

PD-ABB-292

**Audit of USAID/Egypt's
Agricultural Production and Credit
Project No. 263-0202**

**Audit Report No. 6-263-90-05
June 14, 1990**

UNITED STATES OF AMERICA
AGENCY FOR INTERNATIONAL DEVELOPMENT
OFFICE OF THE REGIONAL INSPECTOR GENERAL/AUDIT

June 14, 1990

MEMORANDUM FOR D/USAID/Egypt, Marshall D. Brown

FROM : RIG/A/C, F. A. Kalhammer *Kalhammer*

SUBJECT: Audit of USAID/Egypt's Agricultural Production and
Credit Project No. 263-0202

This report presents the results of the above-mentioned audit. The report was provided to you in draft and your comments are included as Appendix 1. The report's only recommendation is considered resolved upon report issuance. Please advise me within thirty days of any further actions you have taken to close the recommendation. I appreciate the cooperation and courtesy extended to my staff during the audit.

Background

The Agricultural Production and Credit Project (APCP) is designed to increase Egypt's agricultural productivity through deregulation and improved technological and financial services. It was authorized at \$123 million under a grant agreement between the Government of Egypt (GOE) and USAID/Egypt signed on September 30, 1986. The bulk of the grant (\$100 million) was released to the GOE as performance payments to support policy reforms in the agricultural sector. The remaining grant funds (\$23 million) were programmed for institutional strengthening of the GOE's Principal Bank for Development and Agricultural Credit (PBDAC).

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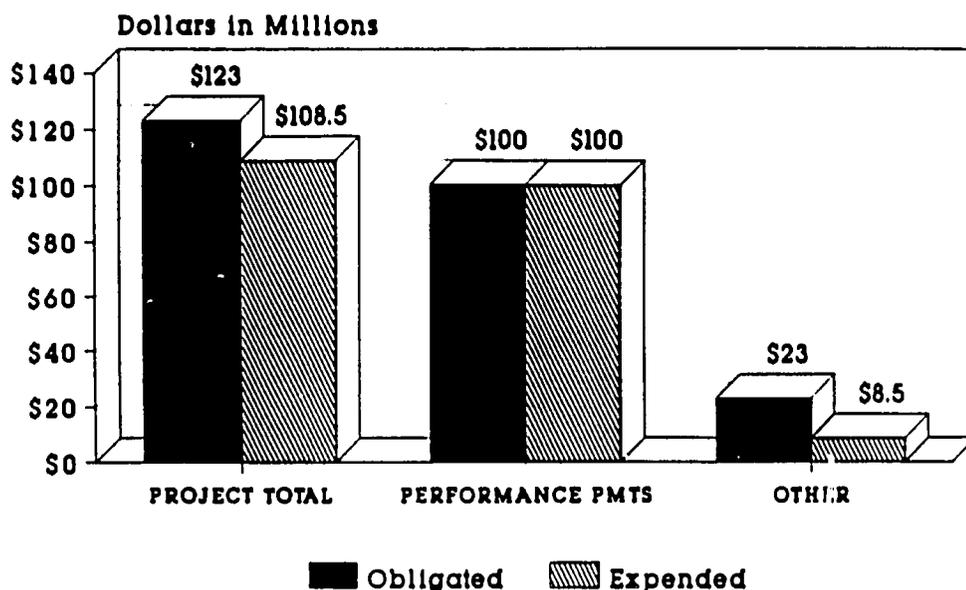
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APCP FINANCIAL STATUS

As of December 31, 1989



As of December 31, 1989, the entire \$100 million in performance payments had been disbursed and about \$8.5 million in USAID grant funds had been expended for institutional strengthening activities. In March 1989 USAID produced a "concept paper" designed to justify amending APCP by adding \$160 million to the grant -- \$150 million for performance payments, and \$10 million for institutional strengthening. This same document also proposed extending the original project completion date, September 30, 1993, by two years. The proposed project amendment was being discussed, but had not been authorized as of December 31, 1989.

