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# VIETNAM
# DELIVERING ON ITS PROMISE

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## ACRONYMS AND ABBREVIATIONS

| | |
|---|---|
| ADB | Asian Development Bank |
| ASEAN | Association of South East Asian Nations |
| CEPT | Common Effective Preferential Tariff |
| CIE | Center for International Economics |
| CIEM | Central Institute for Economic Management |
| CPNET | The government information network |
| CPRGS | Comprehensive Poverty Reduction and Growth Strategy |
| CPLAR | Cooperation Program on Land Administration Reform |
| DANIDA | Danish International Development Assistance |
| DFID | Department for International Development |
| DHS | Demographic and Health Survey |
| GDP | Gross Domestic Product |
| HIPC | Highly Indebted Poor Country |
| IMF | International Monetary Fund |
| JETRO | Japan External Trade Organization |
| MFN | Most-favored nation |
| MOF | Ministry of Finance |
| MOLISA | Ministry of Labor, Invalids and Social Affairs |
| NEA | National Environment Agency |
| NSCERD | National Steering Committee for Enterprise Reform and Development |
| OECD | Organization for Economic Cooperation and Development |
| OSS | One-Stop Shop |
| PRGF | Poverty Reduction and Growth Facility |
| PRSC | Poverty Reduction Support Credit |
| UNCTAD | United Nations Conference on Trade And Development |
| UNICEF | United Nations Children's Fund |
| US | United States |
| VAT | Value Added Tax |
| VLSS | Vietnam Living Standards Survey |
| VPSC | Vietnam Postal Savings Service Company |
| WTO | World Trade Organization |

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The report was written by a team led by Martin Rama with overall guidance provided by Homi Kharas, Klaus Rohland and Nisha Agrawal, and advice from John Samy (ADB). Theo Ib Larsen, with Viet Tuan Dinh and Thang Long-Ton, wrote section 1, on recent macroeconomic developments; Philippe Auffret, with Theo Ib Larsen and Viet Tuan Dinh, was responsible for section 2, on trade liberalization; Thomas A. Rose and Miguel Navarro-Martin were the main authors of Section 3, on credit and banking, with a contribution from Shigeko Hattori (ADB); Daniel R. Musson wrote section 4, on the reform of state-owned enterprises, with Duc Minh Pham; Amanda S. Carlier and Rob Swinkels were in charge of section 5, on private sector development, with additional inputs from Ziba Cranmer and Deepak Khanna; Nguyen The Dzung and Christopher Gibbs wrote section 6, on land; section 7, on education, was written by Thanh Thi Mai, with Christopher Shaw; Samuel Lieberman, Nga Nguyet Nguyen and Adam Wagstaff were in charge of section 8, on health, with a contribution from Sarah Bales; Anjali Acharya wrote section 9, on the environment; Martin Rama and Nga Nguyet Nguyen were responsible for section 10, on coping with social impacts; Soren Davidsen wrote section 11, on legal reform, with Jesper Kammersgaard; Edward Mountfield wrote section 12, on public expenditure management, in close collaboration with Minh Van Nguyen; Martin Rama and Rob Swinkels were the authors of section 13, on public investment; and Ramesh B. Adhikari (ADB) and Soren Davidsen wrote section 14, on public administration reform.

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# EXECUTIVE SUMMARY

After a slowdown period during the East Asian crisis, Vietnam is again growing quite strongly. This improvement is partly due to a series of policy measures that put the economy on an enhanced medium-term growth path. Confidence in the private sector was boosted by the adoption of a detailed reform program in 2001. New private businesses are currently being established at a rate of 1,600 per month, and in early-2002 a special meeting of the Party Central Committee gave the strongest endorsement of the private sector ever. Investors are reacting positively to the reform announcements and commitments made by Vietnam. The country is getting better grades from sovereign risk rating agencies and the macroeconomic situation is stable. Despite an unfavorable external environment, in terms of demand and prices, exports can be expected to pick up as a result of trade liberalization efforts, including the Vietnam-US bilateral trade agreement. Strong economic growth is also associated with an external debt at a very manageable level.

This favorable outlook, combined with Vietnam's remarkable long-term growth potential, suggests that the effects of the East Asian crisis are over. A period of high GDP growth rates, possibly in the order of 7 percent per year, is likely. As in the 1990s, Vietnam could be entering a phase of prosperity. This upbeat assessment of the macroeconomic prospects should not lead to complacency, however. During the previous phase of rapid growth, a key question was whether Vietnam would become a market economy. Today, the question is rather what kind of market economy? Also, the pervious phase of rapid growth was characterized by a dramatic reduction in poverty. The poor represent 37 percent of the population in 1998, compared to 58 percent five years earlier. The question today is: will this new phase of rapid growth be as pro-poor as the previous one?

Vietnam is committed to socially inclusive development. The recently completed Comprehensive Poverty Reduction and Growth Strategy (CPRGS) translates a vision of transition towards a market economy with socialist orientation into concrete public actions. It aims at full openness to the global economy over the coming decade, and the creation of a level playing field between the public and the private sectors. It emphasizes that the transition should be pro-poor, and notes that this will require heavier investment in rural and lagging regions, and a more gradual reform implementation than is often recommended by international advisors. It gives strong emphasis to poverty reduction and social equity, and to a more modern system of governance. The CPRGS is a product of the government of Vietnam, involving all of the relevant agencies and sectors in its preparation. Such ownership and determination are very good augurs. But the task of implementing the CPRGS should not be underestimated.

**The challenges ahead**

Three important challenges lie ahead. The first one is related to further progress in economic reform. Over the last three years, the government of Vietnam has made an impressive series of commitments, and approved a vast number of initiatives aimed at accelerating the transition to a market economy. But these efforts have proceeded at an uneven pace, and some of them may be on a collision course. Fast progress in liberalizing foreign trade and integrating with the world economy is increasingly at odds with the slowdown of state-owned enterprise reform. There is a risk that the unreformed enterprises, once confronted with competition in product markets, will try to shift the burden of their inefficiency to other sectors of the economy, either through explicit transfers or through arrears in the service of their debts. Equally important, decisions are increasingly implemented at the local level. The uneven progress in private sector development across provinces illustrates the difficulty to align concrete policy-making at the local level with the commitments and orientations of the government as a whole. Similar problems occur in almost every sectoral policy.

The second important challenge faced by Vietnam concerns poverty alleviation. The phase of prosperity that followed *doi moi* was remarkable in that it was not accompanied by any noticeable increase in inequality. Aggregate inequality indicators such as the Gini index remained basically unchanged over the 1990s. More disaggregate analyses show that the poor did better than the rich, in relative terms. The combination of fast growth and stable inequality explains the accomplishments of Vietnam in terms of poverty reduction. However, in the absence of vigorous action inequality is likely to increase, maybe substantially, during the new phase of growth. This is because the poverty effects of land redistribution in rural areas are probably reaped by now. At the same time, integration with the world economy will make skills more valuable, so that inequalities in education will translate into increasingly bigger inequalities in opportunities and earnings. The gap between urban and rural areas will widen, as will the gap between those who can fully benefit from globalization and those who are left behind. Increasing inequalities in health cannot be ruled out either.

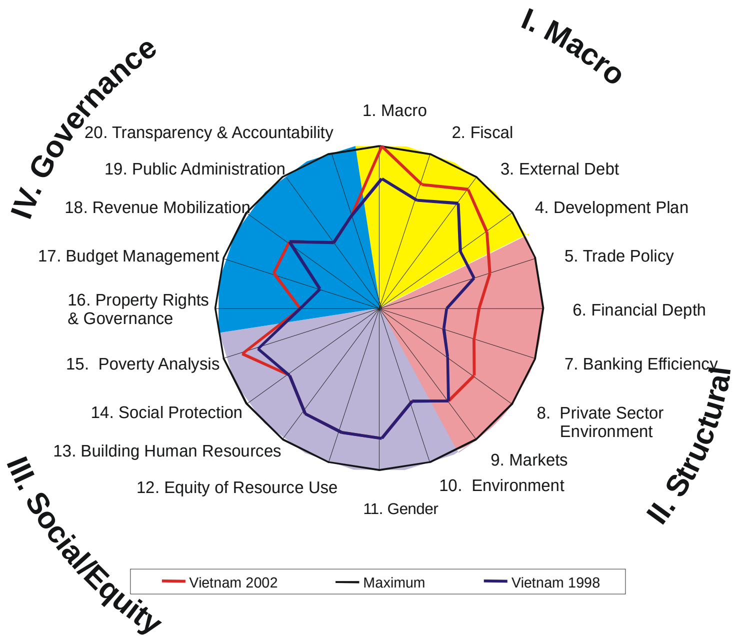
The third challenge faced by Vietnam, and certainly not the smallest, is improving the quality of its governance. It will not be possible to address the other two challenges without an effective public administration, endowed with the appropriate financial management instruments. Implementing the structural reforms and improving the outcomes in the social sectors are tasks requiring a government that can deliver in practice. But the legal framework, the budgetary system and the administrative structure of Vietnam are partly inherited from the period with a centrally-planned economy, and not well adapted to its current needs. This mismatch is a source of economic inefficiency. It also leads to an unhealthy relationship between enterprises (private as well as state-owned) and government officials. The combination of increasingly wealthy urban groups with the perception that wealth is associated with corruption has proven damaging in other countries in the region. If Vietnam fails to address its governance problems, and lets the vested interests capture government transfers to offset their inefficiencies, the new phase of prosperity could later be seen as “borrowed growth”.

The current situation of Vietnam can be interpreted through the lens of its overall policy environment, and how it compares to that of other countries. The World Bank’s country policy and institutional assessment considers 20 indicators: four relating to economic management, six to structural policies, five to policies for social inclusion and five to governance. The outcome of such an assessment is represented graphically in figure I. The further out a policy or indicator is from the center of the graph the better the quality of the score for that characteristic.

As of 1998, at the beginning of the East Asian crisis, Vietnam’s main strengths were in macroeconomic management and in policies for social inclusion. In both respects, Vietnam vastly outperformed the average low-income country. Its indicators actually were similar to those of the most successful 20 percent of countries in this group. Vietnam’s main weaknesses were in structural policies and governance, where it was not doing better than the average low-income country. Four years later, remarkable progress has been accomplished in macroeconomic management. And there has also been progress regarding structural reforms, especially in the trade and financial sectors. These are the improvements underlying the upbeat mood of investors and, more generally, the new phase of economic growth. But the structural indicators are still far behind.

Progress in the other areas was much more modest, and for some indicators there was no progress at all. Vietnam remains a leader in social inclusion and equity, and it has substantially improved its capacity for poverty analysis. But its advantage over other low-income countries in this area has now stabilized. In governance, there was important progress in budget management, but little to report regarding other indicators. Governance is an area where Vietnam still has a long way to go.

**Figure I. Vietnam's strengths and weaknesses**




## Current trends

Good fundamentals in terms of macroeconomic stability, and the adoption of structural reforms, have led to increasing confidence in the economy. In 2002, the expected rate of GDP growth, in real terms, is around 6 percent, which represents an improvement over previous years. This growth performance is sustained by a strong expansion of domestic consumption. Investment has also been an important source of growth in 2002, suggesting that the recovery is sustainable. The many new enterprise start-ups and stronger investor confidence have boosted capital formation and brought the number of new business registrations to nearly 50,000 over a two-year period. By July 2002, investment from new small and medium enterprises in the formal economy alone was about 40 trillion dong (approximately 2.7 billion US dollars). This is the equivalent of around 9 percent of GDP. The formal private sector also employs one million people, which represents almost two thirds of employment in state-owned enterprises.

The non-state domestic sector continues to lead the growth process. Manufacturing thrives, with the private domestic and the foreign invested sectors recording annual output growth rates of 19 and 15 percent respectively. At 12 percent year-on-year output growth, the state sector's achievements are more modest. This mirrors Vietnam's gradual transition to a market economy, with many state-owned enterprises facing increased competitive pressures and harder budget constraints. The formal private sector of the economy has actually outperformed state-owned enterprises, in terms of value-added growth, at least since 1997.

The export performance is less stellar for now. In the first eight months of 2002, exports were down 1.7 percent year on year. This decline is partly due to lower prices of crude oil and other commodities, which account for more than a quarter of Vietnam's total exports. However, in the third quarter of 2002 there was a turn-around in export performance, and growth of around

7 percent is expected for the year as a whole. Substantial exports growth can be expected as a result of progress in trade liberalization, including the Vietnam-US bilateral trade agreement that became effective in 2001.

