs. The estimates project domestic revenue to increase sharply from roughly 40 percent of total government revenues to nearly 60 percent by 2024.

In addition, due to the steady reliance on discretionary Federal programs, these programs, which are subject to annual appropriations, are projected at half of all U.S. assistance.

In summary, the economic provisions of the agreement extend and gradually reduce compact assistance through 2024, establish new conditions for the use of U.S. funds, and reset the trust fund to significantly improve its long-term prospects.

Palau has employed projections of its long-term fiscal condition that rely on increased domestic revenue and continuation of U.S. Federal programs.

Mr. Chairman, this completes my remarks. I'm happy to answer your questions.

[The prepared statement of Mr. Gootnick follows:]

PREPARED STATEMENT OF DAVID GOOTNICK, DIRECTOR, INTERNATIONAL AFFAIRS AND TRADE, GOVERNMENT ACCOUNTABILITY OFFICE

PROPOSED U.S. ASSISTANCE TO PALAU AND ITS LIKELY IMPACT

Why GAO Did This Study

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

In September 2010, the United States and Palau signed an agreement (the Agreement) that would, among other things, provide for additional assistance to Palau and modify its trust fund.

This statement describes (1) the Agreement's provisions for economic assistance to Palau, (2) its impact on the trust fund's likelihood of sustaining scheduled payments through 2044, and (3) the projected role of U.S. assistance in Palau government revenues. GAO reviewed the Agreement; examined Palau's recent single audit reports and budget projections; and assessed trust fund balances and disbursement plans under various assumptions and investment returns.

What GAO Found

The Agreement would provide steadily decreasing assistance totaling approximately \$215 million from 2011 through 2024 (see figure).^{*} This would include the following:

- direct economic assistance (\$107.5 million) for government operations,
- infrastructure project grants (\$40 million) to build mutually agreed projects,
- infrastructure maintenance fund (\$28 million) for maintaining the Compact Road, Palau's primary airport, and certain other major U.S.-funded projects,

^{*}Figure has been retained in committee files.

- fiscal consolidation fund (\$10 million) to assist Palau in debt reduction, and
- trust fund contributions (\$30.25 million) in addition to the \$70 million contributed under the compact.

Under the Agreement, the United States would contribute to the trust fund from 2013 through 2023, and Palau would delay its withdrawals by \$89 million from 2010 through 2023. GAO projects that with these changes the fund would have a 90 percent likelihood of sustaining payments through 2044, versus 25 percent without these changes.

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

Chairman Bingaman, Ranking Member Murkowski, and Members of the Committee:

I am pleased to be here today to discuss the September 2010 agreement between the U.S. and Palau governments.¹ The Compact of Free Association between the Government of the United States and the Government of the Republic of Palau, which entered into force in October 1994, provided for several types of assistance aimed at promoting Palau's economic advancement and eventual self-sufficiency.² In addition to establishing Palauan sovereignty and U.S.-Palau security and defense arrangements, the compact provided economic assistance to Palau.³ This assistance comprised, among other things, direct economic assistance for 15 years to the Palau government; the establishment of a trust fund intended to provide Palau \$15 million annually from 2010 through 2044; investments in infrastructure, including a major road; and the provision of federal services, such as postal, weather, and aviation. The compact also established a basis for U.S. agencies to provide discretionary federal programs related to health, education, and infrastructure. In June 2008, we projected that U.S. assistance to Palau from 1995 through 2009 would exceed \$852 million, with assistance under the compact accounting for about 68 percent and assistance through discretionary programs accounting for about 31 percent.⁴ We also reported, in 2008, that the likelihood of the Palau trust fund being able to sustain the planned payments through 2044 was uncertain.

The September 2010 agreement between the U.S. and Palau governments (the Agreement) followed a formal review of the compact's terms required 15 years after it entered into force.⁵ Provisions of the Agreement would, among other things, extend economic assistance to Palau beyond the original 15 years and modify trust fund arrangements. A bill now pending before the U.S. Senate would approve the Agreement and appropriate funds to implement it.⁶

My statement today describes (1) the extension of economic assistance to Palau as outlined in the Agreement, (2) the impact that this assistance would have on the Palau trust fund's sustainability, and (3) the projected role of U.S. assistance in Palau government revenues.

¹The Agreement between the Government of the United States of America and the Government of the Republic of Palau Following the Compact of Free Association Section 432 Review, Sept. 3, 2010.

²See Proclamation 6726, Placing into Full Force and Effect the Compact of Free Association with the Republic of Palau, 59 Fed. Reg. 49777 (Sept. 27, 1994). Congress approved the Compact of Free Association in Public Law 99-658 of Nov. 14, 1986, and Public Law 101-219 of Dec. 12, 1989. The grant funds specified by the compact are backed by the full faith and credit of the U.S. government.

³Unless otherwise noted, all years cited are fiscal years (Oct. 1-Sept. 30). In addition, all dollar amounts in this report are in current (i.e., nominal) dollars.

⁴GAO, Compact of Free Association: Palau's Use of and Accountability for U.S. Assistance and Prospects for Economic Self Sufficiency, GAO-08-732 (Washington, D.C.: June 10, 2008).

⁵Section 432 of the compact provides for the U.S. and Palau governments to formally review the terms of the compact and its related agreements and to consider the overall nature and development of their relationship, on the 15th, 30th, and 40th anniversaries of the compact's effective date. The governments are to consider the operating requirements of the government of Palau and its progress in meeting the development objectives set forth in section 231(a) of the compact. The terms of the compact shall remain in force until otherwise amended or terminated pursuant to title four of the compact.

⁶The pending bill, Senate Bill 343, amends Title I of Public Law 99-658; approves the results of the 15-year review of the compact, including the Agreement; and appropriates funds for the purposes of the amended Public Law 99-658 for fiscal years ending on or before Sept. 30, 2024, to carry out the agreements resulting from the review.

For this statement, we reviewed the Agreement, assessed trust fund balances and disbursement plans under various assumptions and investment returns, and examined single audit reports and budget estimates prepared for the Palau government. We determined that these data were sufficiently reliable for the purposes of our review. We conducted our work from February to June 2011 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis we conducted, provide a reasonable basis for any findings and conclusions.

BACKGROUND

Palau consists of 8 main islands and more than 250 smaller islands with a total land area of roughly 190 square miles, located approximately 500 miles southeast of the Philippines. About 20,000 people live in Palau, concentrated largely in one urban center around the city of Koror, and more than one-quarter of the population is non-Palauan.⁷ Palau's economy is heavily dependent on its tourism sector and on foreign aid from the United States, Japan, and Taiwan.⁸ Similar to many small island economies, Palau's public sector spending represents a significant percentage of its gross domestic product (GDP).⁹

U.S. relations with Palau began when American forces liberated the islands near the end of World War II. In 1947, the United Nations assigned the United States administering authority over the Trust Territory of the Pacific Islands, which included what are now the Federated States of Micronesia, the Republic of the Marshall Islands, the Commonwealth of the Northern Mariana Islands, and Palau. Palau adopted its own constitution in 1981. The governments of the United States and Palau concluded a Compact of Free Association in 1986; the compact entered into force on October 1, 1994. The Department of the Interior's (Interior) Office of Insular Affairs (OIA) has primary responsibility for monitoring and coordinating all U.S. assistance to Palau, and the Department of State (State) is responsible for government-to-government relations.

