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Report to the Chairman, Subcommittee on Europe and the Middle East, Committee on Foreign Affairs, House of Representatives

June 1988

FOREIGN AID

Improving the Impact and Control of Economic Support Funds

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United States
General Accounting Office
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National Security and
International Affairs Division

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June 29, 1988

The Honorable Lee H. Hamilton
Chairman, Subcommittee on Europe
and the Middle East
Committee on Foreign Affairs
House of Representatives

Dear Mr. Chairman:

As you requested, we reviewed selected Economic Support Fund (ESF) programs to determine how these programs might achieve greater development impact. This report discusses Agency for International Development (AID) efforts to promote economic policy reform through the ESF program and the agency's financial controls over ESF cash transfer funds.

We are making recommendations to the Administrator, AID, to improve the agency's ability to measure the results of its policy reform efforts. We are also recommending that AID take certain actions to ensure that congressional intent concerning separate accounting for cash transfers is met.

We are sending copies of this report to the Administrator, AID; the Secretary of State; and other interested parties. We will also make copies available to others upon request.

Sincerely yours,

Frank C. Conahan

Frank C. Conahan
Assistant Comptroller General

Executive Summary

Purpose

The United States provided about $3.9 billion in Economic Support Fund (ESF) assistance to 48 foreign countries in fiscal year 1987. The ESF program supports U.S. economic, political, and security goals in countries of strategic interest to the United States. It represents about one-half of the U.S. bilateral economic assistance program.

In reviewing how the ESF program could achieve more impact on development, GAO examined (1) the degree each ESF program type contributes to development, (2) the effectiveness of U.S. efforts in encouraging economic policy reform, and (3) the adequacy of program controls to ensure funds are used for authorized purposes.

Background

The Agency for International Development (AID) administers ESF programs under the general policy direction of the Department of State. AID provides ESF through projects, which address development needs; Commodity Import Programs, which finance imports; and cash transfers, which provide foreign exchange to address balance-of-payments problems and encourage economic policy reform. To a lesser extent, AID provides ESF sector grants, which finance broad development activities within a single development sector, such as agriculture or health.

Cash transfers amounted to $2.3 billion in 1987—about 60 percent of all ESF funds. Until 1987, AID disbursed cash transfers directly into recipients' bank accounts containing other foreign exchange. Because funds were commingled, AID could not trace U.S. funds to their specific use. Concerned that this lack of financial accountability could lead to funds being diverted to unauthorized purposes, the Congress enacted legislation in 1986 requiring countries to maintain ESF cash transfer funds in separate accounts.

Results in Brief

Because the United States uses ESF to address not only economic but also political and security objectives, AID needs flexibility in choosing the ESF program type which most effectively addresses U.S. and recipient country needs. Each ESF program type can achieve development impact if the programs are effectively implemented.

In pursuing economic policy reform, AID needs to adapt its approach to individual country circumstances, particularly when other U.S. foreign policy interests compete with the need for policy reforms. Although many factors affect both a country's decisions to adopt reforms and the impact such reforms may have, AID could improve the prospects for successful policy reform efforts by establishing specific goals and milestones for all such programs.

Although AID still needs to resolve certain difficulties associated with cash transfer separate accounting, the new legislative requirement has had the beneficial effect of focusing AID attention on how cash transfers can best address individual country needs. Given congressional concerns for accountability, AID should ensure that all ESF cash grants are maintained in separate accounts and should verify that funds were used for authorized purposes.

Principal Findings

AID Attempts to Match ESF Program Types to Varying Development Needs

AID uses cash transfers to address balance-of-payments problems and as leverage to encourage economic policy reforms. However, AID has difficulty measuring the results of its efforts, and reform actions cannot always be directly linked to the provision of cash transfer assistance. Commodity Import Programs finance needed imports when foreign exchange is in short supply. However, it is cumbersome to use import programs to achieve some objectives, and the program is sometimes an inefficient means of providing balance-of-payments support. Project aid can provide tangible development benefits, but only if the recipient country has sufficient capacity to implement and sustain the activities.

AID Has Had Mixed Success in Encouraging Policy Reforms

AID's approach to economic policy reform depends on U.S. foreign policy interests, the recipient's political and economic situation, and other donor activities. Sometimes AID conducts broad policy discussions with recipients without conditioning the aid on reform actions and other times conditions the aid on specific reforms. AID has had mixed success under the various approaches. A recipient's commitment and ability to implement the reforms ultimately determine the success of reform efforts.

Many factors complicate achieving policy reform progress and impact. In some cases, AID has not established sufficient criteria to guide its policy reform efforts. Although AID set forth clear statements of reform objectives, anticipated time frames or milestones for achieving the reforms, and the anticipated impact for some programs, for others it did not.

AID Encountered Problems in Implementing Separate Accounting for Cash Transfers

GAO reviewed separate accounting for cash transfers in four countries and found that three recipients initially deposited their grants into separate accounts but then transferred and spent the funds from accounts containing other foreign exchange. As a result, AID could attribute disbursements to the cash transfers but could not directly trace the funds to their specific use. It may be difficult for AID to keep cash transfer funds segregated from other foreign exchange in some cases. AID has not explained how it will maintain accountability in these programs when it cannot avoid such commingling.

AID makes some ESF cash grants through certain types of ESF sector grants and projects without requiring separate accounting because it does not consider them cash transfers. Although AID sometimes requires an accounting for local currencies equal to these grants, it does not require an accounting for the dollars provided.

AID requires cash transfer recipients to retain records on separate account disbursements for 3 years and to report to AID on how they used the funds. However, AID has no plans to systematically verify these reports, even though host governments have not always been able to substantiate them in the past. GAO believes AID should verify these reports to ensure that countries have spent cash transfer funds for authorized purposes.

Recommendations

For each ESF cash transfer for which policy reform is an objective, GAO recommends that the Administrator of AID require internal AID program authorization documents to contain specific reform objectives, time frames or milestones, and expected impact to improve policy reform results and facilitate measuring reform progress.

For separate accounting, GAO recommends that AID (1) describe in internal program documents its means of maintaining accountability in cash transfer programs when AID cannot avoid commingling cash transfers with other foreign exchange, (2) require separate accounts for all ESF cash grants, not just those termed cash transfers, and (3) ensure that all separate accounts be independently audited.

Agency Comments

In commenting on this report, AID agreed to (1) include more specific criteria in its cash transfer program documents, (2) ensure that funds in commingled accounts were spent for authorized purposes, (3) study GAO's recommendation that all ESF cash grants be maintained in separate accounts, and (4) ensure that all cash transfer accounts are audited. The State Department agreed with GAO's assessment of the constraints faced in using ESF cash transfers to encourage economic policy reform and with the need to increase the specificity of economic reform goals to facilitate measurement of progress. Based on AID and State Department officials' comments, GAO made revisions to this report where appropriate. (See apps. II and III.)

Contents

Abbreviations

AID	Agency for International Development
CIP	Commodity Import Program
ESF	Economic Support Fund
GAO	General Accounting Office
IMF	International Monetary Fund

Introduction

Because the Economic Support Fund (ESF) program has become the largest component of U.S. foreign economic assistance, the Congress has focused increased attention on how this program can better contribute to economic development while serving other important U.S. political and security interests. The Congress has been concerned about both the impact of the program on development and financial accountability over these funds, which grew from $1.9 billion in fiscal year 1979 to $3.9 billion in fiscal year 1987.

Over the last 2 years, various legislative proposals have been aimed at improving the accountability and development impact of the ESF program. These proposals reflect the views that the Agency for International Development (AID) might achieve more impact by (1) disbursing program resources in ways that more directly contribute to development, (2) conditioning ESF assistance more effectively to encourage economic policy reforms, and (3) improving financial controls to prevent diversions of aid. To review these issues, we examined the implementation of ESF programs in selected countries.

ESF Is Intended to Advance Diverse Foreign Policy Objectives

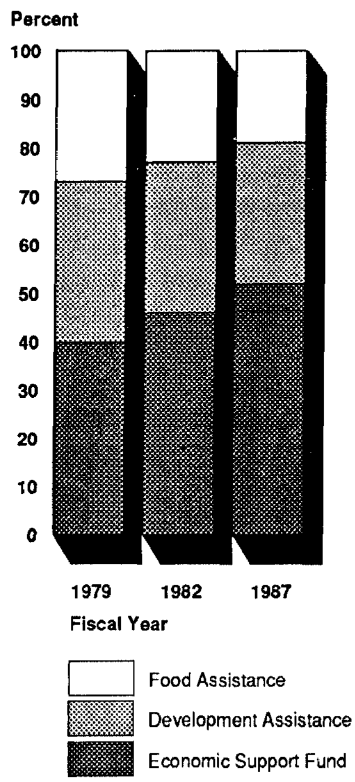
The Foreign Assistance Act gives the President discretion to provide ESF to countries and organizations on such terms and conditions deemed necessary to promote economic or political stability. The United States justifies the assistance on political, security, or economic grounds and provides it to both developed and developing countries. ESF serves a diversity of U.S. objectives, such as (1) enhancing prospects for peace in the Middle East, (2) enhancing political stability, (3) promoting economic reforms important to long-term development, (4) promoting economic stabilization through budget and balance-of-payments support, and (5) assisting countries that allow the United States to maintain military bases on their soil.

The manner in which ESF fits into the context of the U.S. foreign assistance program sets this program apart as a unique type of aid. ESF is presented both as security assistance in the Department of State's budget presentation and as economic assistance in AID's budget proposal. The Department of State directs ESF country allocations and handles policy matters, but AID administers the program. Current congressional guidance on the intent of ESF assistance recognizes the political and security objectives of the program but emphasizes that AID should use ESF, to the extent possible, to promote long-term economic development. Countries are not to use ESF for military or paramilitary purposes under any circumstances.

ESF Represents the Largest Component of U.S. Foreign Economic Assistance

As shown in figure 1.1, the ESF program has grown faster than the other major economic assistance programs over the last 8 years. In 1979, AID provided $1.9 billion in ESF to 12 countries and to 2 regional programs. By fiscal year 1987, the program had grown to $3.9 billion, provided assistance to 48 countries and 4 regional programs, and represented about 52 percent of the total U.S. bilateral economic assistance program.

Figure 1.1: Changes in U.S. Bilateral Economic Assistance



Cuts in the fiscal year 1988 foreign aid budget will heavily affect some ESF programs. For fiscal year 1988, ESF is funded at $3.2 billion, down from the $3.9 billion funded for fiscal year 1987. About 90 percent of the funds are earmarked for specific countries. AID has eliminated ESF programs in 18 African, Latin American, and Caribbean countries and reduced the allocations of others to accommodate these cuts.

AID Increasingly Uses Cash Transfers to Deliver ESF Assistance

Currently, AID provides ESF assistance in a given country through one or more program types: (1) cash transfers, which provide foreign exchange for specified economic purposes, (2) ESF projects, which support development activities similar to those funded from development assistance but which are sometimes for a wider range of activities, and (3) Commodity Import Programs (CIP), which provide financing for specified categories of imported commodities. To a lesser extent, AID finances sector assistance, which is a type of ESF project aid channeled to support broad development activities within a single development sector, such as agriculture or health.

In delivering ESF assistance for fiscal year 1987, the United States provided about $2.3 billion in cash transfers, $1.2 billion in project aid, and $359 million in CIP assistance. Appendix I shows the amounts and types of ESF assistance each country received in fiscal year 1987 and the proposed allocations for fiscal year 1988. As shown in table 1.1, AID is increasingly using cash transfers to deliver ESF assistance. Over the last 8 years, these transfers have grown to represent about 60 percent of the total ESF program and about 30 percent of the total bilateral economic assistance budget.