The fiscal stance remains prudent, with an expected budget deficit of approximately 2.5 percent of GDP before on-lending for 2002. The overall expenditure level has been restrained Capital expenditures, which increased in 2001 to rehabilitate infrastructure damaged by floods, have been capped. As a share of GDP, capital and current expenditures have actually declined during 2002. Credit policies continue to be in line with the program supported by the IMF. Significantly, growth in credit to state-owned enterprises has been kept below the agreed level. In 2002, inflation will reach 4.3 percent, up from nil or slightly negative levels in previous years.

Vietnam's debt service capacity is estimated to be sustainable over the medium to long term, which probably makes it ineligible for debt relief under the so-called HIPC initiative. The stock of outstanding external debt is expected to reach 13.3 billion US dollars by the end of 2002. This represents 37 percent of GDP and 84 percent of exports, with an annual debt service of 8 percent of exports. Most of this debt is on concessional terms, and carries very low interest rates. The outside perception of Vietnam, by risk-rating agencies, is consistent with this medium-term sustainability.

The inflow of resources from abroad is stable, or even increasing. Although information in this respect is limited, remittances from overseas Vietnamese are becoming an important source of foreign currency, and could exceed 2 billion US dollars in 2002. Foreign direct investment commitments have decreased compared to 2001, but implementations have not. If anything, the actual inflow of foreign capital has been on a slightly upward trend. The relative stability of foreign direct investment is often compared to the sizeable rise of commitments in China. But meanwhile East Asia, as a whole, experienced a sharp reduction in foreign investment flows.

**Implementing the reforms**

Continued implementation of structural reforms in the enterprise and financial sectors, and improved management of public expenditures and public investment, are essential to secure that the domestic debt situation remains sustainable in the medium term. The different pace at which reforms are proceeding is another source of concern. The current situation is characterized by uneven progress in the march towards development. While trade liberalization has been moving ahead steadily, even faster than anticipated, in other areas there is much slower progress, if not outright stagnation. If state-owned enterprises cannot cope with increased competition in product markets, they may face difficulties in servicing their debts, further burdening the already heavy stock of non-performing bank loans. The possibility for new entrants to operate in Vietnam's banking system will put an additional strain on a still partly unreformed state sector.

It does not follow that trade liberalization should proceed at a slower pace, or that the progress accomplished so far should be reverted. Over fifteen years tariffs were reduced, a large number of quantitative restrictions was abolished and the foreign exchange rate regime was liberalized. And there is a determination to keep moving in the same direction, as reflected by the recent signature of the Vietnam-US bilateral trade agreement, and the steps undertaken to join the WTO. Given the commitments already made, Vietnam would only stand to lose if it delayed its accession to the WTO. The cost of joining in has become heavier over time, and may increase substantially in 2005, with the conclusion of the Doha development agenda. Moreover, China's recent WTO accession puts Vietnam at a disadvantage. And because WTO implicitly discriminates against non-member countries, accession would put Vietnam in a better position to protect its interests against unjustified barriers to its exports.

The alternative is to reinvigorate the other structural reforms. For state-owned enterprises, the reform plan foresees about 1,700 ownership transformations over the period 2001-05. The main instrument to carry out these transformations is equitization, which is arguably not identical to outright privatization. Equitization is a process whereby some or all of the state capital in the enterprise is sold in the form of shares at a price based on the book value of the assets. In practice, however, it is difficult to implement without the consent of the enterprise director and a majority of the work force. Other reform instruments include direct sale, lease, assignment and liquidation. Enterprises in a long list of sectors deemed "strategic", on the other hand, are to be restructured but remain in state hands.

While efforts to transform and restructure state-owned enterprises have so far been on track, the process appears to be slowing down. At present, the reform mechanisms in place amount to an option, rather than a mandate, for enterprises to divest. Reluctance to do so is understandable when over-staffing is pervasive and transformation could lead to massive job losses. Excessive debt burdens may also dissuade potential buyers. While a compensation scheme aimed at encouraging voluntary job separations has recently been put in place, mechanisms to resolve non-performing loans are only partially effective for now. But the slowdown in the transformation process also seems to reflect the opposition of many state-owned enterprise directors, who could lose from ownership transformation.

A new state-owned enterprise reform plan is in preparation. The names of the enterprises to be transformed will be published, indicating the timetable for their transformation. The monitoring and enforcement of the process, however, may remain weak. New mechanisms are also being considered to deal with the debts of state-owned enterprises to be transformed. But the specifics are unclear yet. Appropriate design is key to avoid creating incentives for further expansion of bad loans and to minimize fiscal risk. Better information on state-owned enterprises would also help strengthen the process. The Ministry of Finance is working on new accounting standards to be issued in 2003. Their adoption would go a long way towards improving transparency. But their effectiveness will crucially depend upon the disclosure requirements to be specified and the enforcement mechanisms to be adopted.

In the banking sector, four large state-owned commercial banks still account for 73 percent of the total assets in the system. But over the past decade they have slowly started to evolve from specialized policy lending vehicles to more commercially-oriented financial intermediaries, with the greatest progress seen in 2001 and 2002. These state-owned commercial banks are now complemented by a number of joint-stock banks, joint-venture banks, and branches and representative offices of foreign banks. In parallel, there has also been a rapid deepening in the level of monetization of the Vietnamese economy. The ratio of bank credit to GDP increased from 13 percent in 1990, to 27 percent in 1995, and further to 44 percent in the year 2000. The growth of the non-banking financial sector, and especially of the insurance business, has been remarkable as well, even if the size of the sector remains small in absolute terms.

The transformation of the financial sector has progressed in some areas at a managed pace, in others with some fits and starts. But the change has not come about without cost. Continued policy lending practices through the 1990s, and limited credit assessment skills in the wake of rapid credit growth have led to the accumulation of non-performing loans. To address this concern, the government has embarked on an important overhaul of the banking system through a multi-year restructuring and recapitalization program. Progress in the resolution of old non-performing loans has been slow. The main difficulty is with loans without collateral, mainly to state-owned enterprises. State-owned commercial banks find it difficult to meet their resolution targets, owing to delays in state-owned enterprise reform.

Going forward, the regulation and supervision of the banking sector would need to be upgraded to promote more commercially-oriented practices. Evaluation of asset quality and other risks in the banks' operations should become routine tasks for inspectors. International auditing standards should also be adopted. And the State Bank of Vietnam should concentrate more clearly on its core central banking and bank supervisory functions.

Regarding private sector development, a significant shift in attitudes occurred with the enactment of the Enterprise Law in 2000, and more recently with the formal endorsement of the private sector following the Fifth Plenum of the Ninth Party Congress in March 2002. Since the enactment of the law, the growth in the number of enterprises registered and in the output of the formal private sector, have been spectacular. But despite all this progress the formal domestic private sector in Vietnam is still tiny and relatively fragile. As of 2002, it accounted for less than 4 percent of total GDP, 6 percent of output in manufacturing, and about 3 percent of total employment.

Growth in the private sector will be of critical importance to absorb the 1.2 million new entrants to the labor market each year. To sustain that growth over time, improvements in the business environment will be necessary. At present, the playing field in Vietnam is far from level. Different enterprise groups, whether they be state-owned enterprises, foreign enterprises, formal private enterprises or household businesses, are each governed by separate legislation and regulations. Access to key factor markets of land and capital also varies according to enterprise type and results in different enterprise behavior. The local dimension is important as well. Local governments have a direct influence on access to factor markets, operating licenses, investment approvals, business registration, and on-site inspections of all sorts.

**Increasing inequalities?**

The growth phase experienced by Vietnam in the 1990s was remarkably pro-poor. This was to a large extent due to land reform. The allocation and distribution of land-use right certificates to households in rural areas, where most of the poor live, amounted to a formidable redistribution of wealth. This allocation was also the source of a major increase in agricultural production. But land reform was a one-time intervention, leading to an increase in the level of household consumption, not necessarily to a sustained increase in its growth rate. In fact, rural households whose livelihoods rely on farming only are the poorest of all; those who manage to diversify into non-farm employment do better.

Further progress in the allocation of land-use right certificates, necessary to increase inefficiency, may not have the same impact on poverty. If anything, it could make some groups more vulnerable. If not done carefully, the allocation of land in mountainous areas could adversely affect ethnic minority groups. Issuing certificates to communities is one option to explore, particularly for ethnic minority groups that do not traditionally recognize the land rights of individual households. The development of an urban land market may be more favorable to the poor, by making urban housing more affordable.

Another key asset, skills, could be associated with increasing inequality. Integration into the world economy will raise the payoffs to education. In the early stages of transition to a market economy, earnings did not vary much with schooling. But an upward trend in the labor market returns to education was already visible in the 1990s. As the economy further integrates with global markets, the skill premium will probably increase. Current inequalities in enrolment and achievement will therefore translate into bigger inequalities in earnings. As a result, the gap between urban and rural areas will increase. The gap between those who are skilled enough to fully benefit from globalization, and those who are not, will increase as well.

Policies in the social sectors, and especially in education and health, are the key to prevent inequality from increasing, or at least from increasing too much during the new phase of growth of the Vietnamese economy. Expansion of school enrolment in Vietnam has been impressive, and it has been characterized by equal access for boys and girls. Over the last five years, there has been a two-fold increase in enrolment in lower secondary education, and a four-fold increase in enrolment in upper secondary education. However, the challenge of getting the last group of children into primary school is quite significant, given that these children often come from poor and remote areas. Also, the proportion of primary school pupils with low achievement in mathematics and reading is sizeable, especially among the poor.

Expanding the coverage and the quality of education, and reducing its cost for the poor, are necessary to prevent inequalities to widen excessively during the new phase of growth of the Vietnamese economy. A high and evenly distributed level of education will also be key to make the new growth phase sustainable in the long run. Further integration into the world economy will necessitate a skilled labor force. Shortages of qualified workers, technicians and managers are already apparent in the most dynamic economic centers. From this perspective, there is a clear link between education and efficiency.

However, expanding the coverage and improving the quality of education requires important changes in the management of public expenditures and public investments, including the allocation of resources across sectors and within sectors. Allocation across provinces matters as well, especially given the increasing reliance on local revenue sources.

A tendency towards increased inequality in health outcomes can also be feared. Vietnam has made impressive gains in its health indicators during the last decades. It has reduced child mortality and maternal mortality to levels typically observed in countries whose income per capita is two to three times higher. Malnutrition among children, although still high by international standards, fell considerably during the second half of the 1990s. But at the same time, there is a growing disparity between the poor and the better off. Under-five infant mortality did not decline among the poorest segments of the population. Basic drugs became cheaper, but out-of-pocket payments for health services are noticeably high, and probably unaffordable by the poor. These trends are partly associated to the gradual introduction of market forces in the health system.

Redressing the imbalances will require changes in the financing of health. The overall allocation of resources across sectors needs be reconsidered. But allocation of resources between health care facilities and levels matters too. More emphasis on preventive care (relative to curative care) and on primary care is necessary, especially at the provincial level. Another imperative is to address the persistent inequalities in health outcomes that are linked to reliance on provincial revenue sources. It may be also the time for Vietnam to review its health insurance system.

Vietnam's rapid growth has been accompanied by damage to its natural resources and declines in environmental quality. Land degradation continues, while biodiversity is under threat. Forest cover has improved marginally, but its quality remains a concern. In cities and towns air, water and solid waste pollution need to be addressed, while environmental services fall short of demand. Coastal and marine resources are also severely affected. Environmental degradation is disproportionately affecting the poor, through impacts on their health and livelihoods. The poor are also often the most vulnerable to natural disasters.

Economic reforms, such as trade liberalization and the transformation of state-owned enterprises, may create losers. While the population at large has much to gain, reforms may also have differential impacts on different groups. Given the priority attached by the government to socially-inclusive development, appropriate mechanisms need to be found to assist those who stand to lose. Social safety nets are also needed to cope with the effects of adverse shocks that are not directly related to the reforms, such as those related to health status or environmental degradation. The issue arises whether social safety nets might be enough to make the new growth phase of Vietnam pro-poor.

In some cases, identifying the potential losers is feasible, and mechanisms to redress the damage can be considered. The social safety net established for redundant workers from state-owned enterprises is a case in point. Since 2002, a fund operated by the Ministry of Finance provides severance pay in more generous terms than specified in the Labor Code to workers who lose their jobs due to the transformation of state-owned enterprises. In other cases, however, the impact of shocks and reforms is more defuse so that targeted approaches need to be ruled out.

By poor country standards, Vietnam has an extensive safety net. Moreover, the volume of resources channeled through it has increased substantially over time. The social safety net is also progressive. Poor households receive bigger transfers, in percentage of their consumption, than rich households. And the system became even more progressive with the increase in the volume of resources it channeled. But the small size of the transfers, as a proportion of household consumption, suggests that safety nets cannot, on their own, make a big dent on poverty and inequality.