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

⁷Palau's private sector relies heavily on foreign workers, mostly from the Philippines. We reported in 2008 that, since 1994, foreign workers, as registered with Palau's Social Security Office, have grown to account for half of Palau's total labor force. Because many of these foreign workers send wage income back to their home nations, in 2005 the annual net outflow of remittances from Palau equaled an estimated 5.5 percent of its GDP.

⁸The International Monetary Fund (IMF) projected that in 2010, Palau's GDP was an estimated \$218 million and reported that Palau's GDP per capita was about \$10,500. Business and tourist arrivals were projected to be 78,000 in 2010. See IMF, Republic of Palau Staff Report for the Article IV Consultation (Apr. 12, 2010).

⁹According to the IMF, in 2010, Palau's public sector spending was projected at approximately 42 percent of its GDP.

Table 1: Key Provisions of Palau Compact of Free Association and Subsidiary Agreements	
Compact section	Description of key provisions
Title one: Government Relations	<p><i>Sovereignty</i> Established Palau as a self-governing nation with the capacity to conduct its own foreign affairs.</p> <p><i>Immigration privileges</i> Provided Palauan citizens with certain immigration privileges, such as the rights to work and live in the United States indefinitely and to enter the United States without a visa or passport. This privilege remains in effect as long as the compact agreement is not amended by mutual agreement or mutually or unilaterally terminated.</p>
Title two: Economic Relations	<p><i>Compact direct assistance</i> Established 15-year term of budgetary support for Palau, beginning on compact's effective date. This support included direct assistance for current account operations and maintenance and for specific needs such as energy production, capital improvement projects, health, and education.</p> <p><i>Trust fund</i> Required the United States to contribute to a trust fund for Palau.</p> <p><i>Compact Road</i> Required the United States to construct a road system (the Compact Road).²</p> <p><i>Compact federal services</i> Required the United States to make available certain federal services and related programs to Palau, such as postal, weather, and aviation. The compact subsidiary agreement implementing such services was in force until Oct. 1, 2009.³</p> <p><i>Accountability for compact funds</i> Required Palau to report on its use of compact funds and required the U.S. government, in consultation with Palau, to implement procedures for periodic audits of all grants and other assistance.</p>

Compact section	Description of key provisions
Title three: Security and Defense Relations	<p><i>U.S. authority for security and defense matters</i></p> <p>Established that the United States has full authority and responsibility for security and defense matters in or relating to Palau, would take action to meet the danger of an attack on Palau, and may conduct activities on land, water, and airspace as necessary.</p> <p><i>Strategic denial</i></p> <p>Foreclosed Palau to the military of any nation except the United States, unless they are invited by the United States and under the control of the U. S. armed forces.</p> <p><i>U.S. defense sites and operating rights</i></p> <p>Established that the United States may establish land and sea defense sites in Palau and has certain military operating rights. The subsidiary agreement implementing this provision provides the United States exclusive use of certain land adjoining the airport and certain submerged land in Malakal Harbor and remains in effect through 2044.</p> <p><i>Service in the armed forces</i></p> <p>Established eligibility of Palau citizens to serve in the U.S. armed forces.</p> <p>The provisions on U.S. authority for security and defense matters, U.S. defense sites and operating rights, and service in the armed forces remain in effect unless the compact is terminated by mutual agreement or, if the compact is unilaterally terminated, until October 1, 2044, and thereafter as mutually agreed. The strategic denial provision remains in effect through 2044 and thereafter until terminated or otherwise amended by mutual consent.</p>
Title four: General Provisions	<p>Established general provisions regarding approval and effective date of the compact, conference and dispute resolution procedures, and compact termination procedures. Required reviews of its terms on the 15th, 30th, and 40th anniversaries of the compact's entry into force—that is, in 2009, 2024, and 2034, respectively.</p>

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

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

¹⁰The compact called for the United States to build the Compact Road according to mutually agreed specifications before Oct. 1, 2000. The road was completed and turned over to Palau on Oct. 1, 2007. See GAO-08-732, Appendix V, for more information.

¹¹*Federal Programs and Services Agreement Concluded Pursuant to Article II of Title Two and Section 232 of the Compact of Free Association*, which took effect in 1995, established the legal status of programs and related services, federal agencies, U.S. contractors, and personnel of U.S. agencies implementing both compact federal services and discretionary federal programs in Palau. Under this agreement, the United States Postal Service (USPS) conveys mail between the United States and Palau and offers other services such as Priority Mail®, Collect on Delivery (COD), and USPS Domestic Money Orders. Palau maintains its own postal service for internal mail delivery. Under this agreement, the National Weather Service (NWS) reimburses Palau for the cost of operating its weather station in Palau, which performs upper air observations twice daily and as requested for the purpose of Palau's airport operations and the tracking of cyclones that may impact other U.S. territories such as Guam; and the Federal Aviation Administration (FAA) provides aviation services to Palau, including en-route air traffic control from the mainland United States, flight inspection of airport navigation aids, and technical assistance and training.

In addition to the U.S. assistance provided under the compact, U.S. agencies—Education, Health and Human Services (HHS), and Interior, among others—provide discretionary federal programs in Palau as authorized by U.S. legislation¹⁰ and with appropriations from Congress. (See app. II for a complete listing of these programs in Palau.)

In our 2008 report, we projected that from 1995 through 2009, U.S. assistance to Palau would exceed \$852 million, with economic assistance provided under the compact accounting for 68 percent and discretionary federal programs accounting for 31 percent of this total (see fig. 1*).¹¹

AGREEMENT WOULD EXTEND U.S. ASSISTANCE FOR 15 YEARS, DECREASING ANNUALLY

The September 2010 Agreement between the U.S. and Palau governments would extend assistance to Palau to 2024 but steadily reduce the annual amount provided. The Agreement would also extend the authority and framework for U.S. agencies to continue compact federal services and discretionary federal programs.¹²

¹⁰The compact's federal programs and services agreement, establishing the legislative framework for the provision of discretionary federal programs in Palau, was in force until Oct. 1, 2009. These services continued under program authority in 2010 and 2011.

* Figure 1 has been retained in committee files.

¹¹GAO-08-732.

¹²Other provisions in the Agreement would define reporting and auditing requirements and passport requirements. The Agreement would require that, by 2018, Palau resolve all deficiencies identified in annual single audit reports, which are required by the Compact's fiscal procedures agreement, such that no single audit report recommendations or deficiencies dating from before 2016 remain. In addition, the Agreement alters the entry procedures for citizens of Palau visiting the United States, requiring them to present a valid machine-readable passport to travel to the United States.

