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AUDIT OF
MAURITIUS ECONOMIC POLICY REFORM PROGRAM
NO. 642-0008

Audit Report No. 3-642-88-02
December 31, 1987

UNITED STATES OF AMERICA

AGENCY FOR INTERNATIONAL DEVELOPMENT
REGIONAL INSPECTOR GENERAL/AUDIT

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December 31, 1987

MEMORANDUM FOR DIRECTOR, Satish Shah (Acting)

FROM: RIG/A/Nairobi, Richard C. Thabet

SUBJECT: Audit of Mauritius Economic Policy Reform Program

This report presents the results of the Office of the Regional Inspector General for Audit, Nairobi audit of the Mauritius Economic Policy Reform Program No. 642-0008. Five copies of the audit report are enclosed for your action.

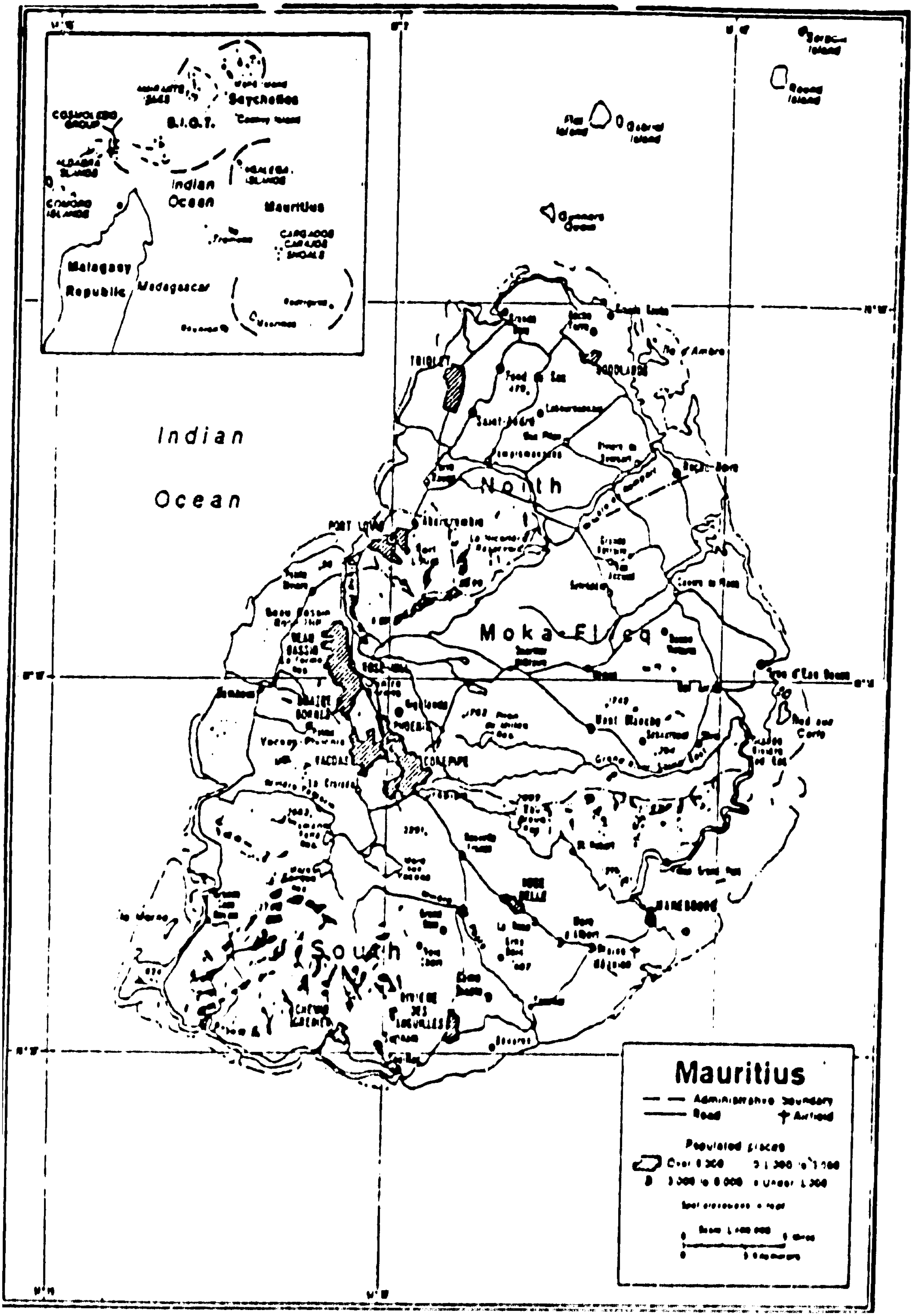
The draft audit report was submitted to you for comment and your comments are attached to the report. The report contains two recommendations. The first is considered closed and requires no further action. Please advise me within 30 days of any additional information relating to actions planned or taken to implement Recommendation No. 2.