In the long term, the best bets of Vietnam to make growth pro-poor, and to limit the increase in inequalities, lie elsewhere. A vibrant private sector, providing job opportunities to the rural poor, and to migrants to urban areas, is key to poverty alleviation. An effective delivery of basic services, leading to sustained gains in educational attainment and health outcomes, is essential to contain the growth of inequalities. However, progress in the structural reform agenda, leading to further private sector development, and in the social agenda, leading to higher human development, will be difficult to achieve without substantial improvements in governance.

**Modern governance**

As Vietnam enters a new phase of rapid growth, the expansion of economic activity could well outpace the modernization of the legal framework. Secure property rights, an independent judiciary and legal transparency are needed to keep attracting investment and generating jobs. The right for citizens to complain and have their grievances addressed are essential to improve public service delivery in areas such as health and education. Effective law implementation is key to avoid abuses and corruption. In all of these areas, much remains to be done.

Vietnam's legal development has been shaped by the transition from a centrally planned economy to a market economy with socialist orientation. Economic liberalization, integration with the rest of the world and a social agenda underlie the legal reform process observed in practice. An important foundation for further legal reform is the Legal Needs Assessment, conducted in 2001 and 2002. However, the policy actions it lays out could be better interpreted as a list of objectives. Considerable efforts will be required to transform them into concrete programs. If an appropriate management structure for legal reform is not put in place, the action plan may fall short of meeting its objectives.

Achieving a socially inclusive development will also require sustained efforts to improve public expenditure management. The current management system of Vietnam has strengths as well as weaknesses. While the government has already made some good progress in addressing the weaknesses, deeper reforms are needed. Processes for prioritizing expenditures remain ineffective. The absence of a credible multi-year fiscal framework means that expenditure planning is conducted without reference to medium-term resource constraints. Prioritization is carried out separately for capital spending (by the Ministry of Planning and Investment) and for recurrent spending (by the Ministry of Finance), with significant imbalances between the two.

There is lack of clarity about the respective roles of sector ministries and provinces in prioritizing expenditures, with unrealistic centrally-specified norms laid down by sector ministries and then largely ignored by provinces.

A fundamental step is integrating budget formulation. Vietnam needs to move beyond "dual budgeting". Capital and recurrent expenditure budgeting should be integrated within a single medium-term expenditure framework, with a single macroeconomic framework and a single set of development goals. But progress in this direction is jeopardized by inadequate financial management information systems. The mechanisms for information recording and reporting that do exist are fragmented, slow and unreliable. Strengthening and integrating financial management information systems are the critical next steps. Poor financial management information also acts as an impediment to further devolution and delegation to local governments.

Regardless of the speed at which the unification of these two public expenditure mechanisms takes place, other measures are warranted to strengthen the public investment program. This program emerges as a compilation of national, regional, provincial and sectoral strategies and plans. Its preparation follows a complex process of consensus building designed to guide decision-making by all actors in the economy. The resulting document is a list of projects that may or may not be implemented over the plan period.

The introduction of an information system, allowing the classification of projects by their source of funding, sector and region, would help align investment policies with development objectives. Important steps in this direction have already been undertaken for the 2001-2005 public investment program. However, a live database of large projects, including an assessment of their economic rationale, and their priority in terms of their contribution to growth and poverty alleviation, still needs to be set up.

Each country's path to good governance is different, depending upon culture, administrative traditions, economic conditions, and many other factors. The public administration system of Vietnam, which is based on the traditional model, still suffers from many weaknesses. However, the government has given strong signals in recent years to reform the public administration system. The agenda for reform and renovation is far-reaching and bold in vision.

Personnel reform is one of its components. A downsizing program was set up, initially aimed at reducing staff numbers by 15 percent, but little progress has been achieved so far. To some extent this is fortunate, as no prior review of functions, roles and work processes across the administration had been undertaken. There is also a determination to review civil service pay, but no practical steps have been carried out. One relevant concern in this respect is the huge volume of resources that could be needed to increase salaries across the board. However, it is not clear that the civil service is consistently underpaid. Personnel with technical and professional skills could possibly earn more in the private sector, but for many at the low end of the hierarchy a more realistic alternative is the informal sector where pay may be much lower. Pay increase across the board would thus fall to align civil service salaries with the market.

Another component of the reform agenda is the application of computers and related peripherals to administrative work. Obstacles in this area are related the lack of cyber laws, including legislation on privacy, digital signature, certification, and authentication. Equally important are measures and actions to review and streamline work procedures and processes. One-stop shops represent one of the most visible achievements of public administration reform at the local level. Although different in scope and outreach, they all serve a geographical area, and tend to operate at the district level.

The biggest challenge in implementing economic reforms, improving public service delivery and improving public administration is decentralization. With a population of 78 million people, Vietnam has a three-tiered structure of local governance. In addition to the national level government, it has local governments for 61 provinces (tier 1), 598 districts (tier 2) and 10,500 communes and wards (tier 3). These various levels of local governments have a high degree of autonomy and authority in decision-making, but little accountability.

Important initiatives to make decentralization work include block grants and grassroots democracy. The block-grant system, whereby public sector agencies are provided a lump sum to cover salary and administrative expenditures, provides more independence to choose the right mix of inputs to provide better service delivery. Ho Chi Minh City thus received a special status, including extensive management autonomy in the fields of socio-economic planning, land administration, infrastructure development, and civil service management.

Grassroots democracy, on the other hand, could minimize the risk of local governance failure, by empowering citizens and making their voices heard in decision-making. A decree defining a ground-breaking framework for consultation, participation, and transparency on a wide range of issues concerning people's lives at the commune level exists. Success in implementing it has been modest, however. Further progress in the decentralization agenda would require that initiatives such as block grants and grassroots democracy be assessed and upgraded.

**A comprehensive strategy**

Despite the upbeat growth perspectives for the coming years, Vietnam is at a crossroads. It may be successful in its attempt to become a market economy with a socialist orientation. High growth, inclusive development and an overall good quality of government will then be its distinctive marks. Or it may fail to remove the obstacles in its reform path, let the vested interests capture government transfers to offset their inefficiencies, and end up accepting the use of public office for private interest as a fact of life. A weak macroeconomic situation, slower growth, increased inequality and generalized corruption could be the likely outcomes in this case.

Whether the balance tilts in one direction or another will have important implications for the poor. Almost thirty million people (more than a third of the population) still live in poverty. Further, many of the gains of the last decade remain fragile, with millions still vulnerable to falling back into poverty. Sickness, death of a family member, and natural calamities (flooding, loss of crop or livestock) remain ever present threats. The starting point of the CPRGS is the recognition that, despite the gains of the 1990s, poverty remains widespread and deep. One of its important features is the use of localized Millennium Development Goals to clearly articulate the vision that Vietnam has set for itself over the coming decade (table I).

The Vietnam Development Goals for the coming decade are ambitious, but attainable. To get there, however, Vietnam will need not only a high level of growth but also the right pattern of growth. Poverty is concentrated in rural areas, in certain geographical regions (the Northern Uplands, North Coast and the Mekong Delta) and in certain groups of people who are particularly disadvantaged (ethnic minorities, women and unregistered migrants to urban areas). To reach these groups, a broad-based pattern of growth has to be combined with targeted efforts. For example, to attain the goal of achieving better education for all, 1.6 million primary school-aged children currently out of primary school will have to be included in mainstream education. This will require that those children least likely to be in school (ethnic minority children, disabled children, street children and others) will have to be targeted for inclusion. Similarly, reaching the health goals will depend crucially on making rapid progress among the poorest quarter of the population and in the most disadvantaged areas. This is especially so for the mortality outcomes, where further gains in some of the best-performing regions are likely to be minimal. And in the areas of good governance, the challenges remain daunting. The pace of implementation of the Grassroots Democracy decree, which is essential for improving local governance, remains slow.

In budget transparency, Vietnam is making steady progress but remains behind countries at a similar development level. And the implementation of the legal reform agenda, which is essential for improving access to justice, is only just beginning.

**Table I: Vietnam development goals**

| Directly based on the Millennium Development Goals |
|---|
| *Goal 1: Reduce the percentage of poor and hungry households* |
| Target 1: Reduce by 40 percent the proportion of people living below the international poverty line between 2001 and 2010<br>Target 2: Reduce by 75 percent the number of people living under the international food poverty line by 2010 |
| *Goal 2: Universalize education and improve education quality* |
| Target 1: Increase the net enrolment in primary school to 97 percent in 2005 and to 99 percent in 2010<br>Target 2: Increase net enrolment rate in junior secondary school to 80 percent in 2005 and 90 percent by 2010<br>Target 3: Eliminate the gender gap in primary and secondary education by 2005, and the gap with ethnic minorities in 2010<br>Target 4: Increase literacy to 95 percent of under-40-year-old women by 2005 and 100 percent by 2010<br>Target 5: By 2010 have improved the quality of education and increase full-day schooling at primary level. |
| *Goal 3: Ensure gender equality and women empowerment* |
| Target 1: Increase the number of women in elective bodies at all levels<br>Target 2: Increase the participation of women in ministries, central agencies and enterprises at all levels by 3-5 percent by 2010<br>Target 3: Ensure that the names of both husband and wife appears on the land-use right certificates by 2005<br>Target 4: Reduce the vulnerability of women to domestic violence |
| *Goal 4: Reduce child mortality, child malnutrition and reduce the birth rate* |
| Target 1: Reduce the infant mortality rate to 30 per 1000 live births by 2005 and 25 by 2010<br>Target 2: Reduce the under-5 mortality rate to 36 per 1000 live births by 2005 and 32 by 2010<br>Target 3: Reduce under five malnutrition to 25 percent by 2005 and 20 percent by 2010 |
| *Goal 5: Improve maternal health* |
| Target 1: Reduce the maternal mortality rate to 80 per 100,000 live births by 2005 and 70 by 2010 |
| *Goal 6: Reduce HIV/AIDS infection and eradicate other major diseases* |
| Target 1: Slow the increase in the spread of HIV/AIDS by 2005 and halve the rate of increase by 2010 |
| *Goal 7: Ensure environmental sustainability* |
| Target 1: Extend forest cover to 43 percent by 2010 (from 33 percent in 1999)<br>Target 2: Ensure that 60 percent of urban population has access to clean and safe water by 2005 and 85 percent in 2010.<br>Target 3: Ensure there are no slums and temporary houses in all towns and cities by 2010<br>Target 4: Ensure that all waste-water in towns and cities is treated by 2010<br>Target 5: Ensure that all solid waste is collected and disposed of safely in all towns and cities by 2010<br>Target 6: Air and water pollution must attain national standards by 2005 |
| Not directly based on the Millennium Development Goals |
| *Goal 8: Reducing vulnerability* |
| Target 1: Increase the average income of the lowest expenditure quintile to 140 percent of that in 2000 and 190 percent of that in 2010<br>Target 2: Reduce by half the rate of poor people falling back into poverty due to natural disasters and other risks by 2010 |
| *Goal 9: Improving governance for poverty reduction* |
| Target 1: Effectively implement the Grassroots Democracy Decree<br>Target 2: Ensure budget transparency<br>Target 3: Implement legal reform agenda |
| *Goal 10: Reducing ethnic inequality* |
| Target 1: Preserve and develop the reading and writing ability of ethnic languages<br>Target 2: Ensure entitlement of individual and collective land-use rights in ethnic minority and mountainous areas<br>Target 3: Increase the proportion of ethnic minority people in authority bodies at various levels |
| *Goal 11: Ensuring pro-poor infrastructure development* |
| Target 1: Provide basic infrastructure to 80 percent of poor communes by 2005 and 100 percent by 2010<br>Target 2: Expand the national transmission grid to 900 poor commune centers by 2005 |

*Source*: Socialist Government of Vietnam (2002).

The key decisions that need to be made have been identified by the CPRGS. Vietnam is one in about 20 countries in the world to have prepared a strategy of a nationally-owned strategy of this sort. It is not only the first country in Asia bust also the largest country in the world to do so. This presents a special difficulty in implementation, which is compounded by the fact that Vietnam is also a highly decentralized country in terms of governance. Inter-ministerial coordination, needed due to the multi-sectoral nature of CPRGS, adds to the difficulty (box I). Despite these difficulties, implementing the CPRGS is the most promising avenue for Vietnam to successfully address the challenges it faces and deliver on its promise.

**Box I: Implementing the CPRGS**

The CPRGS is deliberately designed to be a comprehensive strategy for growth and poverty reduction and will require strong inter-ministerial coordination for its implementation. It will also require rolling out to provincial, district, and commune levels so that local priorities and expenditures can be better aligned to national level development goals. The process of prioritizing, sequencing and implementing the policy matrix of the CPRGS will be facilitated through budget support credits from donors, including the IMF's Poverty Reduction and Growth Facility (PRGF) and annual Poverty Reduction Support Credits by the World Bank.