Assistance to Palau Would Decline through 2024

Key provisions of the Agreement would include, among others, extending direct economic assistance to Palau; providing for further investments in infrastructure; establishing a fiscal consolidation fund; and making changes to the trust fund. U.S. assistance to Palau under the Agreement would total approximately \$215 million from 2011 through 2024.¹³ The pending legislation would authorize and appropriate funds to Interior for this assistance.¹⁴

- **Direct economic assistance (\$107.5 million).**—The Agreement provides for direct assistance—budgetary support for government operations and specific needs such as administration of justice and public safety, health, and education—of \$13 million in 2011, declining to \$2 million by 2023. The Agreement also calls for the U.S. and Palau governments to establish a five-member Advisory Group to provide annual recommendations and timelines for economic, financial, and management reforms. The Advisory Group must report on Palau’s progress in implementing these or other reforms, prior to annual U.S.-Palau economic consultations.¹⁵ These consultations are to review Palau’s progress in achieving reforms¹⁶ such as improvements in fiscal management, reducing the public sector workforce and salaries, reducing government subsidization of utilities, and tax reform. If the U.S. government determines that Palau has not made significant progress in implementing meaningful reforms, direct assistance payments may be delayed until the U.S. government determines that Palau has made sufficient progress.
- **Infrastructure projects (\$40 million).**—The Agreement mandates U.S. infrastructure project grants to Palau for mutually agreed infrastructure projects—\$8 million in 2011 through 2013, \$6 million in 2014, and \$5 million in both 2015 and 2016. The Agreement requires Palau to provide a detailed project budget and certified scope of work for any projects receiving these funds.
- **Infrastructure maintenance fund (\$28 million).**—The Agreement stipulates that the United States make contributions to a fund to be used for maintenance of U.S.-financed major capital improvement projects, including the Compact Road and Airai International Airport.¹⁷ From 2011 through 2024, the U.S. government will contribute \$2 million annually, and the Palau government will contribute \$600,000 annually to the fund.¹⁸
- **Fiscal consolidation fund (\$10 million).**—The Agreement states that the United States shall provide grants of \$5 million each in 2011 and 2012, respectively, to help the Palau government reduce its debts. Unless agreed to in writing by the U.S. government, these grants cannot be used to pay any entity owned or controlled by a member of the government or his or her family, or any entity from which a member of the government derives income. U.S. creditors must receive priority, and the government of Palau must report quarterly on the use of the grants until they are expended.
- **Trust fund (\$30.25 million).**—The Agreement provides for the United States to contribute \$30.25 million to the fund from 2013 through 2023. The government

¹³The compact provided for direct assistance to Palau only through 2009. Since then, Interior’s 2010 annual budget provided \$13.25 million for direct assistance to Palau and other agencies provided additional funds. For 2011, Interior provides \$13 million in direct assistance. For 2012, Interior’s Budget Justification proposes \$29.25 million in direct assistance, while the Agreement provides for \$27.75 million.

¹⁴The pending implementing legislation would also extend the authority, and authorize appropriations, for the provision of compact federal services in Palau. However, the proposed legislation does not appropriate funds for compact federal services.

¹⁵The Agreement requires that Palau undertake economic, legislative, financial, and management reforms giving due consideration to those identified by the IMF; the Asian Development Bank; and other creditable institutions, organizations, or professional firms.

¹⁶The compact requires that the United States and Palau consult annually regarding Palau’s economic activities and progress in the previous year, as described in a report that Palau must submit each year. Our 2008 report noted that Palau had met reporting conditions associated with direct assistance but that, contrary to compact requirements, the bilateral economic consultations had not occurred on an annual basis; and had been informal and resulted in no written records. See GAO-08-732.

¹⁷In 2008, we reported that Palau and U.S. officials had expressed concerns about Palau’s ability to maintain the Compact Road in a condition that would allow for the desired economic development. We also reported that Palau made initial efforts to maintain the road, but at levels that would cause the road to deteriorate over time and would not provide the economic development benefits envisioned for the people of Palau. See GAO-08-732.

¹⁸Under the compact, Palau owes the United States a total of \$3 million. Under the Agreement, Palau would deposit \$3 million in the infrastructure maintenance fund but not expend it. Any future income derived from the \$3 million must be used exclusively for the maintenance of the Compact Road.

of Palau will reduce its previously scheduled withdrawals from the fund by \$89 million.¹⁹ From 2024 through 2044, Palau can withdraw up to \$15 million annually, as originally scheduled. Moneys from the trust fund account cannot be spent on state block grants, operations of the office of the President of Palau, the Olibil Era Kelulau (Palau National Congress), or the Palau Judiciary. Palau must use \$15 million of the combined total of the trust fund disbursements and direct economic assistance exclusively for education, health, and the administration of justice and public safety. Annual U.S. assistance to Palau under the Agreement would decline from roughly \$28 million in 2011 to \$2 million in 2024. Figure 2* details the timeline and composition of assistance outlined in the Agreement.

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

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

- Federal services.—The Agreement would amend the compact’s subsidiary agreements regarding federal services. The proposed legislation implementing the Agreement would authorize annual appropriations for weather and aviation services. The proposed legislation would also authorize appropriations of \$1.5 million to Interior for 2011 through 2024, to subsidize postal services to Palau, the Republic of the Marshall Islands, and the Federated States of Micronesia.
- Federal discretionary programs.—The Agreement would extend the framework for U.S. agencies to provide discretionary federal programs to Palau and the implementation of these programs is contingent on annual appropriations to those agencies. The implementing legislation would extend the eligibility of the people, government, and institutions of Palau for certain discretionary programs, including special education and Pell grants.

AGREEMENT PROVISIONS WOULD SIGNIFICANTLY IMPROVE PROSPECTS FOR PALAU TRUST FUND

The addition of \$30.25 million in U.S. contributions and the delay of \$89 million in Palau withdrawals through 2023, as provided by the Agreement, would improve the fund’s prospects for sustaining scheduled payments through 2044. At the end of 2010, the fund had a balance of nearly \$160 million. Under the Agreement, the trust fund would need a 4.9 percent annual return to yield the proposed withdrawals from 2011 through 2044. This rate is well below the 8.2 percent return it earned from its inception to December 31, 2010.²⁰ Figure 3* shows projected trust fund balances in 2011 through 2044 under the Agreement, with varying rates of return.

The additional contributions and reduced withdrawals scheduled in the Agreement would also make the trust fund a more reliable source of revenue under conditions of market volatility. With these changes, the trust fund would have an approximately 90 percent probability of sustaining payments through 2044. In comparison, the fund had a 25 percent probability, at the end of 2010, of sustaining the \$15 million annual withdrawals scheduled under the compact through 2044.²¹

Figure 4 compares the trust fund’s probability of sustaining the proposed withdrawals under the terms outlined in the Agreement with its probability of sustaining the withdrawals scheduled under the compact.

ESTIMATES PREPARED FOR PALAU PROJECT DECLINING RELIANCE ON U.S. ASSISTANCE UNDER THE AGREEMENT

Estimates prepared for the government of Palau project that Palau’s reliance on U.S. assistance provided under the Agreement will decline, while its reliance on trust fund withdrawals and domestic revenue will increase.²² These estimates show U.S. assistance, as provided under the Agreement, declining from 28 percent of gov-

¹⁹ Under the Agreement, Palau would withdraw \$5 million annually through 2013 and gradually increase its maximum withdrawal from \$5.25 million in 2014 to \$13 million in 2023.

* Figure 2 has been retained in committee files.

²⁰ All rates of return on the trust fund are net of fees and commissions unless otherwise noted.

* Figure 3 has been retained in committee files.

²¹ The probability of the fund’s sustaining \$15 million annual payments through 2044 under the original compact terms has diminished since 2008, when we determined that the probability was 46 percent. See GAO-08-732.

²² The government of Palau provided fiscal projections through 2024 to the Senate Committee on Energy and Natural Resources in January 2011. The estimates were prepared by an independent economist retained by the government of Palau.

ernment revenue in 2011 to under 2 percent of government revenue in 2024. The estimates also show Palau's trust fund withdrawals growing from 5 percent of government revenue in 2011 to 12 percent in 2024. In addition, the estimates indicate that Palau's domestic revenue will rise from 40 percent of all government revenues in 2011 to 59 percent in 2024.²³ Finally, the estimates prepared for Palau project a relatively steady reliance on U.S. discretionary federal programs, ranging from 12 percent of all government revenues in 2011 to 14 percent in 2024. The estimates assume that discretionary federal programs will grow at the rate of inflation; however, discretionary programs are subject to annual appropriations and may not increase over time.