I appreciate the cooperation and courtesy extended to my staff during the audit.

Background

Mauritius comprises a group of small islands in the Indian Ocean east of Madagascar (see map on next page). In 1979, the Government of Mauritius (GOM), with International Monetary Fund and World Bank support, initiated a stabilization and structural adjustment program. Under the program, the GOM implemented such economic policy reforms as reducing consumer subsidies, restraining wage increases and maintaining a liberal trade program.

Despite the implementation of significant reforms over the last few years, serious problems persisted. Unemployment remained high. Investment incentives and tariffs provided too much encouragement and protection to capital intensive, often inefficient, import substitution industries. To help solve these problems, the GOM needed to implement additional policy reforms as part of its on-going stabilization and structural adjustment program.



Seychelles
B.I.O.T.
Indian Ocean
Mauritius
Malagasy Republic
Madagascar
Indian Ocean
North
Moka-Flacq
South
PORT LOUIS
CUREPIPE
MAHEBOURG
Mauritius
Administrative boundary
Road
Airfield
Populated places

A.I.D. developed the Mauritius Economic Policy Reform Program to provide the GOM foreign exchange and budgetary support to ease the burden of further economic policy reforms. A one-year program was approved in September 1985. The completion date was later extended to December 31, 1987 to allow more time for tariff reform implementation.

A.I.D.'s Regional Economic Development Services Office, East and Southern African (REDSO/ESA), with the assistance of the American Embassy, Port Louis, Mauritius, had primary responsibility for administering the grant. The program was implemented by the Ministry of Finance in coordination with the Ministry of Economic Planning and Development.

The Program was financed by $5 million of Economic Support Funds which were granted to the GOM as cash transfers under the African Economic Policy Reform Program. The grant was released in two tranches of $2 million and $3 million, respectively. The first tranche was released in December 1985 and the second in October 1987. The GOM was not required to provide any counterpart funding under the program.

Audit Objectives and Scope

The Office of the Regional Inspector General for Audit, Nairobi (RIG/A/N) made a compliance audit of the Mauritius Economic Policy Reform Program. The audit objectives were to determine whether: (a) the GOM accurately reported on the use of grant funds, and (b) there were adequate criteria for releasing the second tranche of $3 million.

To accomplish these objectives, RIG/A/N obtained relevant documentation and interviewed appropriate officials of REDSO/ESA in Nairobi and the Ministry of Finance and American Embassy in Port Louis, Mauritius. The audit staff attempted to determine program fund uses by tracing through the Ministry of Finance's accounting system the local currency equivalent of $2 million. Internal controls were not reviewed except as related to the report's findings.

The audit was conducted between August and October 1987 and was made in accordance with generally accepted government auditing standards.

Results of Audit

The GOM did not adhere to the Program Grant Agreement's reporting requirements on the use of the local currency equivalent of program funds. In addition, there was a lack of specific criteria for releasing the second tranche of $3 million.

Notwithstanding these shortcomings, the program achieved its purpose of providing the GOM with foreign exchange and budgetary support to ease the burden of policy reforms. The GOM undertook substantial economic policy reforms including industrial incentive reforms and the lowering of tariffs.

The report recommends that REDSO/ESA prepare an action plan for monitoring the use of local currency generated from the second tranche of $3 million and establish policies which ensure that adequate criteria are established for release of funds under any future economic policy reform program.

The GOM did not Accurately Report on the Use of Program Funds

The Program Grant Agreement required the GOM to advise A.I.D. on the specific uses of the local currency equivalent of program funds. Nevertheless these funds were used for unidentified purposes in the fiscal year ending June 30, 1986. This occurred because REDSO/ESA did not adequately monitor the Program Grant Agreement's reporting requirements. This resulted in lack of accountability for the actual use of the local currency equivalent of $2 million.

Discussion - Article 4 of the Program Grant Agreement provided that: "The Grantee agrees to make available within thirty (30) days of the first disbursement under this agreement the Mauritius rupee equivalent of two million United States Dollars ($2,000,000) to fund development activities of the Grantee and to advise A.I.D. of the specific allocations of the Rupees to its development budget."

Although the GOM reported that the fiscal year 1986 funds were spent in fiscal year 1987, the funds were actually used for an unidentified purpose in fiscal year 1986 as shown by the following.