The performance payments, made in three annual tranches, were to be based on the achievement of specific benchmarks designed to measure GOE progress in making policy reforms in deregulating agricultural production. Prior to each payment, the GOE was required to increase the capitalization of PBDAC by at least an equivalent amount of Egyptian pounds. The increased capitalization was to ensure that farmers and agribusiness entrepreneurs had additional credit available to realize opportunities created by the policy reforms.

The institutional strengthening of PBDAC was designed to improve the bank's ability to provide technical and financial services to Egyptian farmers. This included expanding credit and technological systems improved under a predecessor effort, the Small Farmers Production Project (SFPP) No. 263-0079. It also included modernizing the bank's management and accounting systems by procuring computers and other equipment, training, and technical assistance. The technical assistance was obtained through a host country contract between PBDAC and Chemonics International Consulting Division. As a condition of the USAID grant, the GOE was to provide 15.3 million Egyptian pounds (about \$6 million) in local currency and in-kind contributions to support these project activities.

Audit Objectives and Scope

The Office of the Regional Inspector General for Audit/Cairo made a performance audit of the Agricultural Production and Credit Project (No. 263-0202). The original objectives of the audit were to determine whether:

- . GOE sectoral policy reforms, including increased private sector participation, were moving forward on schedule;
- . credit was provided equitably to all eligible borrowers;
- . PBDAC modernization plans were being timely implemented;
- . activities of project-funded contractors were adequately monitored and coordinated;

- . charges made by A.I.D.-financed contractors were eligible and reasonable;
- . procurement of ADP hardware and software and related training was necessary and reasonable;
- . project-funded vehicles were adequately maintained and used in accordance with A.I.D. regulations;
- . the Mission's "project committee" responsible for this project met regularly and documented its deliberations;
- . any project-funded participants had overstayed their training periods outside Egypt, or incurred excessive costs;
- . required audits and evaluations had been performed and been adequately followed-up on;
- . the GOE capitalization of PBDAC was at the proper amount and used to fund unsubsidized loans; and
- . GOE contributions (cash and in-kind) had been timely made and accounted for properly.

Audit survey work showed that a more detailed audit of the above objectives was not necessary at this time except for the first objective related to policy reform, the results of which are presented herewith. During the audit RIG/A staff visited nine villages and six districts in Dakahlia, Sharkia and Qalubiya, representing, respectively, a very active, a moderately active, and a less active governorate in terms of APCP lending . We held discussions with PBDAC, USAID, and contractor officials. We also reviewed the grant agreement and project paper; analyzed progress reports, contract documents, and project files. The audit began in November 1989 and ended in February 1990.

The audit included a review of USAID/Egypt's administrative controls over host country and contractor activities as well as a review of compliance with USAID regulations. Since USAID funds were transferred to the GOE for policy reform progress and not for specific project expenditures, internal controls regarding the use of such funds were not required to be audited. Our review of the internal controls pertinent to the matters included in the Other Pertinent Matters section of this report was confined to those performance audit objectives. The audit was made in accordance with generally accepted government auditing standards.

Results of Audit

In general, the audit found APCP to be a well managed project which was proceeding on schedule. The GOE had made substantial progress towards the project's policy reform goals including a reduction in public sector controls over the production, marketing and processing of certain crops, as well as phasing out farm input subsidies.

A review of USAID/Egypt's administrative controls found that project activities were being adequately monitored and coordinated. Mission staff reviewed contractor implementation plans and quarterly progress reports, authorized host country contracts, training and procurement plans, and attended weekly implementation meetings. The Mission also organized a project committee which met regularly to discuss project issues.

The audit found that, with a few minor exceptions, project activities were conducted in compliance with USAID regulations. The minor deficiencies which came to our attention had to do with project vehicle management, GOE support, and PBDAC retention of earnings -- discussed in the Other Pertinent Matters section of this report.

(See Appendix 1, page 4 for the Mission's summary response.)