In September 2002, the Prime Minister set up a high-level Steering Committee to implement the CPRGS, PRGFs, and PRSCs (Decision 825/QD-TTg). The Steering Committee is Chaired by Deputy Prime Minister Nguyen Tan Dung with two Vice-Chairmen: a Vice Minister of the Ministry of Planning and Investment of the CPRGS and a Deputy Governor of the State Bank of Vietnam in charge of PRGF and PRSCs. Members include Vice Ministers from 20 agencies: (i) Ministry of Finance; (ii) Ministry of Trade; (iii) Ministry of Labor, Invalids and Social Affairs; (iv) Ministry of Foreign Affairs; (v) Ministry of Justice; (vi) Ministry of Agriculture and Rural Development; (vii) Ministry of Industry; (viii) Ministry of Transport; (ix) Ministry of Health; (x) Ministry of Education and Training; (xi) Ministry of Construction; (xii) Ministry of Science and Technology; (xiii) Ministry of Resources and Environment; (xiv) Ministry of Interior; and a chairperson from each of the government bodies: (xv) Office of the Government; (xvi) Committee for Ethnic Minorities and Mountainous Areas; (xvii) General Statistic Office; and (xviii) National Steering Committee for Enterprise Renovation and Development. The Steering Committee will also include: (xix) one leader of the Central Party's Economic Committee and (xx) one representative of the Vietnam Women's Union.

The high-level Steering Committee will be assisted by two working level inter-ministerial groups, one for the CPRGS and one for PRGF and PRSCs, led by Director or Deputy-Director level officials from the Ministry of Planning and Investment and the State Bank of Vietnam, respectively, and with membership from all the other agencies listed above. The tasks of the high level Steering Committee and the two inter-ministerial groups are to implement, monitor and evaluate the CPRGS and to facilitate inter-ministerial coordination as well as the coordination between central agencies and local authorities.

*Source:* World Bank staff.

# INTRODUCTION

Vietnam has the potential to be one of the success stories in development. Its population has a high educational attainment for a country at this development level. Its labor force is widely recognized as hard working and easily trainable. The economy is already quite open to exchanges with the rest of the world, foreign trade being as large as the entire GDP. And despite these advantages, the level of output per capita is still low, implying that there is considerable room to catch up and even leapfrog. According to recent research on development, high educational attainment, openness to trade and a low starting point are the best predictors of robust long-term growth. Vietnam has them all.

Commitment to socially inclusive development, and policy ownership by the government, are less researched ingredients, but they are certainly as important as those listed above, if not more. Vietnam is remarkable in this respect too.

The recently completed Comprehensive Poverty Reduction and Growth Strategy (CPRGS) translates a vision of transition towards a market-economy with socialist orientation into concrete public actions (Socialist Republic of Vietnam, 2002; World Bank, 2002e). It commits Vietnam to full openness to the global economy over the coming decade, and the creation of a level playing field between the public and the private sectors. It emphasizes that the transition should be pro-poor, and notes that this will require heavier investment in rural and lagging regions, and a more gradual reform implementation than is often recommended by international advisors. It gives strong emphasis to poverty reduction and social equity, and to a more modern system of governance. The CPRGS is a product of the government of Vietnam, involving all of the relevant agencies and sectors in its preparation. Such ownership and determination are, again, very good augurs for Vietnam.

The overall economic situation is already encouraging. After a slowdown period, during the East Asian crisis, the Vietnamese economy is growing quite strongly again. Investors are reacting positively to the reform announcements and commitments made by Vietnam. The country is getting better grades from sovereign risk rating agencies and the macroeconomic situation is stable. Despite an unfavorable external environment, in terms of demand and prices, exports can be expected to pick up as a result of the Vietnam-US bilateral trade agreement. GDP growth rates in the order of 7 percent per year are likely over the next few years.

This positive picture should not lead to complacency, however, as important challenges remain. The first one is implementation. Over the last three years, the government of Vietnam has made an impressive series of commitments, and approved a vast number of initiatives aimed at accelerating the transition to a market economy (box 1). Simply making these commitments and decisions effective would be demanding in a country at a higher development level. In Vietnam, it will be a daunting task. Administrative capacity is still limited. Processes inherited from the period under central planning are slow and cumbersome. The consensus-building efforts that characterize policy making are certainly valuable, but they are also time-consuming. More importantly, decisions are increasingly implemented at the local level. Decentralization was one of the features of *doi moi*, and the trend has become stronger over the years. How to align concrete policy-making at the sectoral, provincial or local level with the commitments and orientations of the government as a whole is one of the most serious problems currently faced by Vietnam.

**Box 1. Recent commitments and announcements**

- *The Ninth Congress of Communist Party of Vietnam* reviews and evaluates past achievements and shortcomings, makes decisions for the coming period, and strives to continue with the renovation process (2000).
- *The Socio-Economic Development Strategy* lays down strategies for sectoral development in education, health care, population, nutrition, women, children, and the environment, among others (2000).
- *The Comprehensive Poverty Reduction and Growth Strategy (CPRGS)* translates the Ten-year Socio-economic Development Strategy into a set of concrete measures, with a road-map for implementation (2002).
- *The Millennium Declaration* commits Vietnam to the Millennium Development Goals (2001)
- *The Resolution of the Third Plenum of the Party*, on further re-structuring, renovating, developing, and raising the efficiency of state-owned enterprises, includes a detailed action plan for the period to 2005 (2001).
- *The Resolution of the Fifth Plenum of the Party* endorses renovation policies and mechanisms to promote and facilitate private sector development (2002).
- *The Master Program for Pubic Administration Reform* in 2001-2010 is launched around four pillars: organization restructuring, human resources reform, institutional development and public financial management reform (2001).
- *The Legal Need Assessment* develops a comprehensive strategy, and subsequently an action plan, for the development of Vietnam's legal system (2000).
- *The Ordinance Against Corruption* (amended) focuses on the need to fight corruption and the waste of resources (2000).
- *The Enterprise Law* establishes a legal basis for a level playing field for all domestic private enterprises and simplifies requirements for entry registration of firms (2000).
- *The Private Sector Action Plan*, supported by the Miyazawa initiative, contains a set of measures to unshackle and support the private sector (1999).
- *The Foreign Direct Investment Law* (revised) improves access to foreign exchange, allows mortgaging of land by foreign bank branches in Vietnam, permits automatic registration for some types of foreign investment, and makes provisions for government guarantees to infrastructure projects (2000).
- *The Poverty Reduction and Growth Facility (PRGF) and The Poverty Reduction Support Credit (PRSC)* provide budget support to accelerate reforms in banking, state-owned enterprises, financial management and private sector development (2001).
- *The ASEAN Free Trade Area* implies that Vietnam has to implement its tariff reduction in line with Common Effective Preferential Tariffs, and to phase-out of quantitative restrictions with respect to ASEAN countries between 2001 and 2006.
- *The Vietnam-US Bilateral Trade Agreement* includes phased reductions in tariffs on imports, the opening of areas of the service sector to greater foreign participation and adherence to strict provisions on the protection of intellectual property rights (2001).
- *Negotiations with the WTO* get started with the prospect of gaining accession, and initial offers are made (2002).

*Source*: World Bank staff.

The different pace at which reforms are proceeding is another source of concern. The current situation is characterized by uneven progress in the march towards development. While reforms in some areas have been moving ahead steadily, even faster than anticipated, in others there is much slower progress, if not outright stagnation.

The contrast is very clear regarding structural reforms, where trade liberalization and the reform of state-owned enterprises seem to be on a collision course. The commitments made by Vietnam imply that many sectors of activity which are currently protected will soon face competition from abroad. But some of these sectors are still dominated by un-restructured state-owned enterprises. While the program to equitize, sell or liquidate many of those enterprises is still meeting its targets, it also seems to be facing increasing difficulties to move forward. High levels of enterprise debt make it difficult to attract buyers. Complicated procedures, and the uncertainties associated with ownership transformation, also restrain the enthusiasm of the directors of those enterprises. To outsiders, the distinction between justified hesitancy and outright opposition is somewhat blurred.

There is a real risk that the un-restructured state-owned enterprises will put pressure on the government to get direct or indirect transfers, in order to cope with the increased competition from abroad. An increase in the volume of non-performing loans cannot be ruled out. Such a development could eventually compromise the macroeconomic stability that is necessary for growth to continue. Keeping all of the components of the reform agenda on track is therefore essential for growth to be sustained. In particular, it will be necessary to identify mechanisms to instill a new life into the program to restructure state-owned enterprises, addressing the problems raised by their high debts as well as the hesitancy (or opposition) of insiders.

The second important challenge faced by Vietnam concerns poverty alleviation. The growth phase that followed *doi moi* was remarkable in that it was not accompanied by a noticeable increase in inequality. Aggregate inequality indicators such as the Gini index remained basically unchanged over the 1990s. More disaggregate analyses show that the poor did better than the rich, in relative terms. The combination of fast growth and stable inequality explains the remarkable accomplishments of Vietnam in terms of poverty reduction. However, in the absence of vigorous action inequality is likely to increase, maybe substantially, during the new phase of growth. This is because the poverty effects of land redistribution in rural areas are probably reaped by now.

Land is one of the most valuable assets of Vietnam. Allocating its use to households in rural areas, where most of the poor live, amounted to a formidable redistribution of wealth. But this was a one-time intervention, leading to an increase in the level of household consumption, not necessarily to a sustained increase in its growth rate. In fact, rural households whose livelihoods rely on farming only are the poorest of all; those who manage to diversify into non-farm employment do better. Nowadays, the government of Vietnam has no comparable asset to redistribute.

Meanwhile, integration into the world economy will increase the gap between urban and rural areas. The gap between those who are skilled enough to fully benefit from globalization, and those who are not, will increase as well. Many urban households will become rich in absolute terms, and not simply by Vietnamese standards. The trend is already becoming quite visible in Hanoi and Ho Chi Minh City. This time, in the absence of resolute public action, the rich will do better.

A vibrant private sector, creating jobs for the new labor market, is one of the keys to raise the incomes of the poor during the next decade. About 1.2 million people search for their first job every year in Vietnam. The public sector cannot absorb these large numbers of labor market entrants. Given the relatively high capital intensity of state-owned enterprise firms, compared to their private sector counterparts, the cost of expanding their employment base would simply be unaffordable. If anything, employment in state-owned enterprises will contract over the next few years, as a result of divestiture and increased competition in product markets. The expansion of small and medium enterprises is the only reasonable alternative to generate off-farm employment in rural areas, and to give earning opportunities to migrants to urban areas.

Policies in the social sectors, and especially in education and health, are the other key to prevent inequality from increasing, or at least from increasing too much. Meeting the targets set up by the CPRGS, in terms of expanding the coverage and improving the quality of education, and reducing the cost of education and health care for the poor, are necessary to prevent the gap between poor and rich to widen excessively during the new phase of growth. But implementing the CPRGS commitments requires dramatic changes in the management of public expenditures and public investments, including the allocation of resources across sectors and within sectors.

Decentralization of policy making could add to the difficulty. The greater proximity of local governments to their constituencies offers an opportunity for better identification of the specific measures to adopt, and for better targeting of the beneficiaries. But the merits of decentralization should not be taken for granted. Improving the flexibility and accountability of local governments in the allocation and use of their resources is necessary. Promoting mechanisms for the population to voice their concerns and demands, through more involvement of the civil society, is important as well. In the absence of accountability, decentralization can simply lead to resource misuse and abuse.

The third challenge faced by Vietnam, and certainly not the smallest, is improving the quality of its governance. It will not be possible to address the other two challenges without an effective public administration, endowed with the appropriate financial management instruments. Implementing the structural reforms, keeping the momentum of state-owned enterprise reform, leveling the playing field so that the private sector can develop, and improving the outcomes in the social sectors are all tasks requiring an effective government.

In this respect, however, Vietnam is confronted with a difficult situation. The country is still characterized by a legal and institutional framework partly inherited from the period with a centrally-planned economy. This framework is not well-adapted to the current needs. Given the profit opportunities created by the market economy, there is an enormous potential for corruption.

The combination of potentially higher inequality with corruption (or even simply with the perception of corruption) could have very damaging consequences. If the increasing wealth of the urban segments of the population that will become rich in this period is seen as the result of hard work and creativity, it will be legitimate. But it will not if it is seen as the result of connections, and friends in high places.

Despite the upbeat growth perspectives for the coming years, Vietnam is at a crossroads. It may be successful in its attempt to become a market economy with a socialist orientation. High growth, inclusive development and an overall good quality of government will then be its distinctive marks. Or it may fail to remove the obstacles in its reform path, let the vested interests capture government transfers to offset their inefficiencies, and see an unhealthy relationship develop between enterprises (private as well as state-owned) and government officials. A weak macroeconomic situation, slower growth, increased inequality and generalized corruption could be the outcomes in this pessimistic scenario.