The first $2 million grant tranche was released to the GOM on December 17, 1985. The GOM notified A.I.D. on December 16, 1986, that the funds were used for tourism and water supply projects in fiscal year 1987.

However, the audit showed that all receipts, including the local currency equivalent of $2 million in program funds, were spent during fiscal year 1986.

In fact, fiscal year 1986 was a deficit year. Expenditures were financed by total government revenues and borrowings from the Bank of Mauritius.

The actual use of the funds was unidentifiable due to inadequate REDSO/ESA monitoring of the Program Grant Agreement's reporting requirements. REDSO/ESA did not request the GOM to provide a letter advising A.I.D. on the availability of local currency after 30 days had passed from the date of the first grant tranche release. When the GOM finally sent a letter to REDSO/ESA almost 12 months later, REDSO/ESA did not question the fact that the GOM indicated the funds were used in fiscal year 1987 even though the purpose of the program was to provide the GOM with immediate budgetary support to ease the burden of policy reforms. The fact that fiscal year 1986 was a deficit year should have been a clear signal to REDSO/ESA that the funds were both needed and spent during that year and that the GOM's reporting of program funds was inaccurate.

Inadequate monitoring of the Agreement's reporting requirements resulted in lack of accountability as to the actual use of the local currency equivalent of $2 million of the first grant tranche. Due to the fungibility of money, we could not determine the actual use of program funds. Although the audit did not disclose any improper use of funds (i.e. for non-development purposes) by the GOM, it was clear that more accountability was needed.

Recommendation No. 1

We recommend that the Director, Regional Economic Development Services Office, East and Southern Africa, prepare an action plan on how it intends to monitor the Government of Mauritius' compliance with the Mauritius Economic Policy Reform Program Grant Agreement's local currency reporting requirements for the second $3 million grant tranche.

In responding to the draft report, REDSO/ESA stated that it was likely that the local currency generated by the first $2 million tranche was used for tourism and water supply projects in the GOM's fiscal year 1986. Furthermore, they surmised that the GOM's letter of December 16, 1986 merely contained a typographical error regarding the timeframe in which funds were used.

Notwithstanding these unsupported possibilities REDSO/ESA earlier agreed that the monitoring of the local currency generated from the first grant tranche was inadequate. To insure this does not occur in the case of the second tranche, Program Implementation Letter (PIL) No. 3 was issued during the audit setting out how REDSO/ESA intended to monitor the use of local currency generated from the second grant tranche of $3 million. The PIL called for the local currency generated from the second tranche to be deposited within fourteen (14) days of release in a special account with the Commercial Bank of Mauritius. The PIL further stated that the rupees in the account would be used for mutually agreed upon development activities and required specific reporting procedures.

Although REDSO/ESA took sufficient action to address the recommendation during the audit, RIG/A/N formally reported on this finding to underscore both the Inspector General's and the Congress's concern over the possible misuse of cash transfers and the need to fully implement accounting and reporting requirements. Recommendation No. 1 was considered closed upon the issuance of this report.

A.I.D. Lacked Specific Criteria for Release of the Second Tranche of $3 Million - Release of the second grant tranche required that satisfactory economic policy reforms be made as measured against specific benchmarks. A PIL outlining benchmarks was submitted to the GOM but was never finalized. This occurred because the GOM experienced delays in its negotiations with the World Bank and the International Monetary Fund regarding the overall economic policy reform effort. As a result, REDSO/ESA lost an opportunity to share its economic expertise with the host government.

Discussion - The Program Grant Agreement's condition precedent for release of the second tranche of $3 million was very general: "the Grantee will furnish to A.I.D., in form and substance satisfactory to A.I.D., except as A.I.D. may otherwise agree in writing, evidence that progress has been made in tariff simplification and in the modification of the Grantee's industrial incentive program to increase the international competitiveness of local manufacturers." To help the GOM and A.I.D. evaluate program progress, the Program Assistance Approval Document (PAAD) stated that benchmarks would be set out as specific measures against which progress could be judged. The PAAD also provided that the benchmarks would not be included in the Grant Agreement but rather they would be set out in a PIL.

A.I.D. submitted draft PIL No. 2 to the GOM in December 1985 outlining proposed benchmarks. The GOM never responded to the draft PIL and therefore it was never finalized.

Benchmarks were not finalized because the GOM experienced delays in other related negotiations with the World Bank and the International Monetary Fund. The A.I.D. economic policy reform program in Mauritius was part of a much broader economic reform program. The GOM considered itself unable to enter into an agreement on specific targets with A.I.D. at the same time that it was involved in detailed negotiations with the World Bank and the International Monetary Fund regarding its overall economic policy reform effort.