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

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

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

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

²³In March 2011, the IMF reported that Palau government revenues as a percentage of GDP are below average for island nations in the Pacific. The report cited opportunities for increased tax revenues by eliminating the gross revenue tax, replacing it with a corporate income tax, introducing a Value Added Tax, and increasing the level of taxation on high earners. The IMF also noted that Palau could reform its civil service to decrease wage expenditures. See IMF, Staff Visit to Republic of Palau—Concluding Statement of the IMF Mission (Mar. 8, 2011)

* Figures 5 and 6 have been retained in committee files.

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

Table 2 illustrates the assistance provided to Palau under the compact from 1995 through 2009. Table 3 illustrates the assistance proposed in the Agreement from 2011 through 2024.

Table 2: Past Compact Assistance Provided to Palau

Dollars in millions

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

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

Table 3: Proposed Assistance in the Agreement

Dollars in millions

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

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

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

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

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

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

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

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

Note: HHS is the Department of Health and Human Services.

The CHAIRMAN. Thank you.
[The prepared closing statement of Senator Bingaman follows:]

PREPARED CLOSING STATEMENT OF HON. JEFF BINGAMAN, U.S. SENATOR
FROM NEW MEXICO

I thank all of the witnesses for their testimony, but I have to say the offsets proposed today are not new, and I don't believe that they have the support needed to move this bill forward. I urge each Administration witness to take the message back to OMB—Congress will need other options to move forward and they should look across the entire budget.

The CHAIRMAN. Let me start with a few questions.

Ms. Reed, let me ask you first. On page 16 of the bill that we've introduced, the agreement provides that, quote, "This agreement may be amended at any time by the mutual written consent of the Government of the United States and the Government of Palau."

As you interpret that, would such amendment to the agreement require any action by Congress or any consent by the Congress?

Ms. REED. The response—it would depend upon the circumstances, but once the agreement is in force, whether any congressional action would be required if there's an amendment or change would depend upon the nature of the change or amendment.

Certainly, financial, if we're talking about the amount, any change there, congressional action would be required.

So, I would have to say that I'm nuancing the answer, because it would depend on what type of change we were talking about.

The CHAIRMAN. Very good.

Mr. Babauta, let me ask you about the various options that have been put forward for offsets. You mentioned those.

Senator Murkowski and I wrote to you in April, April 5, I believe, indicating that, in our view, these were not politically viable options, these offsets.

Can you tell us whether the unacceptability of these options is something understood in the Office of Management and Budget?

Mr. BABAUTA. Mr. Chairman, we're aware of the letter that you and Senator Murkowski sent to the Office of Management and Budget. It's something that continues to be worked internally within the Administration.

We have heard the message, though, that was contained in the letter and will, of course, continue to work with the committee as this legislation—

The CHAIRMAN. So there is an ongoing effort to see if there are other options that could be looked to?

Mr. BABAUTA. I would say that we're aware of the concerns that have been expressed by the chairman and the ranking member, as well as the staff. It's something that we continue to work on internally across Federal agencies but also within OMB.

The CHAIRMAN. Thank you very much.

Mr. Scher, let me ask you, you say on page 2 of your testimony, quote, "We must take note of critical security developments in the Pacific that require the department's sustained presence and engagement." Are you able to elaborate at all on what you're referring to there?

Mr. SCHER. A little bit. I think there's certainly 2 important security developments that I, in this session, would be happy to talk to you about.

One is the increasing engagement of other global players, and certainly China among those, and the growing transnational crime that we're seeing throughout there.

In particular, we are seeing increased Chinese military activity that is going out further than what they would refer to as the first island chain and into the second island chain.

In the past, we've actually seen there have been more port calls by Chinese warships in the islands, including Fiji, Papua New Guinea, and Tonga. We've even noticed some developments in China-Fiji defense relations.

Obviously, we have no concern about countries having good and cooperative relations with China on the defense side. We, certainly, seek the same thing. But it's a change in the security environment that we are, obviously, watching.

Second, many of the island states really lack sort of a sufficient legal structure in law enforcement capability to manage a lot of their own security matters. This is especially notable in terms of resources and fisheries. So we've seen an uptick in this and really think that this is a significant change in terms of the environment that require us to have closer relations with these countries to help them and also to help our interests in defeating transnational crime.

The CHAIRMAN. Thank you.

Mr. Gootnick, let me ask you, I believe Ms. Reed referred to what she perceived as the improvements that had occurred in Palau in the 12 years since she was last there.

Are you in a position to give us any kind of a summary of the trends in Palau's economic development under the first term of the compact assistance? Has the situation improved? Has their deficit debt situation improved? What has growth rate been?

Mr. GOOTNICK. Over the term of the compact, there has been actually remarkable growth and development in Palau. There was a significant setback in 2008 with the global recession, with rising gas prices and food prices, and inflation, but over the longer term, as has been alluded to, annual growth rate in the range of 2 percent.

I can tell you that per capita income since 1994 has roughly doubled. Per capita income in Palau is now over \$10,000 annually.

Tourist arrivals, which is a key indicator, of course, of the vibrancy of the key private sector activity, have doubled to nearly 80,000 annually.

So with some challenges, Palau has made steady growth. They do run small operating deficits and have through most of the term of the compact.

The CHAIRMAN. Thank you very much.

Senator Murkowski.

Senator MURKOWSKI. Thank you, Mr. Chairman.

Thank you all for your testimony.

Mr. Babauta, I think we heard very clearly from all 4 at the table here today how important this relationship is between the United States and Palau, how important, essentially, the compact is. So I join the chairman in encouraging you within the department to look critically at how we find the appropriate offset, and, as we mentioned, one that is politically viable, politically achievable.

Whether it is from a national security perspective, whether it is just from the perspective of keeping the commitment that we have made to the people of Palau, we need to make sure that we're able to honor this. As both of us have made very clear in our opening statements, this can't happen until we find that offset. So I hope that everyone is quite committed to digging through and figuring out how we resolve the offset.

Let me ask both you and Mr. Gootnick something, because both of you have discussed in your testimony a great deal about the trust fund. But as I understand it, we've got 4 key factors in Palau's continued economic growth, and the viability of the trust fund seems to be the most important from the U.S. perspective.

But if the other 3 factors, if fiscal reform, foreign investment, and continued access to the U.S. Federal programs are successful, how necessary or how important will the trust fund then be? If we continue to do well and be successful with things like the fiscal reforms?

Mr. BABAUTA. Thank you very much, Senator Murkowski. I can assure you that the department's long relationship with Palau is fully appreciated.

What my colleagues from the Department of Defense and Department of State have mentioned is, you know, Palau's important role in the Pacific for strategic purposes for our country is fully appreciated at the department.

Again, we are committed to working with the committee as we move forward with the legislation on finding an offset that is acceptable.

With respect to the question about how important the trust fund will be if there is success in the other 4 areas, I would think that it continues to be a very important element for the Government of Palau to know that at a time certain into the future, even with the success of these 4 other things—the fiscal reform and foreign investment and being able to reduce expenditures and get rid of old debt—that knowing that there is a continued reliable source of funding, that a source from the trust fund is going to be made available to them, at the very least would be important knowledge for the leaders of Palau to know that it's there as a term of the compact financial assistance ends.

Senator MURKOWSKI. Mr. Gootnick, any comments on that?