Table 1.1: ESF Obligations in Fiscal Years 1979, 1982, and 1987 by Program Type

Figures in percent

Type	1979	1982	1987
Cash	45	54	60
Projects	36	25	31
CIP	19	21	9

In 1979, Israel, Turkey, Jordan, and Nicaragua were the only countries receiving cash transfers. By 1987, AID was providing cash transfers to 26 countries, having greatly expanded the use of this mechanism in Latin America and Africa. In 1979, AID implemented just three CIPs—in Egypt, Syria, and Zambia. AID implemented 9 CIPs in 1987, but the program declined to just 9 percent of the total ESF program. Countries receiving ESF project aid increased from 8 in 1979 to 39 in 1987, although project aid declined as a percentage of the total ESF program.

Growing Concern About the Need for Economic Policy Reform

In recent years, many policymakers have realized that if U.S. assistance is to be effective in promoting economic development, some countries need to redress poor economic policies that deter development. Without such policy reforms, the positive effects of ESF assistance could be negated and economic dependence on the United States and other donors could continue indefinitely. AID officials believe that encouraging countries to adopt needed reforms can enhance the development potential of ESF resources, and they have therefore adopted economic policy reform as an objective in an increasing number of ESF programs, particularly cash transfers.

Many factors cause the economic problems in ESF recipient countries, and some factors are outside of their control. The world recession during the 1980s, increased oil prices, precipitous declines in the price of major exports, limited natural resource bases, dependence on single-commodity exports, burgeoning debt, natural disasters, or war efforts contribute to these difficulties. However, the economic policies that a country chooses to adopt can determine whether and when it will overcome such difficulties. Overvalued exchange rates, excessive government subsidies, inadequate revenue generation, and disincentives for private sector development can exacerbate difficult economic problems and restrain economic growth and recovery.

Recognizing the importance of economic policy reforms to development in many countries, some members of the Congress have questioned how successful AID has been in encouraging such reforms and whether these changes are having the desired impact. Some economies have actually worsened despite policy changes, and we found that AID has not always strongly pressed for needed reforms.[1] Other members of the Congress are concerned that policy reforms could adversely affect the poor populations of many ESF countries. Some fear that pressing too strongly for policy reforms could jeopardize other important foreign policy objectives. All these uncertainties over the advisability of using cash transfers to encourage policy reform have led to suggestions that ESF countries might benefit more directly from project aid or CIPs than cash transfers.

[1] Use of U.S. Conditions to Achieve Economic Reforms (GAO/NSIAD-86-157, Aug. 1986).

Recent ESF Program Accountability Concerns

In recent years, with AID's increased use of cash transfers, the Congress voiced concerns about the way AID was disbursing these funds. Before 1987, AID disbursed cash transfers directly into recipients' bank accounts where the funds were commingled with other sources of foreign exchange. As a result, AID had no way of knowing how the recipients used the cash transfer funds. Concerned that this lack of financial accountability could lead to funds being diverted for unauthorized purposes, the Congress enacted legislation in 1986 requiring all countries receiving cash transfers over $5 million after February 1, 1987, to maintain the funds in separate accounts and not commingle them with other foreign exchange.[2] The intent was to provide a means whereby AID could track the funds to their end use. The Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1988 (Public Law 100-202), requires separate accounting for all cash transfers, regardless of the amount.

In recent years, the Congress has also expressed its desire that AID place a higher priority on programming and monitoring local currency funds. Legislation requires that local currencies resulting from the sale of CIP grant commodities be deposited in a separate account and that at least half of these funds be used to support development activities. As a feature of some cash transfer programs, AID sometimes requires the recipient to deposit local currencies equal to its ESF grant into a special account and to use them as agreed with AID. Although AID considers these funds to be owned by host governments in both cases, AID tries to influence recipients to use these funds in ways that further development. We are including our work related to ESF local currency programs in a separate report on commodity import programs, which we are issuing in the near future.

Objectives, Scope, and Methodology

At the request of the Chairman, Subcommittee on Europe and the Middle East, House Committee on Foreign Affairs, we examined selected ESF programs to evaluate how the overall program might achieve greater impact on economic development in recipient countries. We reviewed (1) the degree to which each ESF program type contributes to economic development, (2) the effectiveness of AID's efforts to encourage economic policy reforms, and (3) the adequacy of program controls to ensure ESF assistance is used for its intended purposes.

[2]In 1984, the Congress enacted similar legislation requiring separate accounting for cash transfers to El Salvador.

We conducted this review in Washington, D.C., and the ESF recipient countries of Egypt, El Salvador, Jamaica, Pakistan, Senegal, Zambia, and Zaire from April 1987 to February 1988 in accordance with generally accepted government auditing standards. We reviewed ESF legislative history and program documentation at AID regional bureaus in Washington and overseas missions. In Washington, we met with officials of AID, the Department of State, and the World Bank. In the countries visited, we met with U.S. embassy and AID mission officials; host government officials from the ministries of finance, economics, and/or planning, central banks, and economic advisers; and representatives of the International Monetary Fund (IMF), World Bank, and major bilateral donors.

We selected ESF programs that afforded us an opportunity to review both CIP and cash transfer programs under a variety of country-specific situations. The cash transfer programs in Egypt, El Salvador, Senegal, and Zambia enabled us to examine diverse program control mechanisms, as well as various approaches to policy reform. The CIP programs in Egypt, Pakistan, Zambia, and Zaire represented over 80 percent of all CIP program funds for fiscal years 1986 and 1987. As agreed with the requester, we did not review AID controls over ESF projects or AID's efforts to achieve policy reform through them.

Because program controls over CIPs are quite detailed, we are preparing a separate report on them. The report will cover controls over the allocation, arrival, and end use of commodities imported under CIPs. It will also cover AID management of local currencies, which are a feature of CIP and some cash transfer programs. A September 1987 classified report on U.S. efforts to encourage policy reform in Egypt through ESF cash transfers and a GAO legal opinion on Egypt's use of ESF to pay U.S. debt incurred under the Foreign Military Sales program also resulted from this review.

In examining AID's selection of ESF program types to address development problems, we discussed with AID officials factors influencing their selections and their views on the strengths and weaknesses of each program type in achieving program objectives and development impact.

In examining AID's efforts to encourage economic policy reforms, we reviewed factors affecting its approach to policy reform, the degree of success it has had in its policy reform efforts, and the impact such reforms have had on development.

In examining ESF program controls, we reviewed AID's non-project assistance handbook guidance, discussed control issues with AID headquarters and field mission personnel, and tested AID's implementation of selected controls in the countries we visited. Specifically, we reviewed AID's implementation of the new legislative provision requiring separate accounting for cash transfers and the new AID guidance on acceptable uses of cash transfers.

We based our conclusions primarily on our recent fieldwork; however, we also drew from our previous reviews of ESF programs in other countries, including Costa Rica, the Dominican Republic, Honduras, Liberia, the Philippines, and Sudan. Other reports that relate to controls and accountability issues and U.S. policy reform efforts are listed at the end of this report. We have also taken into account the extensive work done by AID's Office of the Inspector General on ESF programs.

AID Attempts to Match ESF Programs to Priority Economic Needs

Over the last few years, some members of the Congress have questioned how much ESF cash transfers have contributed to economic development and have suggested that AID deliver more ESF assistance as project aid or CIPs. We found that each program type fills a specific role in the program and that various factors enter into AID's decisions on how to deliver the assistance. AID can achieve development impact through each program type; however, the extent of impact depends on how well the program addresses the recipient's economic needs and how effectively it is implemented.

Factors Influencing AID's Selection of ESF Program Types

In deciding how AID can most effectively deliver ESF assistance, AID officials consider such factors as (1) what foreign policy objectives the United States is trying to achieve, (2) what economic and development needs are most pressing for each country, (3) how much assistance AID is providing and how quickly the funds need to be disbursed, (4) what program objectives AID is advancing, and (5) whether any unique control concerns are present. We found that AID has based its program selections on the following factors:

- AID believes that cash transfers can best address balance-of-payments problems and poor economic policies that pose major obstacles to development. Foreign policy objectives, legislative earmarks, and program designs sometimes foreclose other options regarding program type.
- Although CIPs can help sustain production when foreign exchange is in short supply, CIPs are sometimes inefficient in delivering assistance because AID must often offer a financial incentive to encourage importers to accept the higher costs of importing from the United States.
- Projects can provide tangible evidence of development, provided AID and host countries have the capacities to effectively implement, monitor, and sustain the activities.

Cash Transfers Best Meet Some Program Objectives

AID cites four major purposes that ESF cash transfers serve: (1) U.S. political commitments to Egypt and Israel, (2) security-related commitments to base-rights countries, (3) economic stabilization in countries experiencing serious balance-of-payments difficulties, and (4) economic policy reform.

In countries where U.S. political or security objectives are predominant, AID believes U.S. interests are best served through cash transfers. This is particularly true in the case of base-rights countries where recipients have tended to view the assistance as rent and for Egypt and Israel where the primary objective of the assistance is to promote peace in the Middle East. The Congress has demonstrated that it shares AID's view that cash is warranted in such circumstances by earmarking the ESF legislation to require that certain ESF allocations be given in cash. For fiscal year 1988, appropriations legislation requires that all of Israel's $1.2 billion program and $115 million of Egypt's $815 million program be provided in cash.

A few other programs have required cash because of their designs. For example, AID contributed an ESF cash transfer to Zambia's foreign exchange auction until the auction was cancelled in early 1987 and is providing a $35 million cash contribution to the International Fund for Ireland and Northern Ireland for fiscal year 1988.

Even where political and security objectives, legislation, or program design do not foreclose other program options, AID still often selects cash transfer to deliver ESF assistance. Countries adversely affected by depressed commodity prices, declining export earnings, growing debt problems, and serious balance-of-payments problems sometimes need quick infusions of cash to avert economic crises.

Cash transfers have enabled some recipients to stay in compliance with International Monetary Fund (IMF) economic stabilization and World Bank structural adjustment programs. Staying current on these obligations assists them in obtaining further credit, if needed. Staying current on U.S. debt payments is also important since the Foreign Assistance Act requires that U.S. aid be suspended when a country remains in arrears in its debt payments. Because poor economic policies often pose obstacles to development, AID has increasingly used cash transfers as leverage to encourage macroeconomic policy reforms related to foreign exchange valuation, interest rates, government subsidies, and fiscal policies. Economic policy reform was a major program objective of all five ESF cash transfer recipients included in our fieldwork.

Despite the advantages of cash transfers, delivering assistance in this manner has drawbacks. According to AID officials, it is sometimes difficult to link specific policy changes directly to U.S. policy reform efforts associated with many cash transfers. As a result, AID cannot always point to specific accomplishments stemming from cash transfer assistance. Even if improved economic policies can be associated with cash transfer assistance, they often do not have direct or immediate benefits to general populations and sometimes even have short-term adverse consequences.

CIP Finances Needed Imports

A country's economic growth cannot be sustained if its production is interrupted for lack of needed imports. CIPs can enable a host government and private sector entities to finance needed imports when foreign exchange is in short supply. Local currencies generated from commodity sales can provide important resources to support development activities. In addition, CIPs provide trade and commercial benefits to the United States because legislation requires CIP recipients to purchase the commodities from the United States and to ship at least half of the dollar value of the commodities on U.S.-flagged vessels.

Despite these advantages, AID uses CIPs sparingly in the ESF program. According to AID officials, CIP administrative requirements, which place heavy demands on both AID staff and host governments, figure prominently in AID's limited use of CIP. CIP program regulations require AID to determine whether the items are eligible to be financed, ensure that shipping requirements are met and proper procurement procedures are followed, and ensure that adequate systems are in place to monitor the arrival and disposition of the commodities and to account for the deposit and use of local currencies generated from commodity sales.

CIPs are sometimes an inefficient means of delivering ESF assistance because it is often more expensive for importers to use CIPs to meet their import needs. AID officials said that shipping CIP commodities on U.S. carriers generally costs importers 30 to 50 percent more than shipping on their normal carriers. As a result, AID must frequently offer CIP commodities at a subsidized exchange rate or provide some other type of incentive to encourage importers to use CIPs. Although such incentives compensate importers for the increased cost of using CIPs, this practice results in an inefficient use of CIP funds because fewer goods can be imported.