Since the PIL was not finalized, REDSO/ESA had no criteria with which to measure the GOM's economic reform progress. Lack of specific benchmarks led REDSO/ESA to commission a special evaluation to determine whether sufficient policy reforms had been made to justify release of the second tranche.

The evaluation report concluded that the GOM made substantial progress in the areas of tariff reform and industrial incentives and recommended that A.I.D. release the second tranche. The evaluation found that the GOM had reduced the maximum tariff rate to 127 percent and was committed to reducing it to 107 percent in a year's time. In total, the GOM had reduced or eliminated tariffs on 260 items, which represented nearly 50 percent of the value of imports in 1986. Since this represented substantial tariff reform on the part of the GOM, REDSO/ESA had no choice but to release the second tranche.

Notwithstanding this substantial tariff reform, the lack of mutually agreed upon benchmarks prevented REDSO/ESA from sharing its economic expertise with the host government. The draft PIL called for both lowering the tariff ceiling and reducing disparities in effective tariff protection across the industrial sector. Reducing these disparities would provide positive incentives to export oriented manufacture and negative incentives to less efficient import substitution manufacture. Reductions in disparities, as envisioned in the PAAD and REDSO/ESA correspondence was to be achieved by lowering high tariffs and raising lower ones.

However, the evaluation report found that many lower tariffs were lowered or even eliminated, rather than raised. The report concluded that although effective rates of protection were declining for many products, disparities in effective rates of protection, which REDSO/ESA also wanted reduced, were actually increasing in some cases:

> However, a worrisome feature of this reform effort is its ad hoc nature. Tariffs are changed on particular items without assessing the impact this will have on all categories of items. Tariff rates still vary widely, and this variation may even be increasing. As a result, effective rates of protection continue to vary widely and are even increasing on some products.

In conclusion sufficient tariff reform had taken place to meet the general requirements of the second tranche's condition precedent. However, by not having mutually agreed upon benchmarks, which would have required mutual approval for modifications, REDSO/ESA lost an opportunity to share its economic expertise with the host government. Specifically, the GOM did not achieve REDSO/ESA's objective of reducing disparities in effective rates of protection. To prevent similar situations in the future, conditions precedent under economic policy reform programs should either contain specific benchmarks or require establishment of specific benchmarks as criteria for release of program funds.

Recommendation No. 2

We recommend that the Director, Regional Economic Development Services Office, East and Southern Africa establish policies which require locally approved economic policy reform program grant agreements to include conditions precedent that either contain specific benchmarks or require establishment of specific benchmarks as criteria for release of program funds.

REDSO/ESA disagreed with a statement in the draft report that benchmarks for the second tranche release were not finalized because their establishment was not included in the Program Grant Agreement as a condition precedent. As suggested, the report was modified to state that on-going negotiations with the World Bank and the International Monetary Fund delayed establishment of the benchmarks. However, RIG/A/N still maintained that benchmarks would have been finalized if their establishment had been included as a condition precedent (assuming the GOM and REDSO/ESA would have met the legal requirements of fulfilling conditions precedent prior to releasing program funds). Recommendation No. 2 was intended to insure that this does not occur on future economic policy reform programs. REDSO/ESA also took exception to a statement in the draft report that balance of payments problems could result from the possibility that the GOM went too far in lowering tariffs. RIG/A/N acknowledged that it was too early to predict whether balance of payments problems would actually materialize and therefore deleted this statement from the final report.

Finally, REDSO/ESA expressed agreement with Recommendation No. 2. In a later discussion, REDSO/ESA officials agreed to issue a policy statement implementing the recommendation.

AUDIT OF
MAURITIUS ECONOMIC POLICY REFORM PROGRAM
NO. 642-0008

APPENDICES

UNITED STATES GOVERNMENT

memorandum

DATE: December 18, 1987

REPLY TO ATTN OF: Satish P. Shah - Acting Director, REDSO/ESA

SUBJECT: Mauritius - Draft Audit of Economic Policy Reform Program (642-0008)

TO: Richard C. Thabet, RIG/A/N

PURPOSE:

This memorandum responds to the subject draft audit report. The comments presented herein are further to Mr. Robert Bell's memorandum on the same subject of September 21, 1987 and to our meeting of September 17, 1987 in which we presented reactions to your earlier draft. Our purpose continues to be to seek clarification of certain points made in your drafts.