Mr. GOOTNICK. As the agreement is structured, the trust fund appears to be the key mechanism to offset the decline in direct economic assistance that will occur. So direct budgetary support will go down. The withdrawals from the trust fund will make up that difference.

There's also, again, the presumption that domestic revenues will increase steadily and more steeply than they have in the past. So to the extent that that does not fully materialize—domestic taxation, essentially, does not fully grow in the way that's projected—the trust fund will be a key mechanism to offset and diminish any national deficit that would exist in that setting.

Senator MURKOWSKI. OK, I appreciate that.

Ms. Reed, all of the panel here have mentioned the importance of the relationship between Palau and the United States. I think it is important to recognize that others are watching what direction the United States will take with this agreement.

Secretary Clinton has been very active, very engaged, in the Pacific and working to enhance and build on those relationships that we have in the Asia-Pacific region.

What impact would congressional inaction on this agreement have on the Asia-Pacific view of the United States? If we don't act on this, how are we viewed within the region?

Ms. REED. It's very interesting when you mention that so many others are watching. I think it's important to note that not only are the other so-called compact countries—the Federated States of Micronesia and then the Republic of the Marshall Islands—watching.

I just left Papua New Guinea. We were in Port Moresby. I was part of a delegation for the Global Women's Initiative. There were Pacific women leaders from all of the small island states there, and it's true that they are watching the U.S. commitment.

This has to do a lot with a perceived lack of attention over the past 20 years to many of the small island states, and perhaps, in part, because of an excellent response on the part of the U.S. during a number of disasters, tsunamis that have occurred recently and cyclones. So, I think the impact is enormous.

It's probably larger than life. I say that having lived on an island. A lot of actions are magnified simply because of the distance, geographically. You fly 29 hours to get to many of these locations.

So the perception becomes a large part of the reality. I think the steps that we are taking today will reverberate.

Senator MURKOWSKI. I appreciate that.

Let me ask one final question here, if I may. This is to you, Mr. Scher.

In your testimony, you touched briefly on the difficulty that Palau has in providing maritime surveillance and the enforcement issues. More generally, you spoke about the lack of a military presence, lack of law enforcement.

But in Alaska, our Coast Guard is utilizing UAVs for aerial surveillance of our maritime boundaries. Is this something that is being considered or being utilized in the Pacific areas there?

Mr. SCHER. We work very closely with the department, DHS, and the Coast Guard, in terms of how to figure out how best to support, in all of the Pacific Islands, the security concerns, since so many of them do overlap with law enforcement issues.

I honestly do not know in the particular case of UAVs or surveillance. Obviously, maritime domain awareness is a big part of maritime security and how we approach that issue throughout the region.

DHS, in terms of Coast Guard, especially, has a ship rider program to help Pacific Island countries conduct fisheries patrol.

That is all wrapped up—we tend to view security issues, as I said, holistically within the U.S. Government as we approach the South Pacific Islands because they overlap.

But I don't know the specifics of what elements the Coast Guard might use for that. But it wouldn't surprise me, since they are highly engaged in this area.

Senator MURKOWSKI. Can you give me any more information about what type of transnational crime we're beginning to see in the region?

Mr. SCHER. Throughout the region, overall, we have seen this transnational crime in different parts and different cases—and Ms. Reed knows this very well, as well. For a while there, we, actually, were seeing that lax legislation and regulation in terms of money laundering made this a very fruitful area for that. In fact, terrorists, we saw there was some indication that terrorists were looking at easy access and transit through.

So I think money laundering and terrorism for a while, when we were very focused on terrorism, that they looked around to see where were the easy targets, if you will. So that.

Obviously, illegal fishing is a big piece of this as well.

Frankie, do you have others?

Ms. REED. Transshipment, narcotics, trafficking. Islands are an easy place in which to hide and often very porous. Lack of funding for the security apparatus, and poor communications also.

Senator MURKOWSKI. If you don't have law enforcement there, it's pretty easy to move things through, regardless of what it is. It's an important issue for us.

Mr. Chairman, I have no further questions, but I thank all those who have testified this morning.

The CHAIRMAN. Thank you all very much. It's been very useful testimony.

I'm informed that we do have a group of Close Up students here who are from Palau, and we welcome all of them. Why don't you all stand up so we can give you some applause?

Thank you for being here.

[Applause.]

The CHAIRMAN. All right, that will conclude our hearing, and we will try to move this legislation forward.

Thank you.

[Whereupon, at 11:47 a.m., the hearing was adjourned.]

APPENDIXES

APPENDIX I

Responses to Additional Questions

RESPONSES OF HON. H.E. JOHNSON TORIBIONG TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. On page 4, you say that Palau has stood with the U.S. on key U.N. votes “despite pressure and entreaties of other nations.”

Could you elaborate on what other nations threaten, or offer, Palau to gain influence, and what policies they are seeking to change?

Answer. Yes, but first I will elaborate on just how close Palau is to the U.S. in the U.N. According to the latest U.S. Department of State report on Voting Practices in the United Nations 2010 published March 31st, Palau’s 99.1% overall voting coincidence with the U.S. is the highest among U.N. members, ahead of second-place Israel and significantly higher than the regional percentage of 89.3%. Palau’s 96.5% voting coincidence with the U.S. on contested votes is also the highest among U.N. members, and substantially higher than the regional percentage of 58.2%.

A prime example of efforts of other nations attempts to influence Palau, in this instance, to get Palau to change its votes in the U.N., involves the United Arab Emirates and the Arab League. In February of last year, the Foreign Minister of the U.A.E. visited Palau as well as other small Pacific island states. He announced the availability of \$50 million annually from the U.A.E.

The minister’s visit was followed up with an invitation for me—and other leaders of the small Pacific island states—to meet with the Arab League in Abu Dhabi in June 2010. At the conclusion of that meeting, Palau was asked to sign a final communiqué specifically supporting the Arab Peace Initiative. Palau refused and only agreed to give due consideration to the proposal.

There were other meetings initiated by Arab country governments during the 2010 session of the U.N. General Assembly. Last December, the U.A.E.’s foreign minister again lobbied Palau and other small Pacific island states to change our voting stance at the U.N. towards Israel. Palau, however, did not change its position regarding Israel or any other issue, and all of our efforts to obtain some of the \$50 million a year have been rejected. Palau understands what it would have to do to receive the assistance, but has chosen to remain true to our principles and friends.

This is not the only instance of what I believe to be an effort to influence Palau. Palau has consistently voted with the U.S. in the U.N. on issues relating to Cuba, and as a result has forgone receiving assistance offered by Cuba to Palau. Cuba has several programs to help small Pacific island states, including medical scholarships and cultural programs, and has repeatedly offered to make those programs available to Palau. The Cuban Ambassador to the Philippines was in Palau just last week to renew the offer of assistance.

Question 2. On page 5, you say that China “clearly wants more influence in Palau.”

Would you elaborate on what areas of policy China is interested in, and what offers, or pressure, they have used?

Answer. I cannot say what China’s primary interest in Palau might be or even whether there is a specific primary interest. One particularly noteworthy area of China’s interest, however, concerns a deep-water port. Within the first few months of my Administration, we received word that a Chinese institution was prepared to finance and construct a deep-water port on the west coast of Babeldaob, the big island of Palau, at a cost exceeding \$100 million. It is my understanding that the funds are still potentially available.

Improved port facilities are vital to Palau's development, but the indication was that the Chinese interest in building these important facilities was—not surprisingly—primarily for Chinese benefit.