In some cases, AID has used CIPs partly because legislation mandates this type of assistance or because congressional concerns for accountability foreclosed the cash option. For example, ESF legislation currently earmarks $200 million of Egypt's ESF allocation for CIP. According to AID officials, the Congress imposed the earmark to ensure that AID did not disproportionately cut the CIP if a decision was made to provide cash transfers above the earmarked $115-million level. AID provided CIP rather than cash assistance to Zaire because the Congress believed cash would be more susceptible to corruption than commodities.

AID officials stated that, in some cases, they could use CIP to address debt, import financing, and policy reform problems, but CIP would not be as direct or efficient as cash transfers for these purposes. For example, CIP can provide needed foreign exchange for industrial inputs, thereby freeing other foreign exchange for debt payments. However, providing cash is a more direct means of providing needed financing. AID officials said that it is cumbersome to use CIP to encourage policy reform due to the difficulty in timing commodity procurement and disbursements to respond to reform actions.

ESF Projects Address Development Needs

AID finances a significant amount of project assistance through the ESF program—$1.2 billion in fiscal year 1987. These funds have been used for traditional development projects in such areas as agriculture, education, and health; major infrastructure projects such as power plants, sewer systems, and roads; and technical assistance to support AID's development activities and policy reform efforts. The importance AID places on project aid is illustrated by the fact that 39 of 48 ESF countries received some of their ESF allocation in the form of project aid in fiscal year 1987. AID officials emphasized, however, that project assistance is not appropriate for all ESF countries: developed nations, for example, normally do not receive traditional project assistance. Even some developing country recipients, such as Egypt, have indicated that they prefer cash to project assistance because they can use it immediately to meet pressing economic needs.

According to AID officials, a major drawback of project assistance is its disbursement rate compared to cash transfers and CIPs. Some foreign exchange enters the recipient's economy when project dollars are converted to local currencies to pay for local project costs. However, the foreign exchange is provided over the life of the project, which can be several years. CIPs are usually disbursed more quickly than projects but not as quickly as cash transfers, which result in immediate infusions of foreign exchange. For this reason, project assistance is generally not suited to address immediate balance-of-payments problems. Further, although AID attaches policy conditions to some ESF projects, AID officials said that it is difficult to encourage macroeconomic reforms through projects because host officials dealing with AID on projects are often not those who can enact or influence the needed reforms.

AID officials emphasized that even when project aid is warranted, AID is limited in how much it can effectively administer project aid in some countries. AID officials believe that the capacity of some recipients in administering aid projects as well as AID's ability to monitor them is already seriously taxed. AID officials in Egypt said that it would be difficult to find effective uses for project assistance over the current $500-million level without funding activities counterproductive to AID's development strategy or supporting projects Egypt could not sustain. In El Salvador, where AID administered $124.5 million in project aid in fiscal year 1987, AID officials said they sometimes encounter logistical problems in monitoring projects that are sometimes inaccessible because of war conditions.

AID Can Achieve Development Impact Through All Three Program Types

AID can achieve development impact through all three ESF program types. However, the extent of the impact appears to be related to how well the program addresses the country's economic needs and how effectively it is planned and implemented rather than on the particular program type.

Project AID Offers Most Direct Evidence of Development Impact

Development impact arising from projects is usually easier to identify than from CIPs and cash transfer programs. An irrigation system can result in additional areas under cultivation, an inoculation campaign can lower the incidence of communicable diseases, and agricultural research can improve crop yields. Because the impact of projects is often tangible, some AID officials believe that project assistance should be the preferred way of delivering ESF.

Providing project assistance, however, does not guarantee development impact. Our past reviews of AID projects have shown recurring weaknesses in project implementation, monitoring, and evaluation. Such weaknesses reduce AID's assurance that projects are achieving their objectives and that funds are being used for their intended purposes.[1] We have also identified weaknesses in host government administrative and financial capacities to manage and control project assistance in past reviews. Project aid may not result in permanent development gains if the host country cannot effectively manage or sustain the activities.

Development Potential of CIP Not Fully Realized

CIPs can also achieve development impact if they are designed and monitored appropriately; however, we found wide variances in the degree to which programs were achieving this goal. The CIPs in Zambia and Zaire

[1] See FOREIGN AID: Potential for Diversion of Economic Support Funds to Unauthorized Use (GAO/NSIAD-87-70, Jan. 1987).

appeared to have more impact on development than the programs in Egypt and Pakistan. In both Zambia and Zaire, AID ensured that CIP commodities directly supported AID's development strategy, helped develop accounting systems to track the commodities and local currency generations, and actively participated in programming the associated local currencies to support AID and host government development activities.

In contrast, we found that the Egyptian public sector CIP and the Pakistan CIP might have achieved more impact if they were more consistent with AID's development strategy and if AID could extend the programs' impact through more effective local currency management. Although an important AID development goal in these countries has been to discourage government subsidies, these governments were providing CIP commodities to public sector entities and government-owned enterprises at subsidized prices. AID officials acknowledged the inconsistencies but noted that AID was trying to discourage such subsidies through its economic policy discussions with these governments. They said that these countries should reap economic benefits as they adopt market-oriented pricing policies more conducive to economic growth and development.

We also found that the local currency programs associated with both countries' CIPs were not effectively extending the development impact of the programs. In Pakistan, AID officials said that they had minimized the amounts of local currency the government had to deposit into a special account and spend for development because they believed that a large local currency program would detract from their economic policy reform efforts. In Egypt, CIP assistance generated local currencies for development; however, Egypt had programmed less than half of these funds for development activities and had accumulated the rest. As of January 1987, Egypt had over $325 million in local currencies that had not been programmed. AID officials in Egypt had not placed a high priority on the local currency program because, given limited AID resources, they believed their first priority should be appropriated funds.

AID's management of local currency in both countries technically complied with legislative requirements. The legislation states that CIPs are to generate local currency when a commodity "sale" results in "accrual of proceeds" to the host government. The position AID officials in Pakistan have taken is that transfers to governmental entities do not constitute a sale or result in proceeds and therefore local currency deposits are not required. We noted, however, that AID officials in other countries, including Egypt and Sudan, were requiring local currency deposits on similar transactions. In Egypt, the legislation only requires that local currencies "be made available" to support development. The accumulated funds are technically still available to be programmed for development.

We reviewed a 1982 internal AID study which examined the question of whether the agency could achieve greater development impact from CIPs worldwide. One AID official in Egypt familiar with the study said that he and others agree with the study's conclusions that suggest that AID should be able to achieve more development impact through the CIP. In this official's opinion, AID has not fully considered how it could achieve such impact because the agency largely regards CIP as a means of serving U.S. export interests rather than as a development resource.

Impact of Cash Less Identifiable but Potentially Important to Development

AID officials believe the ESF cash transfer program can contribute importantly to development if AID's associated policy reform efforts are successful. Their view is that the living conditions of general populations and economic conditions will gradually improve as countries adopt economic policy reforms and thereby remove obstacles to development.

Although, in theory, policy reform efforts should lead to economic growth, we found that measuring the success of AID's policy reform efforts was difficult. (See ch. 3.) Without an assessment of AID's efforts, it is difficult to establish what impact cash transfer programs have had on economic development in recipient countries.

In some cases, AID officials try to increase the development impact of cash transfer programs by requiring recipients to spend an amount of local currencies equal to their grants for purposes mutually agreed with AID. For fiscal year 1987, about 35 percent of all cash transfer funds had associated local currency requirements. Local currencies are also generated from the sale of CIP commodities. By participating in the programming of these currencies, AID can attempt to influence countries to spend the funds for activities that further development. However, our separate report on CIPs points out weaknesses in the management and control of these funds which reduce AID's assurance that local currencies are effectively supporting development.

Conclusions

Because ESF serves U.S. political, security, and economic objectives and because country contexts widely differ, AID officials need flexibility to choose the ESF program type or types that they believe can most effectively and efficiently achieve program objectives.

Each ESF program type offers potential for making a positive impact on development. However, how much AID is able to realize this potential depends on many factors. Project assistance can provide tangible evidence of development if AID and the host country are equipped to effectively implement and monitor project activities and the government has the resources and capacity to sustain these activities. CIP can achieve impact if AID ensures that the program is consistent with development strategy and is effectively controlled to ensure that countries use commodities and local currency generations as intended. Cash transfers offer potentially important benefits to development if AID's economic policy reform efforts associated with these programs are successful. AID can improve the prospects for ESF programs to achieve development impact, regardless of the type, by ensuring that programs are consistent with AID development strategies and are effectively planned and implemented.

AID Has Had Mixed Success in Using ESF to Encourage Economic Policy Reforms

AID recognizes that many countries face severe economic problems, such as mounting debt, balance-of-payments difficulties, and poor economic growth, which require significant structural and economic reforms. Accordingly, AID has adopted economic policy reform as a major development objective of many ESF cash transfer programs. AID uses the assistance to encourage governments to change economic policies that pose major obstacles to development. Needed reforms sometimes involve establishing more realistic interest or foreign exchange rates and reducing government deficits, subsidies, and price controls.

AID has influenced economic policies and reforms in some ESF recipient countries; however, the success of this strategy is difficult to determine because

- other foreign policy and political objectives may constrain AID's ability to strongly pursue reform objectives;
- other bilateral and multilateral donors also promote policy reforms, and reforms cannot always be clearly attributed to U.S. efforts; and
- changing economic and political events can adversely affect or even negate the impact of reform actions.

Given the diversity of U.S. objectives and individual country economic and political circumstances, AID needs flexibility in adopting approaches to encourage economic reforms. However, in our opinion, AID could improve the prospects for successful policy reform efforts by establishing specific policy reform objectives, time frames or milestones for achieving the reforms, and the anticipated economic impact of the reforms for all such programs.

AID Takes Diverse Approaches to Policy Reform

Because country circumstances differ, AID permits its missions to decide whether policy reform will be an objective of an ESF program, what reforms, if any, AID will seek, whether to condition the assistance on specific reform actions, and, if so, how AID will encourage compliance with the conditions. Consequently, how much AID uses ESF assistance to seek economic policy reform varies from country to country.

Some countries receive only one type of assistance—cash, CIP, or projects—while others receive their assistance through a combination of these ESF programs. AID may confine the reforms it seeks to a single sector, such as agricultural pricing policies, or it may promote changes in macroeconomic policies dealing with interest rates, foreign exchange valuation, or taxation. Generally, AID uses cash transfers when seeking macroeconomic reforms.

AID may conduct broad policy discussions with the recipient government without conditioning the assistance on specific reforms, or it may extract a commitment from the recipient country to adopt specific reforms after providing the assistance. In some cases, the recipient must take specific reform actions before AID will disburse the funds. To encourage compliance with agreed upon conditions, AID may simply monitor progress, shift ESF resources among sectors depending upon reform progress, or withhold disbursements until the country takes actions.

AID officials said that having the flexibility and credibility to withhold cash transfer funds is a useful tool to encourage compliance with policy related conditions. In El Salvador, for example, AID successfully used withholding to encourage the government to move some crops to the free market exchange rate in 1983. In commenting on our draft report, AID added that the 2-year obligational authority first provided for ESF in the fiscal year 1987 appropriation legislation has increased AID's leverage in this regard. AID officials said that AID had used this provision in several cases, most notably in the Dominican Republic, where it carried over $13.8 million of that country's fiscal year 1987 ESF assistance into fiscal year 1988 to maintain leverage in encouraging the government to adopt sound fiscal policies and a free market exchange system.

AID officials cautioned, however, that AID must use withholding judiciously because the consequences could be counterproductive to foreign policy or national security objectives. They said that delayed ESF disbursements could have a negative impact on a country's economy and thereby defeat the original objective of promoting economic stability. Withholding can also strain bilateral relations and, as a result, jeopardize other equally important foreign policy objectives, such as maintaining access to military bases.