Certain Policy Reform Benchmarks Proved Ineffective in Bringing About Actual Reform - The audit found that many of the policy reform benchmarks, upon which \$100 million in performance payments were based, were ineffective measures of policy reform progress. The achievement of such benchmarks did not necessarily result in the desired policy reform. Although some of the targeted reforms were not fully accomplished, all performance payments were, however, released.

Discussion - The \$100 million originally budgeted under APCP for performance payments to the GOE was a reward for implementing policy reforms designed to deregulate Egypt's agricultural sector. Such reforms were to be sponsored by the Ministry of Agriculture (MOA). The performance payments were to be released to the GOE in three payments or tranches. Each tranche was conditioned upon several requirements, one of which was the achievement of the specific benchmarks relating to the MOA's agriculture policy reform goals. USAID officials had met with representatives of the MOA and other GOE officials, negotiated benchmarks for all three tranches.

Although project files, including justifications for release of the second and third payments, indicated that not all targeted reforms were achieved, USAID officials deemed that sufficient progress had been made toward policy reform goals to justify release of all three tranches as follows:

July 1987	\$33 million
July 1988	40 million
November 1989	<u>27</u> million
Total	<u>\$100</u> million

Certain benchmarks required the issuance of decrees or memoranda which did not in and of themselves ensure that desired policy reforms were achieved. Twelve of the fifteen benchmarks under the first tranche required that the MOA issue ministerial decrees enacting the removal of government controls, and/or memoranda to USAID indicating the MOA's intention to carry out future reforms. The issuance of decrees or pronouncements did not, however, ensure successful achievement of all desired reforms.

For example, one benchmark required that the MOA issue a decree to increase the farm price of cotton for the 1987 season in order to encourage additional production by bringing the price closer to the world price equivalent. This decree failed to achieve the desired results for several reasons. First, although the announcement of a price increase was made in March 1987 prior to the planting season, a survey of farmers revealed that only 37% were aware of the price change prior to planting their 1987 crop. Secondly, influences outside MOA's control affected the reform policy of cotton:

- (a) the Ministry of Industry resisted price increases for cotton purchased by public sector textile industries;
- (b) the GOE failed to anticipate substantial devaluation of its currency in 1987; and
- (c) world prices for extra long staple and long staple cotton increased by 22 and 28 percent, respectively.

The farm price of cotton actually decreased from 35% of the world price in 1986 to 25% in 1988, even though the benchmark had technically been met.

Some benchmarks required that reform progress be studied but did not require that the results be positive. Fifteen of the seventeen second tranche benchmarks called for surveys to confirm the effects of decrees issued under tranche one and to analyze the impact of proposed reforms. Accomplishment of these benchmarks consisted of the completion of the survey or analysis, regardless of whether or not the results showed progress toward desired policy reform. Tranche three benchmarks called for replication of the tranche two surveys as well as analyses of additional reforms completed or proposed.

For example, one survey was to confirm the rate and extent of GOE decontrol of private and public sector processing and marketing of rice. The survey determined that no progress had been made by the GOE with respect to the benchmark eliminating or reducing government controls on rice distribution and milling. But because the GOE completed the survey, the benchmark was considered accomplished.

Two benchmarks were targeted for achievement after all three tranches were released. Two benchmarks for tranche one required the MOA to indicate its intent to eliminate livestock feed subsidies and achieve market rates on all PBDAC loans within three years. Since the benchmarks were established in March 1987, and the third and final tranche was scheduled for disbursement in July 1989 (actually occurring in November 1989), the full achievement of the benchmarks was targeted beyond the expected disbursement date of the final tranche. Although the livestock feed subsidy was removed in June 1988, it appears unlikely that the credit benchmark will be fully achieved during 1990.

One benchmark was vaguely worded allowing for achievement without measuring the degree to which progress had been accomplished. The last tranche three benchmark dealt with the implementation of cotton and other farm price changes to closer approach world prices. This benchmark failed to quantify the degree to which prices were expected to change, only the direction.