The Chinese have pressured Palau on our decision to agree to the request of the U.S. to provide sanctuary to several Chinese Uighur Muslims whom the U.S., under both the Bush and Obama Administrations, determined had been wrongfully detained at Guantanamo. Palau agreed to do this even without hesitation when no other nation would even consider providing such refuge. In three separate meetings with Palau's U.N. Mission, the Government of China stated that it considered this "a very serious issue for Chinese-Palauan relations," that the issue was "not a legal issue but a political one", and, ominously, that China had "a long memory".

Since the Chinese Uighur Muslims arrived in Palau a previously expected increase in Chinese tourist arrivals to Palau has never materialized. Moreover, the construction of the only Chinese investment in Palau, a one hundred room five star hotel, was halted shortly after Palau agreed to resettle the Chinese Uighur Muslims. Prior to that time the construction of the hotel was proceeding apace and had reached the finishing stage. No activity has taken place at the construction site for well over a year now. I am advised that the Chinese investor, who by that time had invested several million dollars into the project, can no longer get money out of China for the project.

Question 3. On page 5, you say that "if there is no agreement, or an end to essential assistance, many in Palau would insist on an end to the United States military rights under the Compact."

The first term of Compact assistance ended with fiscal year 2009 and assistance has been continued on a stop-gap basis through this fiscal year.

What do you think the impact will be on the political debate in Palau if the U.S. continues to provide assistance at FY09 levels on an annual, discretionary basis?

Answer. Thank you for asking this question. There would be several unfortunate impacts upon the debate in Palau.

For one, for Palau to have to seek financial assistance on a year-to-year basis, would be to promote more dependence on the U.S. The Compact Review Agreement provides a road map towards greater economic self-sufficiency through required budgetary and infrastructure maintenance reforms, capital investments in essential infrastructure, fiscal consolidation, and overcoming deficiencies in the capitalization of the Compact Trust Fund. I am concerned that to go to year-to-year uncertainty will deprive Palau of the Agreement's tools for greater self-sufficiency and lead to a focus on obtaining assistance on an annual basis.

Annual appropriations on a simple basis of continuing Fiscal Year 2009 funding is, for example, already likely to cause Palau to lose the opportunity to secure at a highly discounted cost an underwater fiber optic cable to provide broadband Internet, has deprived Palau of funding for imperative infrastructure maintenance, has exacerbated Palau's debt problems, and has delayed the institution of reforms that would come with the terms of the Agreement. Over the long term, financial assistance on a year-to-year basis would leave the Compact Trust Fund in a precarious position.

Incidentally, continuing assistance to Palau on an annual basis at the FY09 level—with the full faith and credit commitment of the U.S. and assurances similar to those provided by the U.S. in its compacts with the other two freely associated states—along with some additional CIP funding, was an option explored by Palau in the Review. However, the U.S. team firmly rejected this option and, instead, insisted on financial assistance on a declining basis that would 'zero-out' before the next required joint review of Palau's assistance needs in FY24.

More fundamentally, although discretionary assistance, even at the FY09 level, would be better than no assistance at all, it would be considered a poor substitute for the package of the Agreement, which was carefully and painstakingly negotiated by my Administration in full view of the Palauan public. Given all that has passed since the Review was begun in May 2009, assistance on an annual, discretionary basis would negatively impact the political debate in Palau respecting the integrity of the association between our states.

Given the existing political debate within the U.S. regarding its own budget and expenditures and the possibility that such debate may extend well into the future, the "discretionary" aspects of annual assistance to Palau at the same level as FY09 will not be well received here in Palau. Since the approximate \$13.125 million direct funding that Palau received in FY09 still constitutes about 24% of our annual budget, even one discretionary decision by the U.S. not to provide such funding to Palau would have catastrophic effect on the ability of the Palau Government to provide essential public services. This would further undermine the confidence of Palauans in the association, bolstering the confidence of those who already want to explore

other international relationships to obtain financial assistance and encouraging more to agree with them. Assistance on a discretionary basis would indicate to those who are already skeptical of the Compact that the U.S. does not have the same long-term commitment to Palau that Palau has to the U.S. The failure of the U.S. to ratify the Agreement, regardless of the reason, would be very difficult for me to explain or justify.

Regarding U.S. defense rights, if there is no agreement, or if there is an end to essential assistance, the consensus in Palau would be that Palau should not continue to let the U.S. have strategic control of our lands and waters. The U.S. Congress not approving the Agreement or not making an equivalent commitment would seriously undermine confidence in the relationship and lead to people suggesting that Palau should move in another direction. The framers of the Compact understood that it is critical that there be a reliable long-term relationship for the confidence of both Palau and the United States.

We very much appreciate the financial assistance that has been extended while the Compact Review Agreement has been negotiated and is being considered by the U.S. Congress. My concern is the viability of the Compact will be called into serious question were the U.S. to appear to not to honor the promise of the association.

RESPONSE OF ROBERT SCHER TO QUESTION FROM SENATOR BINGAMAN

IMPACT ON U.S. SECURITY

Question 1. On page 1, you state that passage of S. 343 “is vital to allowing the Department to continue to benefit from the security arrangement afforded by the Compact.” What would be the impact on U.S. security benefits under the Compact if this agreement is not approved this fiscal year?

Answer. Failure to pass S. 343 could result in sending a negative signal to the region, contrary to Secretary Gates’ pointed remarks about the U.S.’ enduring and strategic interest and presence in the region. The Compact with Palau grants the U.S. defense rights and exclusive access, an advantage which allows us to prevent the establishment of a military presence of a third country on Palau. The fact that only the United States can maintain a military presence in this strategic area so close to Guam is a major security interest. Failure to pass S. 343 this year could threaten DoD’s current military posture on Guam and the Commonwealth of the Northern Marianas Islands, as well as critical DoD military, space, and disaster relief operations in the Western Pacific.

RESPONSES OF DAVID GOOTNICK TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. Would you please summarize the trends in Palau’s economic development under the first term of Compact assistance—for example, their deficit/debt situation and GDP and per capita growth?

Answer. The role of government expenditures in the Palau economy has fallen by about a third since 1994, from about 61 percent to about 41 percent of the gross domestic product (GDP) in 2010.¹ According to the International Monetary Fund (IMF), Palau’s GDP increased from \$82.45 million in 1994, when the Compact entered into force, to \$215.2 million in 2010. According to our analysis of IMF data, per capita income in Palau more than doubled during that period, from roughly \$4,900 in 1994 to \$10,500 in 2010.

Question 2. On page 8 of the bill, the Agreement provides that “Palau shall undertake economic, legislative, financial, and management reforms. . . such as those described in (IMF and ADB reports).” Would you summarize for us some of the key reforms recommended by the IMF and ADB?

Answer. The reports cited in S.343 recommend that Palau undertake various reforms, focused largely on reducing the role of government in the economy and on reforming taxes. In 2007, the Asian Development Bank (ADB) made recommendations in seven broad categories:

1. realigning and streamlining the role of government in the economy by, among other things, limiting government payroll and exploring public-private partnerships for infrastructure projects;
2. undertaking tax reforms, including replacing the gross receipts tax with a simplified form of value-added tax and transforming the country into a lowcost place for doing business;

¹Unless otherwise noted, years cited are fiscal years (Oct. 1-Sept. 30).

3. overhauling foreign investment regulations, so that the same rules apply to local and foreign businesses, among other things;
4. reviewing and reforming the legal system for commercial activities;
5. reforming the financial market, including reforming the collateral framework to increase lending and refraining from attempts to weaken creditors' rights;
6. undertaking land reform; and
7. articulating and implementing a policy to encourage high-end tourism.