Difficulties in Measuring the Success of AID's Policy Reform Efforts

AID's success in influencing policy reform actions is often difficult to measure. Changing circumstances within a country, problems in identifying the impetus for specific policy reforms, and the absence of concrete benchmarks to measure progress complicate such assessments.

The number of policy reforms adopted or a recipient's compliance with ESF conditions at a given time are not always valid indicators of success.

Countries may adopt a reform, but subsequent actions or events may negate the impact of the reform. For example, the severe contraction of Jamaica's bauxite industry exacerbated its foreign exchange shortfall and thwarted the country's economic recovery despite policy reforms. Further, political or economic changes can cause countries that are progressing well on adopting reforms to slow, or temporarily stop their progress, as occurred in the Dominican Republic and Zambia in 1987.

Identifying the catalyst for countries' adoption of economic reforms can also pose problems in evaluating AID's efforts. ESF assistance is often intertwined with other donor assistance, particularly from IMF and the World Bank, in terms of exerting influence on recipient governments to adopt reforms. Consequently, it is difficult to determine whether U.S. efforts, the totality of the pressure brought about by the donor community, or the recipient government's own desires or pressing financial needs prompted reform actions.

In some cases, AID has established specific criteria to guide its policy reform efforts. In establishing specific reform objectives, time frames or benchmarks for achieving the reforms, and the anticipated impact for some programs, AID was able to assess what progress was being made. However, AID did not establish such criteria for all such programs.

We reviewed the program assistance authorization documents used to authorize the 1987 ESF cash transfer programs in the countries we visited and found that the substance of the criteria they contained varied widely. Some program documents specified policy reform goals in broad terms without specifying how progress would be measured. The documents sometimes summarized what policy reforms the government had taken since the last cash transfer but did not establish benchmarks to measure future progress. In the absence of specific policy reform goals, we could not determine the significance of the actions taken or their connection to the provision of U.S. aid or U.S. policy reform efforts.

AID's non-project assistance handbook requires that internal cash transfer program documents contain an analysis of the country's balance of payments, budget, and other major economic variables. However, it does not require the kinds of criteria that we believe are needed to enable AID to assess progress. This may have contributed to the wide variance in the substance of the program documents we reviewed.

Program documents authorizing cash transfers to Senegal, Jamaica, and El Salvador specified policy reform objectives in clear direct statements.

These documents spelled out a means of measuring progress and the anticipated impact of the reforms on the economic development of the country. The program document for the fiscal year 1987 cash transfer program in El Salvador contained criteria that the government of El Salvador had adopted in its calendar year 1987 economic plan. The AID document stated that AID would provide cash transfer funds based on El Salvador's normal progress in implementing its economic plan. The criteria in El Salvador's economic plan appeared to be sufficiently detailed to enable AID to measure reform progress.

In contrast, the program document upon which Egypt's cash transfer was based stated policy reform goals in very broad terms, without specifying how AID would measure progress. Although the program document listed policy reform measures that Egypt had taken since the last cash transfer, it did not attempt to explain the significance of the reforms or to relate them to U.S. policy dialogue efforts. Neither did it give a forward look at what further reforms U.S. officials would seek, time frames, or milestones. Zambia's program document included a clear statement of the specific economic policy reforms that the cash transfer was intended to encourage; however, it did not provide any kind of benchmarks or measures to evaluate progress.

We recognize that AID's approach to policy dialogue varies by country. However, regardless of the approach it takes, we believe that AID needs to set forth clear criteria—at least in its internal program documents if not in actual grant agreements—to guide its policy reform efforts. Although establishing such criteria does not eliminate all the difficulties in achieving and measuring progress and impact, setting forth more specific plans for AID's policy reform efforts should improve the prospects for success.

AID Appears to Have Had Mixed Success in Promoting Policy Reform

Recognizing the limitations in measuring the impact of policy reform efforts, it appears that AID has achieved mixed success, both overall and within specific countries. Some of the successes AID and host government officials credit to ESF policy reform efforts include

- exchange rate adjustments and/or reduction of exchange controls in the Dominican Republic, Jamaica, Guatemala, Bolivia, Zaire, and Costa Rica;
- reduced budget deficits in Costa Rica, Senegal, and Jamaica;
- elimination or substantial reduction of price controls over some commodities in Senegal, Pakistan, Zambia, Guatemala, Jamaica, and Zaire;

- adjustment of utility rates to eliminate or reduce the operating losses of state enterprises in Pakistan and the Dominican Republic;
- reduction of import restrictions in Jamaica and Zaire;
- tax or tariff reform in Jamaica, Pakistan, Senegal, Guatemala, and Ecuador;
- divestment of state-owned enterprises in Costa Rica, Jamaica, and Honduras;
- expansion of nontraditional exports in Costa Rica, Jamaica, and Zambia;
- promotion of private sector activities in Jamaica, Pakistan, Senegal, and Costa Rica; and
- support of Egypt's decision to enter into an IMF Stand-by Arrangement.

Despite these successes, governments have not always taken the key policy measures that AID believes are essential to long-term economic recovery and growth. For example,

- El Salvador has not made needed adjustments in its exchange rate or negotiated an IMF agreement,
- Liberia has been slow coming to terms with its burgeoning foreign debt problem,
- Zambia has cancelled the foreign exchange auction that AID supported, and
- Egypt has not moved quickly enough to adopt the economic reforms necessary to address the numerous and costly inefficiencies that pervade the Egyptian economy.

Various Factors Affect AID's Success

AID, host government, and other donor officials emphasized that there can be no recipe approach to successful policy reform efforts, since the approach must be tailored to reflect both U.S. and recipient country objectives and circumstances. No single approach appears to guarantee success, as evidenced by our review. We found examples of policy reform successes and failures under all three ESF program types, in programs seeking extensive and detailed reforms, and in programs either loosely or strictly conditioned.

According to AID officials, the approach AID takes to policy reform is only one element that can influence policy reform efforts. Other factors AID cited as contributing to successful economic reform efforts included:

- Host government is convinced of the need for reform and is actively seeking solutions to its economic problems.

- Host government is able to weather dissent from unpopular reforms without jeopardizing its political stability.
- U.S. agencies agree on what reforms they can seek without jeopardizing other U.S. objectives and what actions they will take if the recipient country does not comply with agreed upon conditions.
- AID clearly specifies ESF conditions, whether in formal agreements or side letters, in a manner not demeaning to the recipient country. These conditions provide AID needed flexibility to respond to changing conditions and contain sufficient criteria to enable AID to measure progress.
- Conditions are realistic in terms of the nature and the number of reforms sought, the government's capacity to implement the reforms, and the time allotted.
- ESF assistance is sufficient to leverage the anticipated policy reforms and cushion the effects of the reforms. The assistance continues long enough to give the country time to institutionalize the reforms.
- Legislative restrictions and unrelated foreign policy interests do not unduly constrain AID's flexibility in designing the program.
- AID provides economic studies or technical assistance in policy analysis to demonstrate the need for a particular reform and the anticipated economic and political costs and benefits to the host government. Technical assistance continues, if needed, to implement the agreed upon reforms.
- U.S. and host government officials mutually respect each other's objectives and constraints, thus enabling officials to openly negotiate reform goals and discuss implementation problems.
- The reforms AID seeks have sufficient potential for improving economic conditions, and positive results stemming from reform actions are readily apparent.
- A reform program with defined goals and objectives is in place, whether national or multilateral.
- Donors coordinate economic reform programs to avoid conflicting objectives and mutually support reform efforts where possible.
- The AID mission actively monitors, facilitates, and encourages reform progress throughout the year to avoid last minute problems which can delay disbursements or jeopardize future programs and strain bilateral relations.
- The recipient government believes that AID will take the agreed-upon actions, such as withholding disbursements, if the recipient country fails to comply with ESF conditions.
- The recipient agrees to program local currency to support economic reforms, if possible.
- Corruption and mismanagement in the recipient government are not major problems.

Of these factors, AID officials said U.S. foreign policy considerations, the degree to which donors bolster each other's efforts, and the host country's commitment to reform had a significant bearing on the success of their efforts.

Foreign Policy Interests Can Influence AID's Policy Reform Efforts

We found that the degree of influence the United States has with the host government can sometimes strongly influence AID's policy reform efforts. The higher the degree of U.S. influence with the host country, the easier it may be to seek reforms. Influence is determined by such factors as (1) the strength of the bilateral relationship, including day-to-day working relationships, (2) the size of the U.S. aid program relative to the magnitude of the recipient country's financial needs, (3) the financial and political costs of specific policy reforms, and (4) the recipient's access to financial assistance from other donors and lenders.

U.S. political objectives associated with some ESF assistance can also affect policy reform efforts. Generally, the more sensitive the foreign policy interests, the more difficult it is to strongly pursue economic reform and strictly condition the assistance. In this regard, the State Department, in commenting on our draft report, said that legislative earmarking of ESF funds adversely affects U.S. policy reform efforts. As previously noted, about 90 percent of fiscal year 1988 ESF is earmarked for specific countries. The Department said that such earmarking is detrimental, in that earmarked countries are normally less willing to agree to reforms that might entail short-run political costs because they know they will receive their ESF anyway. Moreover, by limiting funds available for other countries, earmarking reduces the U.S. ability to reward countries engaged in serious economic reform efforts with ESF. Such assistance could encourage further reform and cushion any adverse effects.

Recipient Countries Ultimately Determine Whether They Will Adopt Policy Reforms

A host government's attitudes regarding the need for reform, its willingness to accept political risks associated with reform, its sensitivity to external parties' involvement in the reform process, and its acceptance of conditions being placed on external assistance influence both AID's approach to policy reform and the success of its efforts. AID can encourage a country to focus on economic reform, influence the policy dialogue atmosphere, and make it easier for the parties to discuss and implement reforms. However, it is political and economic factors in the country that ultimately determine whether a country will adopt the reforms.

Sometimes a recipient agrees to adopt specific reforms but does not comply because of legitimate unforeseen circumstances. An important variable appears to be a country's economic and political situation. AID officials said its success in policy reform is often related to the seriousness of a country's economic situation. AID has better success when a country is in a serious financial position and needs to show progress in policy reform to obtain further external assistance. AID officials felt that they were also more successful when a recipient government was strong enough to weather popular dissent stemming from some policy reforms.

Full Impact of Economic Reforms on Development Not Yet Realized

The full impact of specific policy reforms on revitalizing economies and eliminating constraints to development is yet to be seen. Although countries realize some economic improvements immediately, they reap other economic impacts only over the long term. Sometimes the linkage between specific policy reforms and development is not readily apparent. Even with successful policy reform, some developing countries' economies may not recover enough to be self-sustaining for many years.

Long-Term Development Impact of Reforms Not Always Apparent

The impact of some policy reforms is sometimes immediate. For example, Ghana, Zambia, Senegal, and Somalia showed measurable increases in agricultural production following changes in exchange rates, pricing, and marketing policies. AID officials said that improvements in Zambia's foreign exchange allocations led to an increased use of factory space, from 25 percent to about 50 percent, and increases in nontraditional exports.

However, the effects of policy reform on economic growth and development are often delayed, and the linkage between specific policies and visible development is not always apparent. As a result, it is often difficult to attribute some economic improvements to specific reform efforts. For example, Senegal embarked on medium and long-term economic adjustment programs in 1984 but is just beginning to realize the impact of its reforms. Its real growth rate has improved from a minus 4.5 percent in 1984 to a positive 4.6 percent in 1986, and its budget deficit has been cut in half. Moreover, sometimes countries must adopt additional reforms before they can realize the full impact of reforms that they have already adopted.