The MOA Failed to Obtain the Cooperation of Other GOE Entities Necessary to Successfully Accomplish All of the Desired Policy Reforms - The lack of progress in certain areas of reform was due largely to the non-cooperation of GOE entities whose cooperation was necessary to achieve the desired reforms. Examples of restrictions imposed by other ministries which affected agricultural policy reform include:

- (a) Ministry of Finance and Central Bank of Egypt implicit policies on allocating foreign exchange for imports;
- (b) Ministry of Supply restrictions on processing and marketing over-quota rice; and
- (c) Ministry of Industry resistance to price increases for cotton purchased by public sector industries.

The problem of cooperation between ministries was raised in an assessment of tranche one benchmarks in June 1987 by the Mission's Program Office. It noted: "we are concerned by the absence of specific documents or language that details the nature of the required concurrence from the Ministries of Supply, Industry, Economics, Finance and others that will be affected by the policy reforms." As USAID/Egypt is now considering a project amendment to add \$150 million in future APCP performance payments, we recommend that USAID/Egypt design the amendment so as to achieve the cooperation of key ministries affected by the policy reforms, and seek to establish a new set of policy reform benchmarks which, if achieved, would result in actual progress toward desired policy reforms.

Recommendation No. 1

We recommend that USAID/Egypt:

- (a) obtain the Government of Egypt's agreement in establishing meaningful, quantifiable benchmarks for the release of future performance payments and relate such benchmarks to actual reform progress, not merely to studies of the situation; and
- (b) include in the proposed project paper amendment an analysis of the cooperation required of key GOE ministries in order to achieve the desired policy reforms, and a plan whereby that cooperation may be achieved.

USAID/Egypt generally agreed with the report's findings and recommendations. However, USAID/Egypt believes that the report overstates the problem of ineffective indicators of progress and lacks objectivity by not reporting more of the successful accomplishments of the project. (See Appendix 1 for the full text of USAID/Egypt's comments and our evaluation of them).

We believe that the performance payment benchmarks in the proposed Memorandum of Understanding (MOU) drafted by USAID/Egypt and the Mission's indication that the draft project paper amendment includes an analysis of key GOE ministries and a plan to achieve their cooperation resolve both parts of the above recommendation. We will close the entire recommendation upon execution of the MOU and an approved project paper amendment, provided they remain consistent with parts (a) and (b) of the above recommendation.

Other Pertinent Matters

The following matters, which were addressed in RIG/A/C Audit Related Memorandum # 6-90-005, also came to our attention.

Project Vehicles - During interviews with PBDAC officials and a visit to the PBDAC garage where A.I.D.-financed vehicles were kept, we found that:

- (a) no maintenance contract had been let to provide maintenance or service for project vehicles after their one-year warranty period expires;
- (b) detailed logbooks had been produced by PBDAC and distributed to all participating governorates; however, these logbooks, which were to be kept with each vehicle, were not found with the project vehicles we inspected; and
- (c) several project vehicles did not bear the A.I.D. "handclasp" emblem, as required.

GOE Support - The GOE cash contribution required by the APCP grant agreement was not being provided as planned. PBDAC was to receive budgetary support from the GOE for more than LE6 million (about \$2.4 million) during the life of the project. Annual requests by PBDAC for budgetary support have been denied by the Ministry of Planning (MOP), although the MOP has given PBDAC permission to "self-finance" project operating expenses from PBDAC revenues. Theoretically, these expenses may be deducted from that portion of revenues PBDAC is required to remit to the GOE. According to PBDAC officials, they have not yet used this method for making cash contributions to the project, but instead have used regular

PBDAC operating funds to finance LE1.3 million (about \$.5 million) in APCP costs, and hope to have those funds reimbursed by the MOP eventually.

Retention of Earnings - According to PBDAC officials, PBDAC has been retaining 100% of earnings from APCP loans even though such retention is not allowed under current GOE policies. Earnings from the predecessor Small Farmers Production Project (SFPP) were allowed to be retained by PBDAC under a provision of the SFPP grant agreement. We suggest that a similar provision be included in the APCP grant agreement in order to ensure that APCP's earnings may be legally retained by PBDAC for future project use.