FINDING/RECOMMENDATION NO. 1:

With regard to the last paragraph on page 6, we request that you clarity that the requirement for the GOM to advise AID on the specific uses of program funds pertained only to local currency generations and not to the proceeds of the cash grant *per se*. The implication of the paragraph as it now stands is that AID had an obligation to track the dollars to end use.

Further, the last sentence in the first full paragraph on page 8 does not accurately reflect the provisions of the Program Grant Agreement which did not "implicitly require their [the local currency generations] use within 30 days of receipt in fiscal year 1986." The requirement was for the Government to advise AID that it had made the funds available within thirty days, not that they be used or expended within that timeframe.

We believe it is likely that the local currencies generated by the first $2 million tranche were used for tourism and water supply projects in the GOM's fiscal year 1986 (July 1, 1985-June 30, 1986) rather than in 1987, since as you point out 1986 was a deficit year and all receipts were used for budgetary support. Furthermore, we surmise that the GOM's letter of December 16, 1986 reporting that the funds were used in fiscal year 1987 contained a typographical error, since it would have been difficult for the Government to report on actual FY 1987 expenditures less than half way into the fiscal year. We intend to raise this possibility with the Ministry of Finance during the next REDSO TDY which is scheduled to take place in January 1988. We will advise you of the outcome.

OPTIONAL FORM NO. 10
(REV. 1-80)
GSA FPMR (41 CFR) 101-11.6
5010-114

Finally, we are pleased to note that procedures for monitoring the use of local currency generations from the second $3 million tranche of the EPRP -- procedures which we were finalizing with the GOM prior to the start of the audit -- fully satisfy your recommendation that REDSO prepare an action plan on how it will monitor future compliance with the Program Grant Agreement.

FINDING/RECOMMENDATION NO. 2:

We wish to point out that we consider the first sentence of the first full paragraph on page 11 to be in error. As we explained at some length in our earlier memorandum and during our September meeting, it is not the case that benchmarks for release of the second tranche were not established as the result of a failure to include them in the Grant Agreement as a condition precedent. As you are aware, the short lead time REDSO had to design and obligate the EPRP before the end of FY 1985 precluded reaching final agreement on benchmarks, although there was agreement in principle that release of the second tranche would be contingent on implementing reforms leading to a signficant increase in exports. Shortly after implementation began, REDSO drafted PIL No. 2 which sought GOM acceptance of a set of specific benchmarks to trigger the release of the second tranche. However, the Government considered itself unable to enter into an agreement on specific targets with AID at the same time that it was involved in detailed negotiations with the IMF and World Bank regarding its overall economic policy reform effort. Given that the Government did not anticipate making an early request for release of the second tranche, REDSO accepted this rationale for delaying agreement on benchmarks. As you know, once the Government felt it was in a position to request the release, it agreed readily to REDSO's suggestion that an independent consultant travel to Port Louis to assess the impact of Mauritian economic policy reforms on its export growth.

Regarding the last paragraph on page 11, we would like to point out that the reduction in disparities in effective tariff protection across the industrial sector was to be achieved by lowering high tariffs and "implementing a minimum tariff level for non-dutiable items." This distinction would avoid the misunderstanding which appears in the first full paragraph on page 12. In this regard, we suggest that the last sentence of the paragraph would be more accurate if it were to read as follows: "If the GOM lowered the tariffs sufficiently this would lead to an influx of imports (which happened), the increased volume of which could, and did, offset the marginal losses following tariff reductions, and resulted in increased exports." As we discussed in September, the purpose of the EPRP grant was to encourage the Government to implement reforms which would result in expanded exports.

Finally, we noted earlier that it is not customary practice for the Africa Bureau to delegate to either bilateral missions or the REDSOs the authority to approve programs under the African Economic Policy Reform Program (AEPRP). In the event we find ourselves in the position to approve such an activity, however, we will endeavor to assure that the resulting grant agreements either specify benchmarks for triggering the release of grant tranches or, if that is not possible at the outset, establish procedures for subsequent agreement on specific criteria for release. In any case, we anticipate participating in the design of future EPRPs and will keep in mind the importance of this point in preparing EPRP design documents. We assume this assurance will enable you to close Recommendation No. 2.

CONCLUSION:

We appreciate the opportunity to comment on this draft of the Mauritius audit and look forward to receiving a copy of the final report. In the event you have any questions about the foregoing comments, please do not hesitate to contact me or Monica K. Sinding.

Drafted by: REDSO/ADIR:MKSinding:16 Dec 87 Uus

Clearances:
REDSO/RLA:KHansen (Draft) Date: 17 Dec 87.
REDSO/APD:RMahoney (subs) Date: 10 Dec 87.

APPENDIX 2

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