In 2008, the IMF made several recommendations based on fiscal consolidation and tax reform. Regarding fiscal consolidation, the IMF reported that the Palau government would need to reduce its expenditures by about 15 percentage points of its GDP in order to achieve sustainability. The IMF also stated that although a piecemeal approach aimed mostly at revenue generation involves risks, it may be the only viable option in the current economic environment. Regarding tax reform, the IMF recommended short-term actions including abolishing exemptions from import taxes (except where prohibited by treaty); expanding the tax base to include in-kind benefits, which are a large part of employee compensation; increasing the hotel tax; increasing the fish export tax; unifying the foreign labor fee; and increasing the water fee. For the medium term, the IMF recommended replacing the gross revenue tax with a net profit tax and considering a value-added tax.

RESPONSE OF DAVID GOOTNICK TO QUESTION FROM SENATOR MURKOWSKI

Question 1. The GAO report notes that under the proposed Agreement, between 2011 and 2024, 50 percent of U.S. assistance will come from discretionary federal programs. Given that the level of direct spending in the proposed Agreement is less than half of the previous fifteen years', could you clarify how the amount of discretionary spending for the next fourteen years compares to prior discretionary funding?

Answer. Projections prepared for the Palau government project that from 2011 through 2024, discretionary federal programs will account for approximately \$211.7 million dollars—on average, about \$15.12 million annually—representing roughly 50 percent of an estimated \$427.45 million in total U.S. assistance to Palau during that time. These projections assume a steady level of funding from discretionary federal programs, rising at roughly the rate of inflation. We estimated that discretionary federal programs in 1995 through 2009 amounted to approximately \$266.7 million dollars—on average, about \$17.78 million annually—but accounted for a smaller proportion of assistance to Palau: 31 percent of the \$852 million in U.S. assistance during that period.²

RESPONSES OF FRANKIE REED TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. On page 16 of the bill, the Agreement provides that, "This Agreement may be amended at any time by the mutual written consent of the Government of the United States and the Government of Palau."

Would such an amendment require any congressional action or consent?

Answer. We would seek action by Congress on those amendments that require additional implementing authority.

Question 2. On page 9 of the bill, the Agreement provides for the establishment of an Advisory Group to make recommendations on economic, financial, and management reforms. On page 11, the Agreement authorizes the Government of the United States to delay the payment of economic assistance to Palau "if the government of the United States determines. . . Palau has not made significant progress in implementing meaningful reforms."

In what form and manner will the Advisory Group present its recommendations for reform? More specifically, how will the Advisory Group formally communicate its recommendations and performance indicators so that both Palau and U.S. governments clearly understand what the performance expectations are?

Answer. The Advisory Group (AG) will report to the two governments on the economic, financial and management reforms it recommends, and the schedule it recommends for their implementation. It will also report annually on the progress the

² Our estimates for 1995 through 2009 included federal funds reported in the single audits for the Palau national government, Palau Community Action Agency, and the Palau Community College; and estimates of the Department of Defense's Civic Action Teams. The 2011 through 2024 projections prepared for the Palau government use data from a 2009 financial statement and assume growth equivalent to inflation.

Government of Palau is making in implementing the reforms recommended by the AG as well as on any other reforms the Government of Palau has taken. The agreement does not specify the form the AG's reports are to take, and we anticipate that the Advisory Group will determine how best to report to both governments to achieve the desired results. The agreement does, however, provide examples of the types of action that would be considered significant progress in a fiscal year: meaningful improvements in fiscal management, including the elimination and prevention of operating deficits; a meaningful reduction in the national operating budget from the previous fiscal year; a meaningful reduction in the number of government employees from the level the previous fiscal year; a meaningful reduction in the annual amount of the national operating budget dedicated to government salaries from the previous fiscal year; demonstrable reduction of government subsidization of utilities, and meaningful tax reform.

Question 3. On page 3 of your statement you say that "China, the Arab States, Cuba and others are actively courting Palau. . ." Could you elaborate on their objectives and tactics?

Answer. We are supportive of the efforts of other countries to be engaged with the Pacific Islands as long as the goal of their involvement is in support of increasing good governance, transparency, and the prosperity of the people of the region. We seek clarity from those nations that engage in an opaque fashion with Pacific Island nations.

China, the Arab League states, and Cuba have expanded their influence in the region. These countries are actively courting Pacific Island states, including Palau, and increasing their economic, diplomatic, and military engagement with the island states. Palau's President Johnson Toribiong mentioned China's growing influence in Palau when he testified, stating that "already some Palauans are enticed by the new economic power of China, which clearly wants more influence in Palau. We all want greater economic interaction with China." The Arab League states continue to lobby Pacific Island nations to vote against the United States in the United Nations on key issues. Cuba has actively increased its engagement with Palau by offering medical assistance. Strong, constructive relations with Pacific Island nations will help advance our national interests by maintaining our partnerships and our military relationships in a strategic zone that spans the Pacific.

RESPONSES OF ANTHONY M. BABAUTA TO QUESTIONS FROM SENATOR BINGAMAN

Question 1a. The Administration witnesses have made a compelling case for approval of this legislation, but I'm concerned that with respect to an offset, you have reiterated three options which Senator Murkowski and I wrote in our April 5, 2011 letter that, "none of these offsets are politically viable."

Can you tell us whether the unacceptability of these options is clear to OMB?

Answer. The Department of the Interior is in receipt of your letters relating to the off sets for the Palau Compact legislative proposal. While the Department defers to the Office of Management and Budget for its specific views on this issue, as I noted in my written statement the legislative proposals included in the 2012 Budget were revenue generators that would be scored for savings by the Congressional Budget Office. These proposals include, for example, the repeal of net receipts sharing, which takes into account the costs of managing federal oil and gas leases before revenues are shared with the states and that by itself could provide more than enough savings to offset the costs of the Palau Compact. This proposal, in particular, has been enacted for four years through annual appropriations language and would be made permanent by this proposal.

Question 1b. Can you tell us whether OMB looked outside of the Interior Department budget for possible offsets?

Answer. The Department of the Interior is not aware of the extent to which efforts were made to secure offsets elsewhere.

Question 2. On page 6 of the bill, the Agreement provides that the United States "shall provide" Direct Economic Assistance to Palau. It appears that this assistance will not be provided through the normal federal grant process and, therefore, the accountability mechanisms that accompany federal grants will not apply.

What alternative mechanisms will be used to assure accountability in the management and use of this assistance?

Answer. There are a number of reporting and financial management requirements contained in the new agreement.

The agreement provides that Palau is to report on the status and use of all funds provided under the agreement and that the status and use will be discussed in the annual bilateral economic consultations. It provides that the financial information

relating to the funding shall conform to the standards of the Government Accounting Standards Board.

Palau will continue to adhere to the requirements of the Single Audit Act, which requires an independent annual audit of all government accounts. Palau has generally been a leader of the FAS and United States territories in its attention to audit requirements.

The audit standards and responsibilities are further elaborated on in Appendix D to the agreement.

The Government Accountability Office and the Inspector General of the Department of the Interior retain authority to audit Palau's programs and use of Compact funds.

Overall, the accountability for this agreement with Palau will be examined by the United States and Palau representatives at the annual, bilateral meetings during which Palau's implementation of required reforms will be reviewed.

The Direct Economic Assistance will be sufficiently safeguarded by the audit processes.