In response to RIG/A/C ARM # 6-90-005, the Mission provided RIG/A/C with a copy of a letter from PBDAC to the APCP project office detailing PBDAC's intention to resolve the above issues.

**Audit of USAID/Egypt's
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Project No. 263-0202**

APPENDICES



CAIRO, EGYPT

UNITED STATES AGENCY for INTERNATIONAL DEVELOPMENT

RECEIVED
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MEMORANDUM

TO: Frederick Kalhammer, RIG/A/C
FROM: Marshall D. Brown, Dir
SUBJECT: Audit of Agricultural Production and Credit Project
No. 263-0202

Attachment 1 is the Mission's Executive Summary to be included in the final Audit Report. 1/

Before responding to the audit recommendation itself, the Mission would like to comment on certain statements made in the report.

- a) (page 8 first)
On ~~page 4, last~~ paragraph, the report stated "The audit found many of the policy reform benchmarks, upon which \$100 million in performance payments were based, were ineffective measurements of policy reform progress." In our judgment, the above statement is misleading and substantially overstates the problem of ineffective indicators of progress. It is important to keep in mind that release of the three tranches was not predicated upon satisfaction of each and every benchmark but upon substantial progress being made toward realization of reform objectives. In terms of numbers, the project had 59 benchmarks 20 for tranche 1, 17 for tranche 2 and 22 for tranche 3. In our judgment, 55 out of 59 benchmarks proved to be effective measurements of progress. Only 4 benchmarks or 7% proved to be ineffective. We believe that this represents a significant achievement and demonstrates correlation between benchmarks and reform progress. 2/

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- b) On page ~~6~~^{7 last}, paragraph 3, the report noted GOE's nonfulfillment of its commitment to decontrol rice processing, but failed to give the GOE credit for having removed controls over the export of oranges, the other main commodity (along with rice) for which USAID had sought specific GOE commitments during the initial negotiations in 1986 and early 1987. GAO 1988 Government Auditing Standard No. 4 for Objective Reporting for Performance Audits calls for balance in tone and content. 3/
- c) On page ~~6~~^{8 first}, paragraph ~~3~~, the report noted that targets for the elimination of subsidies for credit and livestock feed were flawed because the target dates were set beyond the planned period of Tranches 1 through 3. While it is true that the goal to eliminate credit subsidy by the end of 1990 is unlikely to be achieved, the report neglected to mention that the only actual livestock feed subsidy (for imported corn) was indeed eliminated as of June 1988, even before the Tranche 2 and 3 disbursements. Again, we refer to the Government Auditing Standards and the objectivity requirement. 4/

The Mission response to the audit recommendation is as follows:

RECOMMENDATION NO. 1

We recommend that USAID/Egypt:

- (a) obtain the GOE's agreement in establishing meaningful, quantifiable benchmarks for the release of future performance payments;
- (b) relate such benchmarks to actual reform progress, not merely to studies of the situation;
- (c) include in the proposed project paper amendment an analysis of the cooperation required from key Government of Egypt ministries in order to achieve the desired policy reforms, and plan whereby that cooperation may be achieved.

USAID RESPONSE

The Mission recommends that the three-part recommendation be restructured and presented as two separate recommendations. Parts (a) and (b) of the recommendation, both dealing with benchmarks, logically fit together as one recommendation. 5/

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Part (c), which calls for inclusion in the project paper amendment of an analysis of the required GOE cooperation to achieve the desired policy reform, is a completely different subject that merits a separate recommendation.

Notwithstanding the above suggested restructuring, our response to the audit recommendation as presented in the report is as follows:

Parts (a) and (b) The Memorandum of Understanding (MOU), which clearly articulates the medium term goals as well as specific benchmarks for each of Tranches 4, 5 and 6, has been drafted and is currently being discussed between USAID and the GOE. In addition to the MOU, the Mission will prepare a Memorandum to the Files, which will explain the intended purpose and objective of each benchmark and interpret the desired results in order to maintain a unified thinking and understanding of benchmarks. A copy of the draft MOU is attached. You will note that only a few issues remain to be negotiated. We believe the draft demonstrates that the benchmarks for the next period will be fully consistent with recommendations (a) and (b). Based on the above action, we request closure of both recommendations upon issuance.