The difficulties in linking policy reform efforts to development impacts have led to debates over the merits of using policy reform to address development constraints. AID's position, as stated in its policy guidance, is that policy reform is essential to eliminating long-term development constraints. Although project aid directly targeted at improving basic human needs can sometimes accomplish development goals, even when the overall economic policy environment is less than optimal, AID believes that the soundness of domestic economic and social policies will generally determine whether these development gains will be retained. For this reason, AID officials believe that its policy reform efforts should not be rejected solely because the results may not be measurable in the short term.

Political Objectives May Weaken AID's Economic Reform Efforts

AID officials said that criticism of AID's policy reform efforts may be unwarranted in those countries where sensitive U.S. foreign policy concerns regulate the ESF program. They said that in such circumstances, AID cannot always negotiate what it views as essential reforms or strongly enforce compliance with conditions. For example, AID officials in El Salvador said that they have refrained from pushing hard for further exchange rate adjustments due to sensitive foreign policy considerations. AID officials in Egypt said that they have been unable to push the government to adopt a faster pace of reform due to political considerations. In both countries, AID officials said that they are reluctant to condition disbursements on the adoption of specific reforms because the political pressure to release the funds for reasons unrelated to reform progress would prevent withholding disbursements.

Our July 1985 report on assistance provided to El Salvador and Honduras discusses the use of ESF assistance to promote both economic and political objectives.[1] In that report, we recommended that the Congress provide an explicit statement of the relative importance it attached to improved economic policies in these countries, in view of the uncertainties on the extent of congressional support for macroeconomic reform efforts. One AID official suggested that if the Congress wants economic policy reform, it should consider a separate allocation of funds for encouraging policy reform. This official believes that linking political and economic objectives in the existing ESF program weakens AID's policy reform efforts, since sensitive U.S. political concerns often override economic considerations.

The State Department, in commenting on our draft report, said it did not endorse the view that ESF should be separated into accounts directed at

[1] Providing Effective Economic Assistance to El Salvador and Honduras: A Formidable Challenge (GAO-NSIAD-85-82, July 3, 1985).

either economic policy reform or political/security objectives. State said that separate accounting would reduce the flexibility necessary for successful implementation of ESF programs under varying conditions and could reduce the impact ESF has for either objective.

Policy Reforms Alone May Not Eliminate All Constraints to Development

Policy reform alone may be insufficient to bring about sustainable growth in some countries. For example, AID may need to couple its reform efforts with financial and technical assistance aimed at improving host government institutional capacities to manage economic development activities. In other cases, AID may need to provide other types of assistance to cushion the effects of the reforms on local populations. For example, encouraging a country to reduce subsidies can result in higher prices, which can adversely affect the poor. In such a case, AID might design a program targeting assistance to those least able to afford the higher prices.

Even with successful policy efforts, some developing countries' economies may not recover enough to be self-sustaining for many years. Restructuring economies to reduce their dependence on a single export is a key variable to economic self-sufficiency in many developing countries. Other problems, including the serious debts that continue to negate economic gains in many developing countries, must also be addressed. Clearly, economic policy reform alone cannot solve all the problems that developing countries face.

Conclusions

Differing U.S. objectives in providing ESF assistance and diverse recipient country circumstances preclude recommending a single approach to economic policy reform in ESF recipient countries. Successful approaches in one country have failed in others. AID needs flexibility in tailoring its approach to policy reform to country-specific situations in order to respond to changing political and economic situations.

In some cases, unsuccessful policy reform efforts can be attributed, in part, to unforeseen circumstances that are sometimes beyond AID's control. In other cases, AID has been constrained from strongly pursuing its policy reform objectives for fear of jeopardizing other U.S. foreign policy objectives. Although the strong political and security objectives of the ESF program, which often compete with economic development objectives, must be recognized, economic policy reform may be crucial to some countries' economic stability and long-term growth. Failing to strongly pursue policy reform could perpetuate the need for high levels of assistance and over the long term contribute to the instability the United States seeks to eliminate.

If cash transfers based on policy reform are to be justified, AID needs to demonstrate as precisely as possible what progress is being made. Although the difficulties in achieving and measuring reform progress and impact are clear, we believe that AID could improve the prospects for successful policy reform efforts by establish sufficient criteria to guide its policy reform efforts.

Recommendation

To improve the prospects for successful policy reform efforts and facilitate measuring progress, we recommend that the AID Administrator require that each internal AID program document justifying cash transfer programs seeking policy reforms

- clearly state the specific economic policy reforms the cash transfer is intended to encourage,
- specify the anticipated time frames or milestones for achieving these reforms, and
- state the anticipated impacts of the reforms on economic development.

Wherever country circumstances render it practical, AID should also include such details in grant agreements. Subsequent cash transfer program documents should include an assessment of reform progress and impact using the above criteria.

Agency Comments and Our Evaluation

AID said that wherever possible, it would try to enhance its current efforts to ensure that program authorization documents contain the information we suggested and that subsequent program documents assess progress in relation to these criteria.

The State Department agreed that by increasing the specificity and transparency of policy reform goals, it may become easier to evaluate policy reform efforts. State cautioned, however, that the U.S. ability to establish specific goals having a reasonable chance of being achieved may be limited in situations of great political sensitivity. The Department added that in countries where discussion of economic policy reform is sensitive, establishing fixed reform targets in advance could undermine the government's ability to undertake the reforms by fueling public opposition to perceived external domination of economic policy-making. State feared our recommendation could discourage U.S. policy reform efforts where political factors implied great risk of failure and favored discussing key economic issues with key officials rather than a highly specific program with unrealistic expectations.

In pointing to the need for better criteria on reform goals in ESF program documents, we stated that country-specific circumstances would dictate whether specific reform goals should be included in grant agreements. We agree that in politically sensitive cases, their inclusion in formal agreements could lead to public disclosure and possible opposition to reform efforts. Outlining these goals in internal U.S. documents, such as ESF program documents, in such cases can facilitate measurement of progress without leading to the potential problems State envisions.

AID Has Focused Increased Attention on Accountability for ESF Cash Transfers

In enacting legislation requiring separate accounting for ESF cash transfers, the Congress sought to improve AID's ability to know whether funds were spent for authorized purposes. Accordingly, it specified that recipients should maintain cash transfer funds in separate accounts and not commingle them with other foreign exchange. We reviewed implementation of this new requirement in four countries and found the following:

- Some recipients initially segregated their cash transfers into separate accounts but subsequently transferred the funds to accounts containing other foreign exchange. In these cases, AID could not directly trace the funds to their end use.
- Under some circumstances, AID may be unable to avoid commingling cash transfer funds with other foreign exchange.
- AID is able to provide cash to host governments through some ESF sector grants and projects without requiring separate accounting because these grants fall outside AID's definition of cash transfer.
- AID has not established a systematic means to independently verify that cash transfer funds were used for their intended purposes.
- AID did not include cash transfers in its 1987 assessment of internal controls required by the Federal Managers' Financial Integrity Act but will assess implementation of the separate account requirement during 1988.

Opinions vary on the value of separate accounting; however, the requirement appears to have had the beneficial effect of focusing AID's attention on what uses it should specify for cash transfer funds in each ESF country. By consciously focusing on how the funds will be used, AID can better direct the funds to those uses that it believes can best address each country's economic needs.

Separate Accounting in El Salvador

Based on concerns that reported problems in El Salvador's foreign exchange management could lead to diversions of U.S. assistance, the Congress passed legislation in 1984 requiring that cash transfers be maintained in separate accounts. In proposing that the separate account requirement be extended to other countries, the House Committee on Appropriations cited the improved accountability that resulted from separate accounting in El Salvador.

In reviewing separate accounting in El Salvador, we found that even before the Congress mandated separate accounting, AID was aware of problems in El Salvador's foreign exchange allocation system and was assisting the government in overcoming the identified problems. AID had engaged a U.S. public accounting firm to (1) assist the government in developing a system to more fairly allocate foreign exchange, (2) ensure that priority items were imported, and (3) address the problem of capital flight caused by firms reporting erroneous prices for imports and exports. El Salvador integrated its operation of the separate account into this system.

Over the last 3 years, this technical assistance has resulted in a very detailed review process for imports and exports, including a price checking system designed to identify pricing abuses, a prioritization of eligible imports aimed at stimulating the economy, and a more objective system of determining which importers receive foreign exchange. Computerization of the system has provided El Salvador better economic data, which it can use in economic decision-making.

When AID originally instituted separate accounting, it required the government to pay for eligible imports directly from the separate account. However, this system proved unworkable because the government could not accurately estimate how much foreign exchange to reserve for transactions financed from the account until firms actually imported the items. Also, the administrative difficulties of keeping track of changing prices and determining the eligibility and status of transactions delayed disbursements.

In revising the system, AID still requires the government to pay for large oil imports directly from the account but permits El Salvador to advance its own funds to importers for other proposed transactions and then seek reimbursement from the account. Funds remain segregated and are disbursed only after the host government verifies each transaction's eligibility and price. After the funds are disbursed, an AID contractor independently verifies the government's eligibility checks. If the contractor finds a transaction to be ineligible, the government can either submit an alternative transaction for reimbursement or refund the separate account. This method of accounting for the funds constitutes an attribution of import transactions to the cash transfer rather than direct payment from the separate account. However, because the system precludes commingling of cash transfer funds with other foreign exchange, AID believes that it provides adequate assurance that separate account funds are used for authorized purposes.

AID officials said that the extensive checking system developed for El Salvador extended well beyond what is needed to operate a separate account. These officials added that although separate accounting has proved to be a useful management tool, the overall efforts to improve foreign exchange management, not just separate accounting, were responsible for the improvements. They cautioned that the system developed in El Salvador may not be appropriate for all countries because

- AID helped to develop the system in response to specific, identified problems that may or may not exist elsewhere, was costly to develop, and continues to entail considerable staff time to effectively implement and monitor;
- the size of the ESF program and congressional concerns for accountability provided AID leverage to enlist El Salvador's cooperation in making needed changes, but AID may have less leverage in other countries;
- El Salvador recognized that it needed to correct the identified problems and therefore permitted U.S. contractors to become involved in the operations of its central bank, but not all countries would permit such involvement by an external party;
- imposing import and foreign exchange controls in countries with more market-oriented economies could undermine AID's objective of encouraging market forces.

Problems Encountered in Extending Separate Accounting to Other Countries

We reviewed implementation of the separate account requirement in El Salvador and three other countries—Egypt, Jamaica, and Senegal. In the latter countries, we found that the recipients transferred their grants to commingled accounts before disbursing the funds. As a result, the recipients could attribute disbursements to the amounts of the cash transfer funds, but AID could not directly trace the funds to their end use.

Egypt initially deposited its March 1987 cash transfer into a separate account but then transferred the funds to a commingled account from which it spent the funds. Because other funds were in the latter account, Egypt could only attribute disbursements to the amount of its cash transfer. When AID discovered that Egypt had not spent the funds directly from the separate account, it required Egypt to redeposit the amount of the cash transfer—$115 million—into the separate account and spend it directly. Egypt used these funds to make debt payments on past Foreign Military Sales loans.

Similarly, Jamaica initially deposited cash transfer funds into a separate account but subsequently transferred the funds to a commingled account, spent the funds, and attributed disbursements of debt payments to the amount of its cash transfer.

Although Senegal agreed to deposit its cash transfer payments into a separate account, its membership in the West Africa Monetary Union required Senegal to deposit its foreign exchange into an account containing all members' foreign exchange. The Union initially placed the funds into a separate account but then transferred the funds to a commingled account. Monetary Union officials said that once the Union had credited Senegal's account with an equivalent amount of local currency, the Union owned the dollars and had no obligation to AID to account for their use.

AID May Be Unable to Avoid Commingling in Some Cases

Although AID's implementing guidance on separate accounts states that funds should not be commingled with other foreign exchange, the guidance appears to permit commingling when cash transfers are used to pay debts. Moreover, it is unclear how AID will be able to avoid commingling cash transfer funds with other foreign exchange when the funds are provided to members of regional monetary unions, to support foreign exchange auctions, or to serve as U.S. contributions to international funds.