The key decisions that will make the balance tilt in one direction or the other will be made over the next few years. Once inequality has developed and the vested interests have engrained their power, reverting the process will be very difficult. Whether Vietnam will deliver on its promise depends on those decisions.

# I. A Market Economy

# 1. THE PURSUIT OF STABILITY

The economic outlook for Vietnam improved considerably in 2002. This improvement owes to a series of policies and regulations that put the economy on an enhanced medium-term growth path, even as the external environment remains weak. Confidence in the private sector was boosted by the adoption of a detailed reform program in 2001. New private businesses are currently being established at a rate of 1,600 per month, and in early-2002 a special meeting of the Party Central Committee gave the strongest endorsement of the private sector ever. Strong economic growth is also associated with an external debt at a very manageable level. This favorable outlook, combined with Vietnam's potential for sustained long-term growth, suggests that the effects of the East Asian crisis are over and a new phase of prosperity is about to begin. As in the 1990s, Vietnam could experience several years of high GDP growth rates.

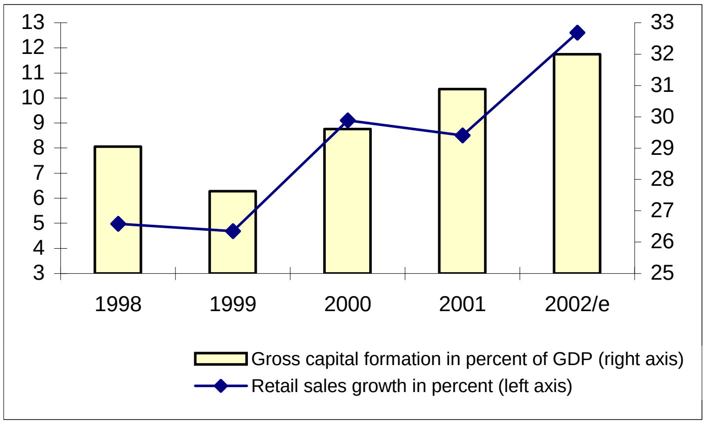
Prosperity should not be taken for granted, however. Continued implementation of structural reforms in the enterprise and financial sectors, and improved management of public expenditures and investment, are essential to secure that the domestic debt situation remains sustainable in the medium term. Fast progress in trade liberalization is at odds with a slow pace of reform of the state sector. If state-owned enterprises cannot cope with increased competition in product markets, they may face difficulties in servicing their debts, further burdening the already heavy stock of non-performing loans. In that case, the new phase of prosperity could simply amount to "borrowed" growth, eventually leading to a costly re-capitalization of the banking system.

**Recent developments**

In 2002, the expected rate of GDP growth, in real terms, is around 6 percent. This estimate represents a noticeable improvement over the previous years. Good fundamentals in terms of macroeconomic stability and the adoption of structural reforms, coupled with increasing confidence in the economy, are the core reasons for faster GDP growth.

The growth performance is sustained by a strong expansion of domestic demand (figure 1.1). The growth rate of retail sales has recovered to levels not seen since the economy was hit by the East Asian crisis in 1997. Production of consumer durables such as household building materials, cars, motorbikes, and TV-sets confirms that consumer spending has increased at a fast pace in 2002.

**Figure 1.1: Domestic demand is picking up**




*Source*: General Statistical Office (2002) and World Bank staff estimates.

Investment has also been an important source of growth in 2002, suggesting that the recovery is sustainable. The many new enterprise start-ups and stronger investor confidence have boosted capital formation and brought the number of new business registrations to nearly 50,000 over a two-year period. By July 2002, capital formation from these new enterprises had increased 45 percent compared to the same period in the previous year. Investment from new small and medium enterprises in the formal economy alone is likely to reach around 40 trillion dong (approximately 2.7 billion US dollars) in 2002. This is the equivalent of around 9 percent of GDP. Total investment by the state sector, including the budget and the enterprise sector, is likely to be about 18 percent of GDP.

## Sectoral trends

The non-state domestic sector continues to lead the growth process. Manufacturing thrives, with the private domestic and the foreign invested sectors recording annual output growth rates of 19 and 15 percent respectively (table 1.1). Underlying these trends is a start-up rate of new enterprises reaching new highs in 2002. At 12 percent year-on-year output growth, the state sector's achievements are more modest. This mirrors Vietnam's gradual transition to a market economy, with many state-owned enterprises facing increased competitive pressures and harder budget constraints. In value-added terms, the formal private sector of the economy has outperformed state-owned enterprises since at least 1997.

**Table 1.1: The engines of growth**

| | Growth rate (in percent) | | | | |
|---|---|---|---|---|---|
| | 1998 | 1999 | 2000 | 2001 | 2002e |
| Total industrial output | 12.5 | 11.6 | 17.5 | 14.2 | 14.4 |
| State | 7.7 | 5.4 | 13.2 | 12.7 | 11.9 |
| Private domestic | 7.5 | 10.9 | 19.2 | 20.3 | 19.3 |
| Foreign invested | 24.4 | 21.0 | 21.8 | 12.1 | 14.7 |
| Total agricultural output | 4.9 | 7.4 | 7.5 | 4.7 | 5.0 |
| Agriculture | 5.7 | 7.3 | 5.4 | 2.6 | 4.5 |
| Forestry | -3.5 | 7.0 | 7.9 | -0.9 | 0.2 |
| Fishery | 3.5 | 7.9 | 19.3 | 17.4 | 8.1 |
| Services 1/ | 5.1 | 2.3 | 5.3 | 6.1 | 6.2 |

1/ Figures for services are based on value added.
*Source:* General Statistical Office.

Agricultural output continued to grow steadily in 2002, despite droughts in the Central Highlands and severe flooding in the South. In services, GDP is growing at around 6 percent annually, supported by tourism. Estimates from the World Travel and Tourism Council suggest that this sector provides Vietnam with 668,000 jobs, or around two percent of total employment (Boye, 2002). In the first nine months of this year, around two million tourist entries were registered, 12 percent more than in 2001. Whether the increased security concerns that hit the region in 2002 will distress the tourism industry in Vietnam as they have in other countries, or whether Vietnam will stand out as a shelter in the storm, is difficult to gauge at this stage.

### External difficulties

The export performance, on the other hand, remains precarious. In the first eight months of 2002, exports were down 1.7 percent year on year. This decline is partly due to lower prices of crude oil and other commodities, which account for more than a quarter of Vietnam's total exports. However, in the third quarter of 2002 there was a turn-around in export performance, and growth of around 7 percent is expected for the year as a whole (table 1.2). Besides rising commodity prices, exports growth is underpinned by substantial increases in sales to the US under the Vietnam-US bilateral trade agreement that became effective in 2001.

**Table 1.2: A modest increase in export earnings**

| | Growth rate (in percent) | | | | | Value 1/ |
|---|---|---|---|---|---|---|
| | 1998 | 1999 | 2000 | 2001 | 2002e | 2002e |
| Crude oil | -12.8 | 69.7 | 67.5 | -10.8 | -0.5 | 3,110 |
| Non-oil | 4.8 | 16.3 | 16.1 | 8.7 | 9.2 | 12,990 |
| Agricultural | 8.4 | 5.6 | -9.8 | -5.1 | 7.1 | 2,009 |
| Seafood | 4.8 | 16.3 | 55.5 | 20.2 | 15.3 | 2,050 |
| Mining products | -8.3 | -5.2 | 2.7 | 3.1 | 14.7 | 130 |
| Garment | 0.2 | 29.3 | 8.3 | 4.4 | 31.6 | 2,600 |
| Footwear | 3.7 | 39.1 | 5.2 | 6.5 | 11.6 | 1,740 |
| Electronics | n/a | 23.5 | 33.8 | -23.9 | -16.1 | 500 |
| Handicraft & fine arts | -8.4 | 51.3 | 40.8 | -0.7 | 34.0 | 315 |
| Other | 2.8 | 5.8 | 31.3 | 25.5 | -3.2 | 3,647 |
| Total exports | 2.1 | 23.4 | 25.4 | 4.0 | 7.0 | 16,100 |

1/ In million US dollars.

*Source:* General Statistical Office and estimates from Ministry of Trade.

Garment and footwear exports, which account for one third of non-oil export revenue, increased by respectively 32 and 12 percent in 2002. Garment exports to the US increased 16-fold between 2001 and 2002, propelling total exports to the US above 2 billion US dollars, and making it the second most important market after the European Union. Exports of seafood to the US increased 28 percent in the first three quarters of 2002, despite US anti-dumping complaints, which have made market access difficult for Vietnam**.** Exports of footwear and handicraft to the European Union increased rapidly over 2002. However, disputes and a temporary import ban on shrimp from Vietnam, on concerns of too high traces of antibiotics, depressed the overall growth in export earnings. Vietnam's non-oil exports to Japan shrank 7 percent this year.

While the performance of Vietnamese exports to the US market is encouraging and holds good omens for the future, sales to China have not fared well. The dollar value of exports to China declined by 8 percent in 2001, and by 5 percent in the first three quarters of 2002. This poor performance casts doubts on the competitiveness of the Vietnamese economy, not least because other countries in the region have been able to increase their exports to China over 2002.

It is also worrying if China, with its increasing openness after WTO accession, becomes a missed opportunity for Vietnam. Trade with China could counterbalance the impact of a slowdown in other regions, especially as its business cycle may be different from those of other major economic hubs, such as Japan and the US.

Oil exports remain important in level, but their growth will be limited. In 2002 and 2003, crude oil is unlikely to raise the dollar value of exports as it did in the past. The very rapid increases in pumped volumes that were achieved in the late 1990's cannot be repeated. Capacity constraints imply that even a substantial surge in oil prices, pushing the average price in 2002 above 30 US dollars per barrel, would only have a marginal impact on the growth of export earnings.

**Macroeconomic management**

The fiscal stance remains prudent, with an expected budget deficit of approximately 2.5 percent of GDP before on-lending for 2002, around the same level as in 2000 and 2001. However, maintaining the present level of revenue over the medium term calls for concerted efforts to raise non-oil revenue. In 2002, oil revenue provided 32 percent of total government revenue, a figure expected to drop to 28 percent in 2004. Offsetting this decline will require a strengthening of VAT policy and administration. The need to improve the efficiency of the VAT system, and to develop revenue sources not directly dependent on foreign trade are further accentuated by the potential decrease in tariff revenue that could result from commitments under the ASEAN Free Trade Area and the Vietnam-US bilateral trade agreement .

The overall expenditure level has been restrained to safeguard the budget and has been managed very cautiously in 2002. Capital expenditures, which increased in 2001 to rehabilitate infrastructure damaged by floods, have been capped. As a share of GDP, capital and current expenditures have actually declined during 2002. In Vietnam, the level of public expenditure is less of a concern than its allocation.

The current situation of robust domestic demand creates a window of opportunity to reduce the deficit further in order to consolidate public finances. In particular, it would be important to move more decisively towards containing the fiscal risks associated with the government's contingent liabilities, related to the reform of state-owned enterprises and the level of non-performing loans in the banking sector.

Vietnam's stock of outstanding external debt stood at 12.1 billion US dollars in 2001 and is expected to reach 13.3 billion by the end of 2002. This represents 37 percent of GDP and 84 percent of exports, with an annual debt service of 8 percent of exports. Most of this debt is on concessional terms, which means that it carries very low interest rates. As a result, Vietnam's debt service capacity is estimated to be sustainable over the medium to long term making it probably ineligible for debt relief under the so-called HIPC initiative (World Bank, forthcoming c). The outside perception on the risk associated with Vietnam is consistent with this medium-term sustainability (box 1.1). The management of the debt is more of a concern. At the moment, it is fragmented among several government agencies using inappropriate databases (World Bank, 2002a).

Credit policies continue to be restrained in line with the program supported by the IMF. Significantly, growth in credit to state-owned enterprises has been kept below the agreed target. In June 2002, the ceiling on interest rates for lending in domestic currency was removed, allowing banks to better price credit risk and hence to extend loans to the emerging private sector.

In 2002, inflation will reach 4.3 percent, up from nil or slightly negative levels in previous years. This basically reflects increases in the price of rice, which makes up around half of the consumer price index. However, there have also been noteworthy increases in the prices of building materials.