Part (c) An analysis of the cooperation required from key GOE ministries for the achievement of desired policy goals has been incorporated into the draft project paper amendment. A plan whereby the GOE cooperation may be achieved has also been included. Our initial discussions with GOE officials have dealt with specific steps to be taken by the Ministry of Supply and Ministry of Industry related to policy reforms already agreed for inclusion in the MOU. We will request closure of this recommendation upon approval of the project paper amendment.

Att: a/s above

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ATTACHMENT 1

EXECUTIVE SUMMARY

While we are in substantial agreement with the findings of this audit report we believe that the report's concentration on the satisfaction or relevance of individual benchmarks tends to obscure the dramatic overall gains of the project.

Implementation under the Agricultural Production and Credit Project has been excellent and ahead of schedule since its inception in 1986. Major policy reform accomplishments during the 1986-1989 period have included the cancellation of mandatory low-priced government procurement of ten crops (only three remain controlled), elimination of the subsidies (previously about \$150 million per year) for imported corn, and initial reduction in subsidies for fertilizer and other inputs. This project has succeeded in launching a policy reform and deregulation process which is rapidly moving Egypt's agricultural sector to rely on market forces. This project has already had an impact on production and productivity. At the same time the GOE has increased PBDAC's loanable funds so that small farmers and entrepreneurs have financing available to capitalize on private sector development opportunities created by the policy reform program.

It is important to keep in mind that release of the three tranches was not predicated upon satisfaction of each and every benchmark but upon substantial progress being made toward realization of reform objectives. In terms of numbers, the project had 59 benchmarks 20 for tranche 1, 17 for tranche 2 and 22 for tranche 3. In our judgement, 55 out of 59 benchmarks proved to be effective measurements of progress. Only 4 benchmarks or 7% proved to be ineffective. We believe that this represents a significant achievement and demonstrates correlation between benchmarks and reform progress.

On some specific issues we believe the report is lacking in balance. For example, the report criticized the GOE for nonfulfillment of its commitment to decontrol rice processing, but it failed to give the GOE credit for having removed controls over the export of oranges which went beyond its benchmark commitments and for which USAID had sought specific GOE commitments during the initial negotiations with GOE. In addition, the report noted that target dates for the elimination of credit and livestock feed subsidies were set beyond the planned disbursement dates for Tranches 1 through 3, but it failed to mention the elimination of the livestock feed subsidy was in fact achieved prior to the Tranche 2 disbursement.

In conclusion, we are satisfied with our accomplishments in implementing this policy reform project.

RIG/A/C's Evaluation of Selected Mission Comments

- 1/** The draft report provided to the Mission was in Memorandum format which does not include an Executive Summary. The Mission's proposed addendum to the non-existent summary is included as part of its overall response to the report in this Appendix.
- 2/** The Mission's comment indicates that in their opinion, only 4 out of 59, or 7% of the project benchmarks proved to be ineffective. Mission project files list only 38 benchmarks for the three tranches, not 59. Further, to have any significance the above percentage assumes that all benchmarks are of equal or near equal importance. This is clearly not the case as 11 benchmarks required only that the GOE write memoranda to USAID indicating an intention to carry out reforms, 20 benchmarks were to conduct surveys or assessments of reform impact, but only 7 called for actual policy reform action by the GOE.
- 3/** We did not comment on the removal of marketing controls on oranges because, per benchmark #4 of the first tranche, oranges were excluded from the benchmark as were cotton and sugarcane.
- 4/** The report has been modified to reflect this comment.
- 5/** We prefer to consolidate the first two parts of audit Recommendation No. 1 and have amended the report accordingly.

APPENDIX 2

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