Debt Payment

AID's cash transfer guidance states that host governments may pay debts from general debt accounts using cash transfer funds if they can document that they (1) transferred funds from a separate account to a general debt account and (2) made debt payments equal to the transferred amounts from the general debt account. Unless the debt account contains no other revenues, this system results in the cash transfer being commingled with other funds, as occurred in Jamaica.

Foreign Exchange Auctions

AID provides cash transfers to support foreign exchange auctions in some ESF countries. In such auctions, the host government auctions off foreign exchange to importers for needed imports. This system helps to establish a fair market value for the country's currency and an equitable means of allocating foreign exchange. In such cases, countries would commingle U.S. cash transfers with other donors' contributions, thereby precluding a direct tracking of funds to their end use. For this reason, AID's guidance states that AID can support auctions through cash transfers but only when separate accounts are possible and AID can track the funds.

It is unclear how such segregation will be accomplished. AID officials said that, although it might be somewhat cumbersome, AID could arrange with host governments to hold some weekly auctions that contain only U.S. cash transfer funds. Unless such segregation is accomplished, artificial accounting for cash transfer funds could occur. For example, in Zambia, one donor requested separate accounting for its contributions to preclude its funds from being auctioned to pay for imports from ineligible countries. Although Zambia credited that donor's contribution to a separate subaccount, all auction funds remained commingled, and Zambia simply attributed acceptable transactions to that donor's separate subaccount. Such assurances are not very meaningful, since Zambia's weekly auction reports were insufficiently detailed to permit donors to know what specific imports their contributions financed. In fact, the documentation we reviewed was insufficient to enable us to verify that $2 million of a $17 million cash transfer was actually transferred into the auction between December 1985 and October 1986. AID officials said that because Zambia credited local currencies totaling the full $17 million to a special account, as required by its cash transfer agreement, Zambia had simply made an accounting error in failing to credit the $2 million to the auction account. However, neither AID nor Zambian officials were able to provide documentation to show that the funds found their way into the auction.

Regional Monetary Unions

AID provides cash transfers to some countries, such as Senegal, that are members of regional monetary unions. As mentioned, monetary unions sometimes do not allow members to maintain their own foreign exchange accounts but instead require them to deposit their foreign exchange in a pooled account managed by the monetary union. Because foreign exchange is commingled and AID could not trace U.S. funds to their end use, AID is examining how it can implement separate accounting in such countries.

At the time of our review, AID was working out an arrangement with the West Africa Monetary Union to provide a subaccounting for U.S. cash transfers to Senegal deposited to the Union's pooled account. One option being considered was permitting the Union to attribute U.S. imports financed from the pooled account to the amount of the cash transfer. Such a system would constitute attribution rather than direct disbursement from a segregated account. As of February 1988, AID policy officials had not issued guidance on how AID officials should handle cash transfers going into monetary union countries.

Contributions to International Funds

AID will also be unable to avoid commingling when cash transfers serve as U.S. contributions to international funds. For example, in fiscal year 1987, AID provided a $35 million cash transfer to Ireland through the International Fund for Ireland and Northern Ireland. In such cases, AID would be unable to directly trace the use of the cash transfer funds because the funds would be commingled with other donors' contributions.

Some Cash Is Transferred to Recipients Outside AID's Definition of Cash Transfer

The applicability of separate accounting to ESF funds may hinge on AID's interpretation of what constitutes a cash transfer. AID's Non-Project Assistance Handbook defines cash transfer as the provision of cash assistance in the absence of, or in advance of, specifying requirements for use. This definition may be outdated in view of the new separate account legislation, which permits AID to specify uses for the funds and trace them to their end use. AID's separate account guidance defines cash transfer as "the furnishing of rapid-disbursing balance-of-payments assistance on a cash basis to a recipient in furtherance of United States national security, economic, and developmental objectives."

AID's definition permits some latitude in determining what programs constitute a cash transfer and thereby require separate accounting. For example, AID can provide ESF cash grants to host governments through certain ESF sector grants and projects without requiring separate accounting because AID does not consider them to be cash transfers. The features of some ESF sector grants and cash transfers can be quite similar. Under one type of sector grant, AID provides cash to host governments, which then make local currencies available for specified development activities within the sector. As long as the host government accounts for the use of the local currencies, it does not have to account for how it used the dollars. AID officials could not readily determine the extent to which AID is funding such sector grants.

AID also provides cash as a feature of some ESF projects but terms the cash payments "performance disbursements" rather than cash transfers. For example, in Egypt, AID is implementing an Agricultural Production and Credit Project, whereby Egypt will receive $100 million in three cash installments after enacting specified agricultural policy reforms. Egypt must then deposit an equal amount of local currency into the government's agricultural credit bank for loans to farmers. Although the bank must account for these local currency loan funds, Egypt can spend the cash as free foreign exchange without accounting for its use. As with sector grants, AID officials could not quantify the extent to which

AID is funding this type of project. These features are similar to those of cash transfer programs prior to separate accounting.

AID legal advisers told us that the distinction between ESF cash transfers, sector grants, and performance disbursements is somewhat blurred since the features are sometimes similar. They said that generally, AID has not considered sector grants and projects using performance disbursements as cash transfers because (1) AID usually provides the funds for a development purpose rather than for balance-of-payments support and (2) project assistance requirements govern the activities that the grants support. AID officials said that AID is considering expanding its use of both sector grants and performance disbursements.

AID Does Not Require Independent Verification of Disbursements From Separate Accounts

AID requires cash transfer recipients to periodically report to AID on how they used the funds, to make the records supporting these reports available to AID for audit for a period of 3 years after the final disbursement from the account, and to redeposit any funds spent for purposes that AID might later disallow. AID does not plan to systematically verify the accuracy recipients' reports.

Given the size of the cash transfer program and congressional concerns for financial accountability, we question whether AID should rely totally on unverified reports and limited audit coverage to provide assurances that countries spent the funds for authorized purposes. Our past reviews and recent fieldwork have shown that, when asked, host government officials sometimes cannot substantiate the reports they submit to AID. Further, AID itself has identified inadequate audit coverage as an agency-wide internal control weakness in past assessments under the Federal Managers' Financial Integrity Act. Accordingly, there is no guarantee that these accounts will be audited regularly unless special provision is made.

Cash Transfers Will Be Included in AID's Internal Control Assessments

The Federal Managers' Financial Integrity Act requires each agency to assess its internal controls and report to the President on any identified internal control weaknesses. In its report for 1987, AID said that it had not assessed newly instituted agency procedures for tracking ESF cash transfer dollars or its management of associated local currencies. To remedy this shortcoming, AID said that it would require its overseas missions to assess and test control objectives and techniques related to ESF cash transfers during fiscal year 1988 to determine compliance with AID policy and the adequacy of procedures and controls. An AID official said that increased testing of internal controls over local currency funds would be part of these assessments.

AID Recommendations on the Uses of Cash Transfer Funds

Before AID instituted separate accounting for cash transfers, it did not seek to determine how recipients used the dollars transferred under the programs. Once separate accounting created a means of tracking funds to their end use, AID began examining the question of what uses it should specify for them. In October 1987, AID issued guidance to its staff overseas recommending allowable uses for cash transfer funds depending on country-specific circumstances. Table 4.1 describes four different country situations varying in the degree to which recipients impose controls over imports, foreign exchange allocation, and foreign exchange rates and, for each case, AID's recommended use and expected controls.

Table 4.1: AID Priorities for Uses of Cash Transfer Funds Based on Recipients' Foreign Exchange and Import Systems

Characteristics	Recommended Uses	Controls
1. Strict government or monetary control over imports, foreign exchange allocations, and exchange rates. No substantial liberalization underway or anticipated.	Import financing, either direct or reimbursable, with the following priorities: a. U.S. imports of raw materials, intermediate and capital goods, and essential consumer goods. b. Other sources as approved.	No military, police equipment or other ineligible imports. Price checking, where needed, to prevent capital flight. Reimbursements must be for specific transactions and part of a timely sequence, not attributions.
2. Substantial liberalization of import/foreign exchange control systems is underway or anticipated, and AID wishes to encourage rather than impede this movement toward market forces.	Support for auction or auction-like foreign exchange system, where priorities for auctioned dollars are a. Approved U.S. imports. b. Free World transactions.	Dollars must remain segregated until used and be traceable to identifiable import transactions. Procedures ensure that dollars are not used for military or other ineligible items. Totally unrestricted auctions are not appropriate.
3. Debt is a significant barrier to growth and development, and the recipient's keeping currenton debt service payments will have a significant effect on leveraging additional flows of development finance; or institutional arrangements preclude traceable use of the funds.	Debt service payments, where U.S. nonmilitary items shall have first priority.	AID precludes use for military debt, unless the Congress approves, and other uses prohibited by law.
4. Relatively advanced recipients with essentially market-determined foreign exchange allocation/liberal import systems and well-established standards of financial accountability.	Debt service or large-scale import transactions.	Procedures should be simplified and as minimal as possible. Simplified monitoring procedures appropriate where AID has no development presence.

As shown by table 4.1, AID recommends that cash transfers be used to finance U.S. imports and, in some cases, imports from other countries when the recipient tightly controls imports and foreign exchange allocation. For countries with more market-oriented economies, AID recommends that cash transfers support foreign exchange auctions, be used for debt payment, or finance large-scale import transactions. By matching the use of the funds to fit the degree to which the country controls economic activity, AID hopes to ensure that ESF funds do not inadvertently undermine efforts to promote economic activity based on market forces rather than government controls.

Payment of Military Debt Generally Precluded

AID's guidance also specifically precludes the use of ESF cash transfers to repay debts incurred under the U.S. Foreign Military Sales program, except where statute or legislative history validates such use.

The new policy grew out of congressional inquiries about the legality of AID's allowing Egypt to use its March 1987 cash transfer to repay its military debt to the United States. Both we and AID were asked to provide opinions on this issue in view of the prohibition in the Foreign Assistance Act against the use of ESF for military purposes. AID concluded that payment of debt served an economic purpose rather than a military purpose and was therefore not illegal. We concluded that it was improper for AID to allow Egypt to use its ESF to repay military debts because (1) there was "too close a nexus between the purchase of the military equipment and the ESF disbursement to be consistent with the statutory prohibition," and (2) AID had testified before the Congress in 1984 that it would consider such use illegal.

In view of the disparate views, AID requested that the Department of Justice also examine this question. Justice concluded that AID may make ESF funds available to foreign nations for debt relief even when the debt to be repaid includes outstanding military debt because (1) repayment of debt, including military debt, aids the economy of a foreign nation and (2) does not directly advance any military purpose. It further concluded from reviewing ESF legislative history that the Congress had, in effect, authorized such use in the case of Israel. Although Justice supported AID's view, AID said that in view of expressed congressional objections, it would not allow recipients to use ESF for this purpose except where the Congress so authorized.

Has Separate Accounting Improved Accountability for Cash Transfers?

AID officials were divided in their opinions on the value of separate accounting in achieving greater accountability for cash transfers. Some felt that increased financial accountability could broaden congressional and public support for the cash transfer program and that AID should welcome the opportunity to demonstrate its control of the assistance. However, many others feared that the separate accounting requirement could adversely affect the program.

Some said it was fruitless to insist on a detailed accounting for U.S. assistance because such accounting cannot provide assurance that countries use foreign exchange freed as a result of the assistance in ways acceptable to the United States. Others said that insisting on detailed accounting could reduce the program's flexibility, result in cumbersome administrative requirements that could slow the rate of disbursement, and jeopardize achievement of other U.S. foreign policy objectives. The former AID Administrator testified before the Congress that AID's accountability over cash transfers should be measured in terms of improvements in the recipients' economies brought about as a result of the policy reforms AID encouraged. In commenting on our draft report, AID reiterated its concerns about the administrative burdens associated with separate accounting and the limits it places on AID's flexibility in designing cash transfer programs. (See app. II.)