Question 3. On page 11 of the bill, the Agreement provides that the U.S. will provide a total of \$40 million for mutually agreed Infrastructure Projects.

Has there been tentative agreement on what these projects will be—can you tell us what Palau's priority needs are for the use of this construction assistance?

Answer. Palau has not yet selected infrastructure projects for consideration. When they are selected, however, the projects must be mutually agreed upon by both Palau and the United States, and scope and funding will be identified.

RESPONSE OF ANTHONY M. BABAUTA TO QUESTION FROM SENATOR MURKOWSKI

Question 1. The Compacts with the FSM and the Marshall Islands focused funding in six sectors, with education, health, and infrastructure getting the bulk of the money. The Compact with Palau, however, provides direct assistance for education, health, justice, and public safety. Has one approach been more effective than the other?

Answer. The proposed agreement, resulting from a review of the functioning of the Palau Compact over the first 15 years since it took effect, provides direct assistance in a manner similar to the provision of direct assistance under the first 15 years. Participants in the 15-year compact review did not believe that a significant change of approach was warranted. During the negotiation of the amended compacts of free association with the Republic of the Marshall Islands and the Federated States of Micronesia in 2003, participants believed that a new, six-sector approach was necessary to properly focus the deployment of financial assistance in these two countries on the most important needs and in particular on primary and preventive health care, primary education, and infrastructure related to these two sectors. The different approaches are appropriately tailored to the circumstances in each of the three countries.

APPENDIX II

Additional Material Submitted for the Record

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, DC, April 5, 2011.

Hon. HILLARY CLINTON,
Secretary of State, 2201 C Street NW, Washington, DC.

Hon. KEN SALAZAR,
Secretary of the Interior, 1849 C Street NW, Washington, DC.

DEAR MADAM AND MR. SECRETARY:

We are writing to follow-up on our letter of March 17, 2011 regarding legislation to amend Public Law 99-658 which approved the Compact of Free Association between the United States and the Republic of Palau. The proposed legislation has been introduced in the Senate as S. 343 and hearings are scheduled for April 14. The bill would approve the Agreement reached between the United States and Palau following the 15-year review that was conducted pursuant to Section 432 of the Compact and includes the appropriation of future financial assistance to Palau.

In our March 17 letter we asked the Administration to provide language for an amendment that would offset the bill's estimated 10-year budget impact of \$194 million. Last week, our staffs received a list* (attached) from the Interior Department that described several possible offsets. Unfortunately, none of these offsets is politically viable.

We share your commitment to enacting legislation to strengthen the close and long-standing ties between the U.S. and Palau and to secure our strategic interests in the Western Pacific. However, recognizing that strong objections would be raised against the recently-transmitted offsets, we urge you to consult with the Office and Management and Budget to identify other possible offsets within the Interior, State, and Defense department budgets, and work with us to select an offset that can gain the support needed to pass Congress.

We look forward to working with you to find a viable offset and move this bill forward as quickly as possible. Thank you again for your assistance.

Sincerely,

JEFF BINGAMAN,
Chairman.

LISA MURKOWSKI,
Ranking Member.

U.S. DEPARTMENT OF STATE,
LEGISLATIVE AFFAIRS,
Washington, DC, April 5, 2011.

DEAR MR. CHAIRMAN:

Thank you for your letter of March 17 regarding the proposed legislation to amend Public Law 99-658 regarding the Compact of Free Association with Palau. The Department of Defense and Department of Interior will respond separately to the specific points you raised regarding national security interests and funding for the Palau assistance agreement. We would like to comment on the broader significance of our relationship with Palau and the importance of the Compact agreement.

The agreement reached with the Government of Palau to provide financial assistance to Palau pursuant to Section 432 of the Compact confirms our commitment to

*List has been retained in committee files.

Palau and the special relationship between our countries from which the United States receives considerable benefit. Palau is a reliable voting ally of the United States in multilateral forums, particularly in the United Nations. Palauans contribute to international peacekeeping efforts and serve in U.S. military units in Afghanistan, Iraq and elsewhere. It takes great care of historical sites, visited by thousands of American visitors each year, that honor those who died protecting U.S. and global freedom during some of the bloodiest battles of World War II.

Of urgent significance, as you note, the agreement reinforces an important element of our Pacific strategy for defense of the U.S. homeland. Palau is strategically located near the western edge of a U.S. security zone that stretches from California to the Philippines. Coupled with our assets in Hawaii and U.S. territories, our influence in the Freely Associated States of Palau, the Marshall Islands, and Micronesia creates an invaluable security zone that spans the entire width of the Pacific. The U.S.-Palau Compact includes provisions that give the United States military exclusive rights and access to facilities in Palau. This right of strategic denial is vital to our national security.

Enacting and funding the proposed legislation will help confirm the United States' renewed commitment to the region and keep Palau allied with the United States at a time when other international actors are aggressively courting Pacific Island countries.

The Compact Review agreement cannot enter into force until Congress passes necessary legislation approving and funding it. The Department of the Interior, the agency responsible for implementing most provisions of the proposed legislation, is addressing funding issues. The Department of Interior has assured us that congressional budget requirements will be met.

Thank you again for sharing your views regarding the Palau Compact review and on this important bilateral relationship. We hope this information is useful to you. Please do not hesitate to contact us if we may be of further assistance.

Sincerely,

MIGUEL E. RODRIGUEZ,
Acting Assistant Secretary,

U.S. DEPARTMENT OF DEFENSE,
UNDER SECRETARY OF DEFENSE,
Washington, DC, April 5, 2011.

Hon. JEFF BINGAMAN,
Chairman, Committee on Energy and Natural Resources, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN:

I am writing to express the Department of Defense's support for S. 343, a bill to amend Title I of Public Law 99-658 regarding the Compact of Free Association between the Government of the United States of America and the Government of Palau. This bill would approve the results of the 15-year review of the Compact, including the Agreement Between the Government of the United States of America and the Government of the Republic of Palau, conducted pursuant to Section 432 of Public Law 99-658, and appropriate funds for the purposes of the amended Public Law 99-658 for fiscal years ending on, or before, September 30, 2024, to carry out the agreements resulting from that review.

Implementing the proposed legislation is vital to maintaining the bilateral security relationship between the United States and Palau. Since World War II, Palau has been a longstanding U.S. strategic partner. Under the 1994 Palau Compact, Palau provides the United States exclusive defense rights, and the United States has taken responsibility for the security and defense of Palau. This security arrangement provides an unyielding foundation that supports the position of the United States in an increasingly contested region and allows the United States to maintain critical access, influence, and strategic position in the Western Pacific region.

Critical security developments in the region require the United States' sustained presence and engagement, particularly given the range of U.S. strategic interests and equities in the Western Pacific, including the Reagan Ballistic Missile Defense Test Site at the U.S. Army Kwajalein Atoll facility, and areas that are important to DoD when called upon to support disaster relief operations throughout the region. Failure to follow through on our commitments to Palau, as reflected in the proposed legislation, would jeopardize our defense posture in the Western Pacific. This posture will become increasingly important as the United States seeks to protect its interests and fulfill its commitments to Asia-Pacific security.

Enactment of S. 343 would be an important expression of the U.S. commitment to Palau as an irreplaceable partner and a reinforcement of our shared interest in regional and international security.

The Office of Management and Budget advises that, from the standpoint of the Administration's program, there is no objection to the presentation of this letter for the consideration of the committee.

Thank you for your consideration.

Sincerely,

MICHÈLE A. FLOURNOY

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