**Box 1.1: How risky is Vietnam?**

In 2002, Vietnam's grades have been marked up by international risk rating agencies. Moody's Investor Services, Capital Intelligence and the OECD's Country Risk Classification all improved their ratings and outlook for Vietnam. Initial ratings were issued in June by Standard & Poor's and Fitch Ratings, at the request of the Government. The improved and the newly assigned ratings for Vietnam confirm a significantly better perception of the investment climate.

| | Fitch Ratings | Moody's | Standard & Poors |
|---|---|---|---|
| | A (+/-) | A3 | A (+/-) |
| High | China<br>Korea<br>Slovenia | China<br>Hong Kong<br>Hungary | Estonia<br>Hungary<br>Korea |
| | BBB (+/-) | Baa3 | BBB (+/-) |
| Investment Grade | Egypt<br>Mexico<br>Thailand | Croatia<br>Kazakhstan<br>Thailand | China<br>Egypt<br>Philippines |
| | BB (+/-) | B1 | BB (+/-) |
| Medium | Bulgaria<br>India<br>Philippines<br>Russia<br>*Vietnam* | Bulgaria<br>PNG<br>Turkey<br>*Vietnam* | Bulgaria<br>India<br>Peru<br>*Vietnam* |
| | B (+/-) | B2 | B (+/-) |
| Low | Brazil<br>Indonesia<br>Romania<br>Turkey<br>Ukraine | Brazil<br>Romania<br>Ukraine | Brazil<br>Indonesia<br>Romania<br>Russia |

*Source*: Websites of the agencies, October/ November 2002. Countries are in alphabetical order within each category

## Growing financing needs

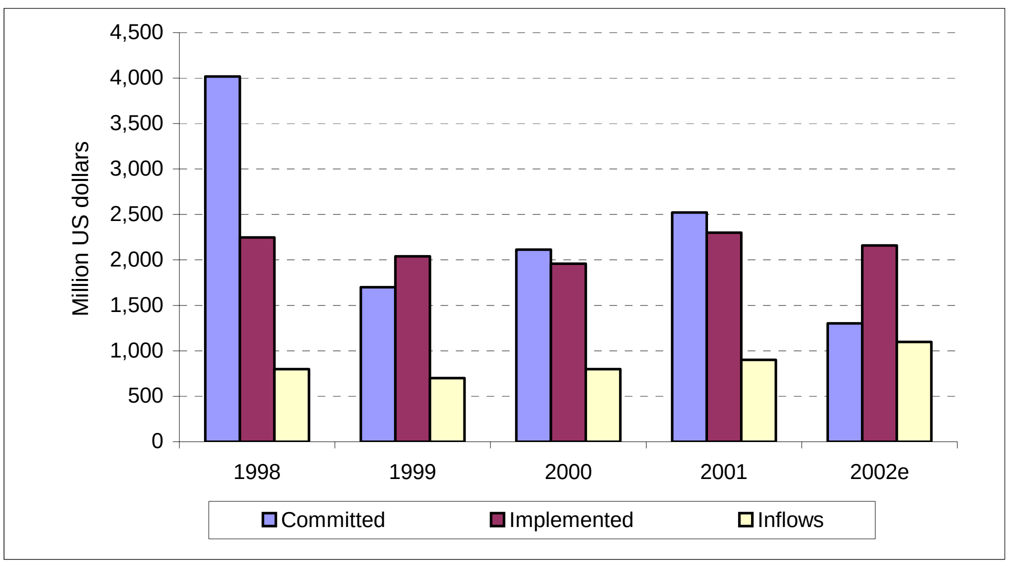
As Vietnam implements the planned reforms in the state sector, including a social safety net for retrenched workers from state-owned enterprises and the restructuring of the banking sector, total external financing requirements are expected to rise. Imports are increasing as well, at a robust rate of 15 percent in 2002, reflecting strong domestic demand and in particular demand for key production inputs and capital goods, such as machinery and equipment. As a result, the current account will slide into a deficit of approximately 2 percent of GDP in 2002.

Over the medium term, export earnings will reduce the financing requirements. Non-trade sources such as tourism and remittances from overseas Vietnamese will also become important suppliers of foreign currency. Some in the Vietnamese banking sector estimate that inward remittances from overseas Vietnamese reached 1.9 billion US dollars in 2001, and are likely to exceed 2 billion US dollars in 2002. These figures also include funds that are coming in through unofficial channels.

The inflow of foreign direct investment remains stable. Compared to 2001, commitments have been lower in 2002, but the number of project approvals has been higher, indicating a changed pattern towards smaller foreign investment projects. Anecdotal evidence from the foreign business community indicates increasing investor interest in more export-oriented industries. After the initial negative impact of the East Asian crisis in 1997, actual implementations have been remarkably stable throughout the period (figure 1.2). Implementations include domestic counterpart investments. The actual inflow of foreign capital has been somewhat lower, but nonetheless on an upward trend.

The relative stability of foreign direct investment reflects Vietnam's intermediate position in the region. East Asia, as a whole, experienced a sharp reduction in foreign investment flows (UNCTAD, 2002). But new commitments in China rose by 33 percent in the first seven months of 2002. Implementation continued its upward trend, rising by 21 percent over the same period. China's attractiveness to foreign investors makes it all the more important for Vietnam to improve its own investment climate (Le Dang Doanh, 2002).

**Figure 1.2: Stable foreign direct investment**




*Source*: Ministry of Planning and Investment and World Bank staff estimates. "Committed" refers to registration of projects by foreign investors. "Implemented" is estimated according to the aggregate disbursement schedules of the projects, including equity and loan components. "Inflows" is estimated based on average shares of foreign and domestic equity investors and lenders, and information about major project disbursements.

In 2002, total financing needs of about 2.35 billion US dollars are expected to be covered mainly by disbursements of overseas development aid and foreign direct investment inflows. Vietnam's gross financing requirements will gradually grow to 2.7 billion US dollars by 2005 (table 1.3). Export growth will go some way towards reducing the financing needs, but given current amortization schedules and a need to build up and maintain prudent reserve levels, a considerable inflow of capital will be needed. Foreign investments, and annual disbursements from approved development loans and grants in the range of 1.1 to 1.5 billion US dollars per year, will be the main financing sources. The main providers of official development assistance will be Japan (roughly 30 percent), the Asian Development Bank (20 percent), and the World Bank (30 percent). This forecast assumes that the government will continue to improve project implementation, thus speeding up disbursements from the current project pipeline.

**Table 1.3: Financing requirements and sources**

| | 2002e | Projected | | |
|---|---|---|---|---|
| | | 2003 | 2004 | 2005 |
| *Financing needs* | *2.35* | *2.35* | *2.54* | *2.71* |
| Current account deficit | 0.59 | 0.91 | 0.88 | 0.98 |
| Mid and long-term amortization | 1.35 | 1.11 | 1.13 | 1.18 |
| - of which foreign direct investment | 0.72 | 0.70 | 0.67 | 0.66 |
| Use of IMF credit (net) | -0.04 | -0.05 | -0.01 | 0.03 |
| Others (net) 1/ | 0.02 | 0.00 | 0.00 | 0.00 |
| Reserve requirements | 0.43 | 0.38 | 0.54 | 0.52 |
| *Financing Resources* | *2.35* | *2.35* | *2.54* | *2.71* |
| Official grants | 0.15 | 0.15 | 0.15 | 0.15 |
| Long-term borrowing | 1.60 | 1.55 | 1.67 | 1.66 |
| - Official development assistance | 1.00 | 1.27 | 1.37 | 1.36 |
| - Non-concessional | 0.59 | 0.28 | 0.30 | 0.30 |
| Foreign direct investment | 1.10 | 1.30 | 1.35 | 1.45 |
| Short-term capital (net) | -0.50 | -0.80 | -1.00 | -1.00 |
| Arrears | 0.00 | 0.00 | 0.00 | 0.00 |
| Debt relief | 0.00 | 0.00 | 0.00 | 0.00 |
| *Additional financing needs 2/* | *0.00* | *0.15* | *0.38* | *0.45* |

1/ Including errors and omissions.
2/ Including funding not yet formalized nor signed.

*Source:* Vietnamese authorities and World Bank and IMF staff estimates. Figures are in billion US dollars.

With the recent adoption of the CPRGS, the government has committed to a substantial program of reform that warrants continuing quick-disbursing assistance from the donor community. The World Bank's Poverty Reduction Support Credit (PRSC) and the IMF's Poverty Reduction and Growth Facility (PRGF) are likely to disburse a total of 260 million US dollars in 2003. Other quick-disbursing sources include 55 million US dollars from ADB program loans, and co-financing of the PRSC from Denmark, the Netherlands, Sweden and the UK. New donor commitments would need to be maintained at the level of the past few years to ensure proper project disbursements in the medium term and adequate concessional inflows in the coming years.

## 2. TRADE AS AN OPPORTUNITY

Since the introduction of *doi moi*, change in trade policies has been impressive. Back then, the trade regime was characterized by a small number of Foreign Trading Corporations, with effective monopolies over imports and exports of their product range. Planned import volumes were determined by the projected differences between domestic demand and supply for particular goods. Export volumes were set at levels necessary to finance planned imports. Fifteen years later, tariffs have been reduced, a large number of quantitative restrictions have been abolished and the foreign exchange rate regime has been liberalized. And there is a determination to keep the pace, as reflected by the recent signature of the Vietnam-US bilateral trade agreement, and the steps undertaken to join the WTO.

While this impressive progress opens new opportunities, it also raises new challenges. Liberalization in trade and services may soon conflict with the slow pace of implementation of other reforms, including the restructuring of state-owned enterprises and state-owned commercial banks. Increased competition in product markets, and the possibility for new entrants to operate in Vietnam's banking system, will put an additional strain on a still largely unreformed state sector. This prospect could very well act as a catalyst to improve the performance of state-owned enterprises and state-owned commercial banks, and to accelerate ownership transformation as well. But the temptation to shift the burden of adjustment to the rest of the economy, through explicit transfers or debt arrears, will be strong.

It does not follow that the pace of trade liberalization should slow down. On the contrary, given the commitments already made, Vietnam would only stand to lose if it delayed its accession to the WTO. The cost of joining in has become heavier over time, and may increase even further. Moreover, China's recent WTO accession puts Vietnam at a disadvantage. And because WTO implicitly discriminates against non-member countries, accession would also put Vietnam in a better position to protect its interests against unjustified barriers to its exports.

**On the fast track**

Liberalization efforts have concerned almost every aspect of the trade regime. Domestic prices were liberalized. Restrictions to establish Foreign Trading Corporations were relaxed, allowing for a rapid increase in the number of enterprises allowed to engage in trade, from about 30 in 1988 to over 1,200 by the end of 1994 and 16,200 in 2001 (CIE, 2002, and World Bank, 2002d). New trade policy instruments, including quantitative restrictions and tariffs, were introduced, and then gradually reduced. The foreign exchange regime was also liberalized. Lately, reform measures have been consolidated in a number of regional and multilateral trading arrangements.

The process has continued at a steady pace in recent years (table 2.1). All the quotas and targets which, together with domestic production targets, were the basis of the central-planning system have been progressively eliminated. By early 2003, all quantitative restrictions on imports will be abolished with the exception of sugar (to be kept until 2005) and petroleum products. Quantitative restrictions on imports of cement, motorbikes and vehicles for up to eight passengers are scheduled to be abolished by end-2002.

Quantitative restrictions on the exports of most sectors have been eliminated as well. The exceptions are textiles and garments and a list of sensitive items. Vietnam not being a member of WTO, it would not have to comply with the Agreement on Textile and Clothing that is scheduled to replace the Multi-Fiber Agreement. Bilateral quotas on textile and garments will remain allocated through an auction process. Importantly, the schedule to phase out quantitative restrictions was announced as part of the Five-Year Import-Export Program (2001-05), allowing the private sector to anticipate and adjust to the new trade regime.

**Table 2.1: Major changes in trade policy since 2000**

| Year | Objectives: Increase numbers of foreign trading companies | Develop trade policy instruments | Remove exchange rate distortions | Become a member of international trading arrangements |
|---|---|---|---|---|
| 2000 | | • Removed quantitative import restrictions on 8 out of remaining 19 groups of products i.e. including fertilizer, liquid soda, ceramic goods, plastic packaging, DOP plasticizer, ceramic sanitary ware, electric fans, and bicycle | | • Signed a bilateral trade agreement with the US in July paving the way for MFN access of Vietnamese exports to the US market, gradual opening up of Vietnam's economy, for goods and services as well as investments |
| 2001 | • Permitted all legal entities (companies and individuals) to export most goods without having to acquire a special license by revising the implementing decree of the Trade Law | • Removed quantitative restrictions multilaterally on all tariff lines of the following groups of products: liquor, clinker, paper, floor tiles, construction glass, some types of steel, and vegetable oil | • Reduced the foreign exchange surrender requirement from 50 to 40 percent | • Moved 713 tariff lines from the Temporary Exclusion List to the Inclusion List |
| 2002 | | | • Reduced the foreign exchange surrender requirement from 40 to 30 percent (May) | • Detailed a list of goods and tax rates for implementing the Agreement on the Common Effect Preferential Tariffs Scheme of ASEAN countries for the year 2002<br>• Issued the implementing decision for the US Bilateral Trade Agreement, including guidelines for responsibilities and actions (March)<br>• A Government negotiation team started working sessions on WTO accession in Geneva (April) |

*Source:* World Bank staff.