The concerns AID officials expressed over separate accounting are understandable, particularly since the requirement is new and AID has not had time to resolve some of the difficulties. However, we believe that some of AID's criticisms of separate accounting may be overstated. First, concerning the administrative burden, we believe that the normal start-up activities associated with any new system may account for some of the time AID has spent setting up separate accounting. Once the systems are established, the time AID needs to spend on related matters should diminish.

Some officials may also have concluded that separate accounting is administratively burdensome by equating the extensive verification systems related to foreign exchange management in El Salvador to separate accounting. As noted, these activities extend well beyond the requirement for separate accounting, and AID officials believe that type of system has limited transferability to other countries. Regarding delays in disbursing the funds, if countries operate import-oriented programs on a reimbursement basis as is the case in El Salvador, disbursements should not be unreasonably delayed.

Second, it is true that even with detailed financial accounting for U.S. cash transfers which separate accounting can provide, AID still has no assurance of how recipients spend funds freed as a result of the assistance. However, before separate accounting was instituted, AID had no means of knowing either how recipients spent their cash transfers or how they spent the funds freed as a result of the assistance. The current accounting system is an improvement in that AID can now provide an accounting for the U.S.-provided funds.

Third, we do not believe that separate accounting limits AID's flexibility in designing cash transfer programs that best meet the country's economic needs. AID still has the flexibility to design programs that finance imports, assist members in paying external debt, support foreign exchange auctions, or serve as contributions to international funds. While the specific accounting mechanism varies with the type of program, the program design options remain open.

Fourth, some have argued that ESF cash transfers are offered in exchange for the cooperation of countries in furthering U.S. interests, for example, access to military bases or peace in the Middle East, and that AID should allow these countries to spend the funds as they see fit without undue accounting requirements. However, we believe that achieving good financial accountability for cash transfer funds strengthens, rather than weakens, the ability of U.S. administrators to pursue the major foreign policy objectives of the ESF program. By being able to demonstrate that recipients are using their assistance in ways that enhance their economic and political stability, U.S. officials can gain the popular and congressional support needed to continue these efforts. An important benefit of separate accounting is that it encourages AID to focus attention on how the funds will be used. By consciously examining alternative uses for the funds, AID can better direct the funds to those purposes that can best contribute to each country's economic and political stability.

Finally, we agree that if AID chooses economic policy reform as an objective of cash transfer assistance, it should assess progress being made in this regard as one measure of the program's accomplishments. However, the Congress has also expressly indicated that it wants better financial accounting for cash transfers. We believe that separate accounting provides AID a means of ensuring that cash transfer funds are used for their intended purposes.

Conclusions

The separate accounting requirement for cash transfers provides AID a means of assuring the Congress that funds are used for intended purposes. While not all AID officials are convinced of the value of separate accounting, we believe that it has important advantages. However, to ensure that the congressional intent of the new legislation is met, AID needs to resolve certain questions.

First, in view of congressional concerns for accountability over ESF funds, we believe AID needs to ensure that it maintains accountability over all cash transferred under the ESF program. AID's current funding mechanisms for some ESF sector grants and projects permit AID to continue to transfer cash without a means of determining how the funds were used. As a matter of policy, we believe that AID should require recipients to maintain all ESF cash grants in separate accounts whether or not it terms the grants cash transfers. Moreover, AID missions should be required to justify any deviation from this general policy.

Second, AID needs to reexamine the accounting mechanisms it will permit for cash transfers. In enacting the separate account legislation, the Congress specified that cash transfers should not be commingled with other sources of foreign exchange. The accounting system AID will permit for debt payments may result in such commingling, and it is questionable whether AID will be able to avoid commingling when cash transfers support foreign exchange auctions, are provided to members of regional monetary unions, or serve as contributions to international funds. In such cases, AID needs to explain more clearly in its program documents how it will maintain accountability over the funds transferred.

Finally, because cash transfers comprise about one-third of all U.S. bilateral economic assistance, knowledge of how recipients use these funds is important to an understanding of how the program contributes to economic development. AID's guidance on the recommended uses of cash transfers should help AID officials decide what uses are appropriate to specific country contexts. However, in view of the size of this program and congressional concerns about financial accountability, we believe that AID should not rely only on unverified reports submitted by recipient governments to ensure that funds are used for their intended purposes.

Recommendations

To ensure that AID's implementation of separate accounting is consistent with congressional intent, we recommend that the AID Administrator

- describe how AID will maintain accountability in cash transfer programs when it cannot avoid commingling cash transfers with other foreign exchange,
- require recipients to maintain all ESF cash grants, not just those termed cash transfers, in separate accounts, and
- ensure that all cash transfer separate accounts be independently audited once every 3 years.

Agency Comments and Our Evaluation

AID said that as a general rule, it should be able to ensure that all cash transfer separate accounts are audited once every 3 years, as we recommended.

On our recommendation that AID explain how it will maintain accountability for cash transfers deposited to commingled accounts, AID said that it could ensure that all the funds in a commingled account are used for appropriate transactions but could not trace U.S. funds to specific procurements. AID said that it would have to obtain special statutory authority to trace funds contributed to the International Fund for Ireland and Northern Ireland and would have to forego support of other programs, including some foreign exchange auctions, if it were required to trace cash transfer funds to their specific use.

The point of our discussion of monetary union countries, foreign exchange auctions, and international funds was that AID would find it difficult to meet the legislative requirement that cash transfer funds not be commingled with other foreign exchange in such circumstances. We did not intend to suggest that AID should forego its support of such programs. If AID can ensure that all funds going into such commingled accounts are used for authorized purposes, this would appear to provide sufficient accountability. However, in such cases, we believe AID should explain in its cash transfer program documents why it cannot avoid commingling and the means through which it will maintain program accountability. For example, AID could state whether there would be a subaccounting for cash transfer funds or if AID would ensure that all transactions from the commingled account were used for authorized purposes, what records would be maintained and by whom, what reports would be required, and whether AID would make an independent verification of records and reports.

In commenting on our recommendation that all ESF cash grants be maintained in separate accounts, AID said that it had appointed a working group to consider our recommendation along with other alternatives. AID said that the working group will consider how it can best satisfy congressional intent in enacting the separate account requirement while preserving the features that AID believes differentiate sector grants from cash transfers. AID did not articulate the specific features that it believes differentiate ESF sector grants from cash transfers.

We endorse AID's establishment of a working group to examine the question of accountability in ESF sector grant and performance disbursement programs in view of the uncertainties that AID officials expressed to us about when separate accounting should be required. In addition to considering separate accounting for such grants, we believe that the working group should seek to quantify the extent to which the agency is funding such programs and examine whether current AID policy guidance needs to be modified to clarify distinctions between cash transfers and ESF sector grants.

Economic Support Fund Obligations for Fiscal Year 1987 and Proposed Levels for Fiscal Year 1988

Dollars in millions

Countries by region	Cash transfer	Commodity import program	Projects	Fiscal year 1987 total[b]	Fiscal year 1988 total (estimated)
Africa					
Botswana	$ •	$ •	$5.0	$5.0	$ •
Cameroon	7.5	•	1.5	9.0	•
Chad	•	•	5.0	5.0	10.0
Djibouti	•	•	1.9	1.9	3.3
Gambia	6.0	•	•	6.0	•
Kenya	•	14.5	.5	15.0	10.0
Liberia	•	5.0	10.0	15.0	11.0
Madagascar	•	•	1.0	1.0	•
Mauritius	•	1.0	•	1.0	•
Mozambique	•	9.8	.2	10.0	•
Niger	1.9	•	.1	2.0	•
Senegal	11.6	•	.4	12.0	10.0
Seychelles	•	2.4	•	2.4	3.0
Somalia	15.1	•	2.0	17.1	25.0
South Africa Republic	•	•	1.7	1.7	3.4
Sudan	•	•	•	•	14.4
Tanzania	12.0	•	•	12.0	•
Zaire	•	•	10.0	10.0	•
Zambia	12.2	•	.2	12.4	•
South Africa regional	•	•	24.2	24.2	•
Total[a]	**$66.3**	**$32.7**	**$63.7**	**$162.7**	**$90.0**
Asia, Near East, North Africa, and Europe					
Asia					
Afghanistan	$ •	$ •	$12.2	$12.2	$22.5
Cambodia	3.4	•	•	3.4	3.5
Pakistan	•	58.0	192.0	250.0	220.0
Philippines	150.0	•	85.0	235.0	174.0
Thailand	5.0	•	•	5.0	5.0
Near East and North Africa					
Egypt	$115.0	$200.0	$495.0	$810.0	$815.0
Israel	1,200.0	•	•	1,200.0	1,200.0
Jordan	7.0	60.0	37.0	104.0[c]	18.0
Lebanon	•	•	7.0	7.0[d]	•
Morocco	•	•	10.0	10.0	20.0
Oman	•	•	15.0	15.0	13.0
Tunisia	•	8.3	7.9	16.2	10.0

(continued)

Countries by region	Cash transfer	Commodity import program	Projects	Fiscal year 1987 total[b]	Fiscal year 1988 total (estimated)
Europe					
Cyprus	•	•	15.0	15.0	15.0
Ireland	35.0	•	•	35.0	35.0
Portugal	64.7	•	.1	64.8	32.0
Spain	•	•	5.0	5.0	3.0
Turkey	100.0	•	•	100.0	32.0
Poland	•	•	1.0	1.0	1.0
Local Cost Support	•	•	•	•	10.0
Regional Programs	•	•	16.3	16.3	7.0
Total	**$1,680.1**	**$326.3**	**$898.5**	**$2,904.8**	**$2,636.0**
Latin America and the Caribbean					
Belize	$1.7	•	$1.6	$3.3	$ •
Bolivia	7.2	•	.3	7.5	7.3
Costa Rica	119.8	•	22.7	142.5	90.0
Dominican Republic	•	•	.2	.2	•
Ecuador	18.8	•	.5	19.3	•
El Salvador	157.0	•	124.5	281.5	185.0
Guatemala	90.8	•	24.3	115.0	80.0
Haiti	33.0	•	2.2	35.2	•
Honduras	100.0	•	31.8	131.8	85.0
Jamaica	23.0	•	2.0	24.9	•
Peru	•	•	5.3	5.3	•
Uruguay	11.5	•	.6	12.2	•
Regional Programs	$6.5	$ •	$23.0	$29.5	$15.0
Regional Office for Central America and Panama		•	5.3	5.3	•
Total	**$569.2**	**$0.0**	**$244.2**	**$813.3**	**$462.3**

(continued)

Countries by region	Cash transfer	Commodity import program	Projects	Fiscal year 1987 total[b]	Fiscal year 1988 total (estimated)
Other					
AID Bureau for Science and Technology	•	•	1.0	1.0	•
Total	**$2,315.5**	**$359.0**	**$1,207.4**	**$3,881.9**[e]	**$3,188.3**
Percent of total	59.7	9.2	31.1	100.0	

[a]Totals may not add to detail due to rounding.

[b]Fiscal year 1987 figures include the supplemental.

[c]Contains obligations from fiscal year 1985 supplemental.

[d]Contains obligations from fiscal year 1983 supplemental.

[e]An additional $30.353 million from previous years' appropriations was obligated in fiscal year 1987 and another $65.650 million appropriated in fiscal year 1987 will be carried over to be obligated in fiscal year 1988.

Comments From the Agency for International Development

UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

ASSISTANT
ADMINISTRATOR

MAY 10 1988

MEMORANDUM

TO: Mr. Frank C. Conahan,
Assistant Comptroller General,
National Security and International Affairs Division
United States General Accounting Office

FROM: AA/PPC, Richard E. Bissell

SUBJECT: Comments on GAO Draft Report, "Improving the Impact and Control of Economic Support Funds"

This memorandum responds to your letter of April 6, 1988 in which you requested comments on subject draft report.

We believe the draft report provides a constructive view of ESF cash transfers. We agree with the GAO that A.I.D. needs considerable flexibility to choose from among a number of program modalities if it is to effectively and efficiently achieve program objectives. There are some instances, however, in which GAO's interpretation of specific facts and events, and the significance it attaches to them, differ from ours. The balance of this memorandum comments on specific aspects of the draft report that we believe need clarification, and also provides A.I.D.'s response to the draft report's recommendations. Except for our first comment which is in reference to pages 70-74, the rest are keyed sequentially to sections of the draft report.

<u>Clarifying Comments</u>

Now on pp. 44-46.

<u>Pages 70-74</u>. The assertions (a) that separate accounting does not limit our flexibility in designing cash transfer programs that meet a particular country's need, and (b) that separate accounting need not pose undue administrative burdens or delay disbursement of the assistance are not consistent with our experience in attempting to implement the system. An inordinate amount of A.I.D. staff time has had to be devoted to working

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out the arrangements necessary to meet the legislative requirements. It has also in some cases placed a heavy burden on recipients. Israel, for example, specifically objected to the administrative burden created by the special account. This would be even more of a problem for recipient countries with less developed administrative structures. We believe that GAO's assertions are valid only if the focus of the accounting on the use of cash transfer dollars is to ensure that the dollars are not being used for inappropriate purposes, rather than on the particular uses of the dollars.

Under ideal circumstances, the GAO case made with regard to cash transfers as a quid pro quo for the cooperation of countries in furthering U.S. interests--access to military bases, peace in the Middle East--might make sense. We doubt, however, that this is so in the imperfect set of circumstances in which A.I.D. operates, especially since we cannot withhold what are effectively rent payments to bring about a better utilization of these resources. Congressional earmarks may well work to undercut A.I.D.'s ability to achieve policy reform in these, as well as in other cases.

Now on pp. 15-16.

Page 24. In the discussion of program objectives best met through cash transfers, the draft report would present a somewhat more balanced view if it pointed out that Congress also shares the view that in particular instances U.S. interests are best served through the use of the cash transfer modality. For example Congress has earmarked cash transfer assistance for Israel and Egypt, required a cash contribution to the Fund for Ireland and,from some quarters, asked that A.I.D. provide cash assistance to the Aquino government in the Philippines.

Now on p. 17.

Pages 27-28. The draft report implies that the only reason for our CIP in Egypt is that Congress mandated it, or that it stemmed from an Agency response to the separate account requirement. A.I.D. has requested a $200 million CIP level for Egypt for a number of years. Thus, it was not necessary for Congress to earmark ESF resources to assure the establishment of a $200 million level CIP. Rather, we believe the earmark was Congress's way of ensuring that A.I.D. would not disproportionately cut the CIP (in favor of project aid) if we had to make room for more cash transfer assistance.

Now on pp. 19-21.

Pages 31-33. While no explicit statement is made, the draft report implies that A.I.D. officials interpreted local currency requirements in the case of the Pakistan CIP in a manner that is in violation of applicable legislation. This possible

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misunderstanding probably derives from the way USAID/Pakistan treats public sector CIP procurement. When the CIP involves sales by the public sector to the public, producing sales proceeds (e.g. fertilizer), USAID requires a Sec. 609 (F.A.A.) deposit. Where, on the other hand, the CIP involves an import for a ministry's use with no sale of goods to the public but merely a budget transfer to the Ministry of Finance, USAID requires no deposit in that no sale, within the meaning of Sec 609, has occurred. This interpretation of Section 609 has been verified by our Regional Legal Advisor in Islamabad and the Office of General Counsel in A.I.D./W. The draft report should be appropriately modified.

Deleted.

Page 33. While the funds must be provided to Egypt, the Agency has discretion in the legislation to use the $200 million for the Egypt CIP program for either the public or private sectors, the mix to be determined by A.I.D.

Now on pp. 23-24.

Pages 36-39. The discussion of A.I.D.'s economic reform efforts would be more complete if it recognized the role of two year obligational authority for ESF as a source of leverage. This authority was first provided for ESF in FY 1987, under the Continuing Resolution. There are several cases in which two-year availability has been used to positive effect. The most notable has been in the Dominican Republic where approximately $13.8 million in FY 1987 ESF balance of payments assistance was carried over into FY 1988 to maintain leverage towards achieving sound fiscal policies and a free market exchange system.

Now on pp. 25-26.

Pages 39-41. The draft report cites El Salvador as an example of a case in which the FY 1987 cash transfer agreement did not include concrete benchmarks to be used in measuring the success of A.I.D.'s policy reform eforts. While it is true that the 1987 ESF agreement contained no explicit targets, that agreement was, nevertheless, predicated upon a GOES commitment to implement an economic plan acceptable to A.I.D. This plan contained specific targets that had in large measure emerged from the protracted A.I.D./GOES negotiations. These targets were all detailed in the PAAD for the 1987 ESF assistance and they provide adequate benchmarks for measuring progress.

Now on p. 27.

Pages 42-44. We believe that the notable progress made by Costa Rica in the divestment of state-owned enterprises and expansion of non-traditional exports should be included among the cited examples of successful A.I.D. promoted policy reforms.

Now on pp. 43-44.

Page 70. The Department of Justice opinion on the eligibility of FMS debt repayments was not limited to Israel as is implied

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in the draft report. The Justice memorandum stated that their conclusion applied in the same fashion to every country receiving ESF. However, as a matter of policy, A.I.D. currently restricts the use of cash transfer assistance for FMS debt servicing purposes to Israel.

Response to Recommendations

See p. 33.

A.I.D. will try to enhance current efforts wherever possible, and depending on individual country circumstances, to more fully comply with GAO's first recommendation--that program authorization documents contain specific reform objectives, timeframes or milestones, and expected impact, and that succeeding program documents assess progress in relation to these criteria.

See p. 47-48.

Part (a) of the second recommendation asks A.I.D. to describe how it will maintain accountability in cash transfer programs when it cannot avoid commingling cash transfers with other foreign exchange. This does not present a problem as long as we are working under the original intent of the legislation. In enacting a separate account requirement, we believe original Congressional intent was to ensure that cash transfer dollars were not used for corrupt or otherwise inappropriate purposes, rather than a desire to trace the individual dollars to the particular procurement. Against this background, we believe that statutory and GAO requirements are satisfied if the control system assures that all the money in a commingled account, as for example, a foreign exchange auction fund or an international development fund, is used for appropriate transactions. On the other hand, if we must trace the individual dollar to the particular procurement we will need either special statutory authority (as in the case of the Ireland Fund) or will be forced not to participate in other programs (as in the case of some auction systems).

See pp. 47-48.

The A.I.D. Administrator has appointed a senior staff working group to expeditiously consider part (b) of the second recommendation--that would have A.I.D. require recipients to maintain all cash grants, not just those termed cash transfers, in separate accounts--along with other alternatives that would satisfy what we believe was Congressional interest in enacting a separate account requirement, and at the same time preserve and enhance the features which we believe set the different types of sector program assistance apart from cash transfers.

See p. 47 and GAO comment.

As a general rule it should be possible to ensure that all cash transfer separate accounts are audited once every three years, as part (c) of the second recommendation calls for.

The following is GAO's comment on the Agency for International Development's letter dated May 10, 1988.

GAO Comment

In a draft of this report, we recommended that separate accounts be audited at least every 3 years. Upon further consideration, we have deleted the specific reference to the frequency of the audits to avoid the impression that every 3 years is a desirable standard. It may be feasible and desirable to provide for more frequent audits.

Comments From the Department of State

United States Department of State

Comptroller

Washington, D.C. 20520

May 4, 1988

Dear Mr. Conahan:

I am replying to your letter of April 6, 1988 to the Secretary which forwarded copies of the draft report entitled Foreign Aid - Improving the Impact and Control of Economic Support Funds (Code 472131) for review and comment.

The enclosed comments on this report were prepared in the Bureau of Economic and Business Affairs.

We appreciate the opportunity to review and comment on the draft report.

Sincerely,

Roger B. Feldman

Roger B. Feldman

Enclosure:
As stated.

Mr. Frank C. Conahan
Assistant Comptroller General,
National Security and
International Affairs Division,
U.S. General Accounting Office,
Washington, D.C.

GAO DRAFT REPORT COMMENTS: FOREIGN AID - IMPROVING THE IMPACT AND CONTROL OF ECONOMIC SUPPORT FUNDS (CODE 472131)

See p. 9.

The draft GAO report generally does a good job of indicating the constraints faced by the U.S. Government (USG) in trying to use cash transfer ESF to encourage economic policy reform in developing countries. We agree that economic assistance in the absence of a policy environment conducive to economic growth is not the ideal use of ESF, and that cash transfer assistance provides more leverage for reforms than either project or CIP assistance. Commitment to reform by the recipient country government is a critical determinant of a successful reform program. The USG has a better chance of achieving policy reforms, other things being equal, when sensitive political factors do not constrain our ability to condition the assistance in a credible way on reform actions that the recipient country must take. Short-run political considerations can work against the medium-to-long term efforts to persuade the recipient country to achieve a self-sustaining and stable economy.

See p. 29.

The draft report notes that over 90 percent of ESF funds are currently earmarked. Although GAO mentions that Congressional restrictions on the use of ESF funds often constrain their effectiveness for economic policy reform, the report does not give sufficient weight to the role of earmarking in this regard. When ESF funds are earmarked for a particular country, our ability to use the funds as leverage for policy reform is seriously undermined. The government benefiting from the earmark, knowing that it will almost certainly receive the funds in any case, is normally less willing to agree to reforms which may entail short run political costs. Alternatively, by severely limiting funds available for non-earmarked countries, earmarking sharply reduces our ability to reward friendly governments engaged in serious economic reform efforts with ESF which could encourage further reform and cushion the adverse impact of adjustments on the populations concerned.

See p. 9 and pp. 33-34.

We do not quarrel with the GAO recommendation that the USG increase the specificity and transparency of its policy reform goals so that the results of these efforts become easier to evaluate. However, we would caution that, in situations of great political sensitivity, our ability to establish specific goals which have a reasonable chance of accomplishment may be very limited. In addition, in countries in which discussion of economic policy reform measures is politically sensitive, the very act of establishing fixed reform targets in advance can

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undermine the government's ability to undertake reforms by fueling public opposition to perceived external domination of economic policy making. The GAO recommendation could have the unanticipated consequence of discouraging USG efforts at stimulating policy reform in cases where political factors imply great risks of failure. In some situations a less specific economic reform program which allows us to discuss economic reform issues with key officials of the recipient government may be preferable to a highly specific program with unrealistic expectations. In the latter case, our credibility on economic policy issues with the recipient government could be seriously damaged, and our efforts will be counterproductive to improved economic performance.

We do not endorse the view expressed by one A.I.D. official that, if Congress really wants policy reform, it should divide ESF into separate accounts directed at either economic policy reform or political/security objectives. This would run counter to the flexibility which the GAO report rightly says is necessary for successful implementation of ESF programs under varying conditions. It also would tend, in many cases, to reduce the impact our ESF has for either type of objective. Ultimately, achievement of economic and political stability as well as self-sustained growth in friendly developing countries directly serves our overall political and strategic objectives.

Eugene J. McAllister
Assistant Secretary
Bureau of Economic and
Business Affairs

Related GAO Reports

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Foreign Aid: Potential for Diversion of Economic Support Funds to Unauthorized Use (GAO/NSIAD-87-70, Jan. 1987)

Foreign Assistance: U.S. Use of Conditions to Achieve Economic Reforms (GAO/NSIAD-86-157, Aug. 1986)

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The Philippines: Accountability and Control of U.S. Economic Assistance (GAO/NSIAD-86-108BR, May 1986)

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AID Needs to Strengthen Management of Commodity Import Programs (GAO/NSIAD-84-47, Feb. 1984)

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