The tariff schedule was rationalized in 1992 and simplified in 1999, following Vietnam's accession to the ASEAN Free Trade Area. Currently, there are three sets of rates. Most-favored nation (MFN) tariff rates are applicable to imports from countries with which Vietnam enjoys the MFN status. Items in this category represent about 75 percent of total imports. Common Effective Preferential Tariff (CEPT) rates are applicable to imports from ASEAN countries. General tariff rates, 50 percent higher than MFN rates, apply to all other countries. In practice, trade with those other countries is negligible.

The average (un-weighted) MFN tariff rate has increased, partly due to the conversion of quantitative restrictions into explicit tariffs (table 2.2). But the number of tariff lines and the maximum tariff rate have decreased. The average (un-weighted) CEPT rate has also declined. It stood at 10.7 percent as of 2002.

**Table 2.2: Tariff rates with a roadmap for the future**

| Years | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| MFN Tariff Rate 1/ | | | | | | | | | | | |
| Average | 12.3 | 13.4 | 13.6 | | | 15.1 | 15.7 | | | | |
| Range | | 0-200 | | | | | 0-120 | | | | |
| CEPT Implementation 2/ | | | | | | | | | | | |
| Number of Items | | | | | | | | | | | |
| Inclusion List | 856 | 1,496 | 1,996 | 3,590 | 4,230 | 4,830 | 5,430 | 6,030 | 6,030 | 6,030 | 6,030 |
| Temp. Exclusion List | 2,123 | 1,483 | 983 | 2,440 | 1,800 | 1,200 | 600 | 0 | 0 | 0 | 0 |
| Sensitive List | 26 | 26 | 26 | 51 | 51 | 51 | 51 | 51 | 51 | 51 | 51 |
| Gen. Exceptions List | 213 | 213 | 213 | 202 | 202 | 202 | 202 | 202 | 202 | 202 | 202 |
| Total | 3,218 | 3,218 | 3,218 | 6,283 | 6,283 | 6,283 | 6,283 | 6,283 | 6,283 | 6,283 | 6,283 |
| Tariff rate | | | | | | | | | | | |
| Inclusion List | 7.0 | 6.8 | 5.8 | 5.6 | 4.7 | 3.9 | 3.8 | 2.8 | 2.6 | 2.5 | 2.3 |
| Temp. Exclusion List | 19.9 | 19.9 | 19.9 | 19.9 | 19.8 | 19.6 | 19.4 | 17.5 | 13.4 | 8.9 | 3.9 |
| Average | 12.7 | 12.6 | 12.1 | 11.9 | 11.4 | 10.9 | 10.7 | 9.3 | 7.4 | 5.3 | 3.0 |

1/ The Most Favored Nation (MFN) tariff applies to goods imported from countries having MFN status in trade relation with Vietnam.

2/ Common Effective Preferential Tariff (CEPT) rate imposed on goods imported from ASEAN countries.

*Source*: Athukorala (2002), Matin and Pham Minh Duc (2000) and CIE (1997). Tariff rates are un-weighted averages, in percent.

Major steps have been taken to liberalize the foreign exchange market, including a gradual phasing out of the foreign exchange surrender requirement by end-2003. This requirement was already reduced to 30 percent in May 2002. The tax on profit remittances from foreign-invested enterprises will be eliminated by end-2002, consistent with efforts to harmonize tax treatment between foreign and domestic enterprises. However, there are still some restrictions on current international transfers and payments (IMF, 2002).

Reform measures have been framed in the context of a number of regional and multilateral arrangements including the 1992 preferential trade agreement with the European Economic Community, the 1995 membership in the ASEAN Free Trade Area and the 2001 Vietnam – US bilateral trade agreement. In 1995, Vietnam submitted an application to join the WTO and has started the process of negotiating the conditions of accession.

### Coordination with other reforms

Vietnam has so far been able to liberalize the trade regime while maintaining a policy bias in favor of domestic-market oriented industries, particularly those dominated by state-owned enterprises. Line ministries and other agencies have been able to comply with the trade liberalization commitments made by the government while still protecting the enterprises under their dependence. From a legal standpoint, all registered firms, regardless of ownership, can engage in foreign trade. But barriers exist which discourage trading by non-state enterprises. For example, stringent regulatory requirements demanded by line ministries prevent private firms to participate in rice exports and fertilizer imports. Also, monopolies in production may translate into monopolies in trading, as in the case of coal.

The tariff structure also embodies a policy bias in favor of domestic industries, particularly those dominated by state-owned enterprises. Most low tariff rates are on items predominantly used by those enterprises as inputs.

Although Vietnam has taken steps to meet its commitments on tariff reductions under the ASEAN Free Trade Area regime, it has been able to defer their impacts by maintaining a number of key products in the General Exception List. Items in this list are effectively excluded from any tariff reduction schemes. The list includes alcoholic beverages, vehicles with less than 15 seats, motorbikes with a capacity of less than 250cc and the corresponding kits.

This policy bias could have considerable welfare costs, in particular because of its impact on investment decisions. Scarce resources are driven towards the manufacturing sector, and especially towards specific industries (table 2.3). The effective protection rate, a standard indicator of inefficiency, is as high as 599 percent for domestic-oriented production of motor vehicles and motorbikes, 366 percent for sugar, 241 percent for tea, 181 percent for wearing apparel, and 163 percent for plastic products (Athukorala, 2002). As a result, a large share of public and foreign investments are directed toward these sectors (MPI, 2002; McCarty, 1998 reported in Fukase and Martin, 1999)).

**Table 2.3: Effective rates of protection**

| Sector | Effective rate 1/ | |
|---|---|---|
| | 1997 | 2002 |
| Agriculture | 7.7 | 7.4 |
| Mining | 6.1 | 16.4 |
| Manufacturing | 121.5 | 96.0 |
| Average (Simple) | 59.5 | 54.1 |
| Tradables | 72.2 | 58.5 |

1/ The effective rate of protection is defined as the percentage change in producers’ value-added over the level that would have prevailed in the absence of trade barriers, including quantitative restrictions. The table reports simple averages, in percent.

*Source*: Athukorala (2002).

The implementation of already ratified international trade agreements provides an opportunity to revitalize and deepen the reform of state-owned enterprises and state-owned commercial banks.

Many industrial sectors, and state-owned enterprises in particular, will be affected by reduced protection. Commitments under the ASEAN Free Trade Area imply that most quantitative restrictions have to be abolished. Items in the temporary exclusion list are to be transferred to an inclusion list by 2003, and tariffs to be reduced to a maximum of five percent by 2006. In addition, the sensitive list is expected to be phased out by 2010. The average (un-weighted) CEPT rate applicable to imports from the ASEAN region is expected to decline from 10.7 percent in 2002 to 3 percent by 2006 (table 2.2). It is likely that management of the enterprises that will be directly affected will pressure the government to increase the fiscal transfers and credit they receive. This would only shift the burden of maintaining inefficient state-owned enterprises to other sectors of the economy.

Commitments under the Vietnam-US bilateral trade agreement imply that Vietnam has to open up to competition in important services, including banking and insurance (box 2.1). The process will start in 2005, and will have a direct bearing on banking reform.

**Box 2.1: Joining regional and multilateral trade agreements**

**ASEAN Free Trade Area**

- Tariffs on the vast majority of tariff lines (95 percent, according to preliminary estimates) on ASEAN imports will be reduced to at most 20 percent by the start of 2003, and to 0-5 percent by beginning of 2006.
- Average tariffs on manufactures from ASEAN countries will be cut by 50 percent by early 2004.
- Average tariffs on ASEAN imports of textiles, leather, wood products, non-metallic mineral products (e.g. glass and ceramic products) and food products will fall by more than 60 percent by early 2004.

**Vietnam-US bilateral trade agreement**

- Trading rights for US firms will be liberalized in three to six years.
- Tariff rates on a limited range of industrial and agricultural items (about 250) will be reduced by 30 to 50 percent over three years.
- Quantitative restrictions on most products will be removed in three to seven years. Restrictions on steel and cement will be removed after six years, and those on petroleum products after seven years.
- In the services sector, Vietnam will provide more market access than low and middle income countries under the Uruguay round, and only slightly less than the larger transition economies.
- Majority US ownership of banks will be allowed after three years. National treatment will be granted in the possible equitization of state-owned commercial banks. National treatment of deposit-taking activities will be phased in after eight years.
- One-hundred percent US equity in financial leasing and in other leasing activities will be allowed after three years.
- Majority US ownership of insurance firms will be allowed after three years. Restrictions on the operation of joint ventures will be eliminated after three years (and for wholly US-owned companies, after six years). Wholly US-owned firm, will be permitted after five years.
- Immediate introduction of one-hundred percent US equity in a range of technical services, including in legal, accounting, engineering, computer-related, and construction areas.
- All WTO-inconsistent measures regarding investment (e.g. local content requirements) will be phased out within five years.
- WTO-consistent protection of intellectual property rights is to be introduced in 12-18 months.
- All laws and decisions governing issues in the agreement will be published. Administrative or judicial tribunals for review will be established, as will the right of appeal.

**WTO**

- Vietnam made its initial offer on specific commitments in services in January 2002.
- The fifth meeting of the Working Party on accession of Vietnam, held in April 2002, reviewed the status of Vietnam's bilateral access negotiations and action plans for implementation of a number of WTO agreements, including those related to investment and intellectual property rights.
- The sixth meeting, held in December 2002, marked the beginning of negotiations.

*Source:* World Bank staff.

Commitments to implement international trade agreements should also be taken into account in the context of tax administration reform. A major consideration in the planned reduction in tariffs is its medium-term impact on government revenue. The net outcome depends on whether the increase in the tax base more than offset the decrease in tariff rates. This outcome should be factored in when developing a long-term tax strategy.

**Accelerating WTO accession**

Vietnam would greatly benefit from fast accession to WTO. By setting accepted rules of trade among its members, WTO discriminates against non-member countries. As the experience of China indicates, accession can generate considerable benefits in terms of improved legal framework and enabling environment all of which result in substantial productivity gains and incremental capital inflows (Liqun, 2002).

As a WTO member, Vietnam would also be in a better position to defend its interest on the international scene. Lacking other instruments, importing countries tend to intensify the use of sanitary standards, or allegations of price dumping, to protect the interests of their domestic producers. Exports of shrimp and gas lighters to the European Union, of frozen fish fillets to the US, and of garlic and water-proof footwear to Canada, have already suffered from trade barriers of this sort. Because Vietnam is not yet a member of WTO, hence cannot take advantage of its dispute settlement mechanism, it must use separate legal measures. In addition, dispute resolution may be very costly and require technical expertise which may not be readily available.

Moreover, the cost of WTO accession will increase over time. The demands put on new members will be higher than those current members had to meet when they joined in. The Doha Development Agenda, in particular, is likely to raise the entry point. To the extent possible, it is important that Vietnam accede WTO before the conclusion of this agenda, which is scheduled for January 1, 2005.

China's accession to WTO creates additional incentives for Vietnam to become a member. Competition with China's exports in third markets will intensify. Vietnam will be especially affected by the abolition of quotas on Chinese textile and apparel exports, starting in 2005. Also, China's WTO accession will improve China's business environment and this could divert away some foreign direct investments from countries with a similar comparative advantage, including Vietnam (box 2.2).

**Box 2.2: Impact of China's WTO accession on Vietnam**

China's accession to WTO presents both opportunities and challenges for East Asian economies and Vietnam in particular. Its impacts will be felt through on a number of outcomes:

1. *Overall welfare*. A decline in China's protection will increase production possibilities, leading to an overall gain in welfare. However, China's large size may also shift the terms of trade with possibly negative impact on third countries, including Vietnam. There will also be a downward pressure on unskilled wages in third countries, including Vietnam.
2. *Aggregate exports*. China' commitment to abolish non-tariff barriers and reduce tariffs (from an average of 13.3 percent in 2001 to 6.8 percent at the end of the implementation period) will fuel trade with the rest of the world. However, China's accession to WTO is expected to have an insignificant overall impact on Vietnam's exports. The increase in Vietnam's exports to China is expected to be more than offset by substitution of third-country imports away from Vietnam.
3. *Exports to China*. Increased access to China's market is expected to stimulate exports from Vietnam across most industries including rice production, food processing industry, light manufacturing, metals and petrochemicals, and electronics.
4. *Exports to third markets*. Competition with China's exports in third markets will intensify as a result of China's accession to the WTO. This will hold especially for countries like Vietnam, which have similar comparative advantage in labor intensive products. For example, Vietnam's textile and garment industry will be directly affected by the abolition of quotas on Chinese textiles and apparel exports to the US and the EU starting in 2005.
5. *Transparency and predictability*. China's trading partners will benefit from the increased transparency and predictability of its trade policy. The specific commitments involve uniform application of the trade regime, independent judicial review and a mechanism to bring problems of local protectionism to the attention of the central government. Access to China's market will be more secured and disputes will be resolved following international standards, an important benefit to China's trading partners including Vietnam.
6. *Foreign direct investment.* The opening of the service sector, including telecommunication, distribution, banking, insurance, asset management, and securities to foreign direct investment, as well as the provision of national treatment to foreign-funded enterprises, may represent the most significant part of China's accession to WTO. Entry into the WTO will require China to amend its laws, regulations and practices to align them with a number of international investment-related rules. China will also be required to abide by international standards in the protection of intellectual property and increase legal transparency. As China improves its business environment, foreign direct investment may be diverted away from other countries including Vietnam.
7. *Bargaining power*. China's accession to the WTO will strengthen the voice of developing countries, and East Asian countries in particular, in this international forum. Also, Vietnam can learn from China's experience in accessing the WTO which could facilitate its own accession.

*Source:* Ianchovichina, Suthiwart-Narueput and Zhao (2002); Ianchovichina and Martin (2001, 2002).

### Infrastructure for trade

Vietnam's infrastructure for trade has been improving slowly. For example, the modification of port facilities and operations has increased the efficiency and reliability of container handling operation. Also, the adoption of the new Customs Law in October 2001 has improved operations drastically. Customs clearance has already been streamlined. The modification of customs valuation in consistency with WTO rules, to be implemented by end-2003, will increase efficiency. Ratification of the Convention on Facilitation of International Maritime Traffic, of the International Maritime Organization, should streamline the documentation process relevant to ship calls

However, further improvements are required to make the current system meet existing needs and keep up with future increases in trade volumes (table 2.4). One important issue is the low efficiency of state-owned enterprise cartels in ports and airports. Monopolies in air cargo, coastal shipping, railways, power and telecommunications also result in high cost. For instance, the telephone installation fee is 93 US dollars in Hanoi, compared to 66 dollars in Bangkok, 33 in Jakarta, and 28 in Beijing. A three-minute call to Japan costs 6.9 US dollars from Hanoi, more than twice as much as from Bangkok, Jakarta or Beijing (JETRO, 2002).

Key elements in the modern logistics of trade, including e-commerce and web pages, face stringent regulations that are difficult to justify from an economic perspective. Transport by land by the private sector is also constrained by low rural accessibility and poor road maintenance (Hopkins, 2002; Nomura Research Institute, 2002; Almec Corporation, 2000). Further deregulation and standardization of logistics industry, and greater private participation in infrastructure services, could help address these concerns.

Quality trade support services are in short supply, and are not very effective (International Trade Center, 2002). Existing government services tend to be driven by what officials think is important to supply, rather than driven by the demands of exporters. Leaving service provision to private business associations could improve their efficiency (Pham Van Thuyet, 2002).

**Table 2.4: Trade–related infrastructure**

| | Ports/ Airports | Air freight | Inland waterway shipping | Road freight | Railways freight | Power | Telecom-munication |
|---|---|---|---|---|---|---|---|
| Market structure | State cartel | State monopoly | Large barges: publicly owned<br>Small barges: privately owned | Private and public trucks | State monopoly | State monopoly | State monopoly |
| Availability of service | Reasonable | Good | Good | Good | Good | Poor<br>• Unreliable with voltage fluctuation | **Poor**<br>• **Delays in new line installation**<br>• Restrictions on internet-based business tools. |
| Price | High | Not available | Depends on location | Competitive | Adequate | Adequate | Very high |
| Productivity | Low<br>• Insufficient container handling capacity in ports.<br>• Insufficient airfreight facility in airports | Low<br>• Insufficient cold storage<br>• Delays due to outdated security checks<br>• Unsatisfactory facilities and handling techniques | Low<br>• Insufficient management leading to insufficient dredging and lack of safety enforce-ment | Low<br>• Insufficient road development and maintenance | Very low<br>• Underused railways capacity | Very low<br>• High losses | Low |
| Overall impact on trade | Varies by region and product | Negative | Varies by region and product | Neutral | Negative | Negative | Negative |

*Source*: Adapted from Hopkins (2002) and Nomura Research Institute (2002).

# 3. A TEST CASE FOR REFORM

The reform of state-owned enterprises, an essential component of the overall reform agenda of the government, was formally endorsed by the third Plenum of the Ninth Party Congress in 2001. An Action Plan, whose aim was to further the restructuring, reform, development and efficiency of state-owned enterprises was approved by the Prime Minister in the following months.

The approach to state-owned enterprise reform in Vietnam differs from that carried out elsewhere, however. Its main instrument, first introduced in 1992 and adjusted in 1996 and subsequently, is equitization, which is arguably not identical to outright privatization. Equitization is a process whereby some or all of the state capital in the enterprise is sold in the form of shares at a price based on the book value of the assets. Directors and employees are given preferential treatment as purchasers of these shares, and often buy all of them. The largest share of equity any individual can buy is 30 percent. The equity cannot be traded within a three-year period, except with special permission. In practice, equitization is difficult to implement without the consent of the enterprise director and a majority of the work force. Equitization yields entities operating under the Enterprise Law.

Other mechanisms, apart from equitization, are also used to restructure the state sector in Vietnam. Small state-owned enterprises can be sold, leased or assigned to their workers at a negotiated price, or even for free. Non-viable enterprises are to be liquidated. Others can be merged into larger units. The overall reform plan foresees about 1,700 of these transformations between 2001 and 2005. Enterprises in a long list of sectors deemed "strategic", on the other hand, are to be restructured but remain in state hands. The overall process is implemented in a relatively decentralized way, as some enterprises report to line ministries, others to provincial governments, and others to two types of sector groupings known as General Corporations 90 and 91.

While efforts to transform and restructure state-owned enterprises have stayed on track so far, the process appears to be slowing down. At present, the reform mechanisms in place amount to an option, rather than a mandate, for enterprises to divest. Reluctance to do so is understandable when over-staffing is pervasive and transformation could lead to massive job losses. Excessive debt burdens may also dissuade potential buyers. While a compensation scheme aimed at encouraging voluntary job separations has recently been put in place, mechanisms to resolve non-performing loans are only partially effective for now. But the slowdown in the transformation process also seems to reflect the opposition of many state-owned enterprise directors, who could lose from ownership transformation.

### A sector large and small

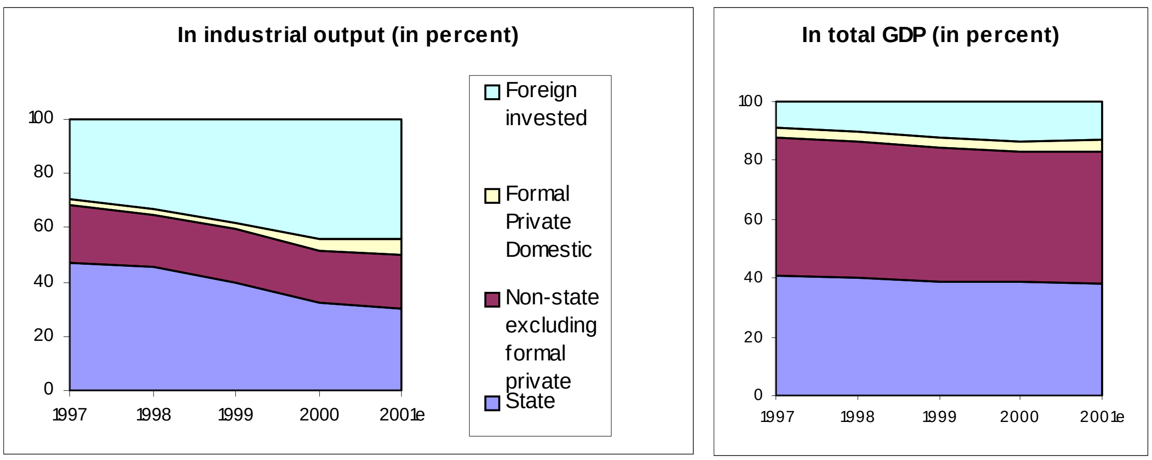
State-owned enterprises still generate an estimated 38 percent of Vietnam's GDP. As they tend to operate in capital intensive industries, they account for dramatically different shares of the country's factors of production. With their 1.7 million workers, they only absorb about 4 to 5 percent of the total labor force. This is the equivalent to one and a half years of entrants into the labor market. Because of the sustained increase in educational attainment, these 1.7 million workers are not more skilled than the new entrants. From this perspective, state-owned enterprises do not represent an overwhelmingly large drag on the economy.

On the other hand, the share of capital absorbed by the state sector is presumably large. A precise estimate is difficult to obtain, due to problems in the valuation of assets in a transition economy. In state-owned enterprises, equipment and machinery are counted at book value, which may over-estimate their market price. More importantly, land is not appropriately accounted for, despite the fact that it represents the most valuable asset of many enterprises. An indirect way to assess the share of capital absorbed by the state sector is to consider its share of domestic credit. The outstanding bank debt of state-owned enterprises amounts to 90 trillion dong, or about 6 billion US dollars. This represents roughly 40 percent of total domestic credit.

Many of the loans given to state-owned enterprises by state-owned commercial banks might never be recovered. While the exact value of non-performing loans is difficult to estimate, the current situation amounts to a claim by the state sector on future capital accumulation. The share of credit going to state-owned enterprises is gradually declining. But in 2002, it still represented around 25 percent of new loans.

A similar picture, whereby the size of the state sector remains large despite its decline, is obtained when other indicators are considered. The downward trend is quite considerable when the chosen indicator is the share of industrial output. It is more modest, however, when the share of total GDP is considered instead (figure 3.1).

**Figure 3.1: Shares of the state and the private sectors**




*Source*: General Statistics Office.

## Unsteady progress

A prominent indicator in the policy reform process is the total number of state-owned enterprises. Following the reduction from over 12,000 enterprises in 1990 to about 6,300 in 1992, in the context of a major economic crisis, there was a period between 1993 and 1997 where the number of transformations was very low. From 1997 onwards, as the equitization mechanism introduced a few years earlier started to be implemented, the process regained momentum. But it now appears to be stalling.

Several hundred state-owned enterprises were transformed or liquidated in the five years leading to the Ninth Party Congress in 2001. After a modest start, with ten equitizations in 1997, numbers increased into the hundreds. A target of 400 transformations was set for the first year of the Action Plan, and it was attained. Provincially administered state-owned enterprises took center stage in this process, accounting for 57 percent of all transformations (table 3.1). Since the beginning of 2001 about 70 percent of equitizations have involved the sale of more than 65 percent of the equity to non-state shareholders.

The sizes of the state-owned enterprises equitized and transformed by other means have been relatively small by international standards. The average number of employees is about 250 and the charter capital roughly 5.7 billion dongs, or 380 thousand US dollars. On average, these enterprises carried 5.6 billion dongs of bank debts (about 370 thousand US dollars) prior to their transformation. Thus, enterprise transformation has resulted in removing significant debt from the public sector.

**Table 3.1: Divestiture… and creation**

| | | 1998 | 1999 | 2000 | 2001 | 2002 1/ |
|---|---|---|---|---|---|---|
| Total transformations | | | | | 288 | 139 |
| By transformation type | Equitization | 102 | 242 | 211 | 200 | 116 |
| | Sale | | | | 17 | 5 |
| | Assignment | | | | 41 | 13 |
| | Liquidation | | | | 30 | 5 |
| By authority | Line ministry | | | | 25 | 30 |
| | Province | | | | 255 | 96 |
| | G. Corporation | | | | 8 | 13 |
| Total creations | | 87 | 94 | 74 | 43 | 8 |
| By authority | Line ministry | 14 | 28 | 35 | 19 | |
| | Province | 66 | 52 | 31 | 15 | |
| | G. Corporation | 7 | 14 | 8 | 9 | |

1/ As of September.

*Source:* NCERD and CIEM.

On the other hand, a number of state-owned enterprises were created during the same period. Not all of them result from new ventures. The registration of existing units, typically utilities, as state-owned enterprises underlies some of the large creation figures that are often mentioned. Also, some equitizations lead to the establishment of an Enterprise Law company out of a pre-existing state-owned enterprise that remains in operation. It is estimated that only 30 to 40 percent of the new state-owned enterprises created in 1998-2001 represented new activities. Most of the new enterprises were very small.

The process of creating new state-owned enterprises came almost to a halt in mid-2001. From then onwards, the Prime Minister’s approval has been required for any new venture. This commitment was ratified in 2002. The creation of new state-owned enterprises is now strictly controlled.

The reduction in the number of smaller state-owned enterprises, and the development of the larger, more successful ones, means that the absolute size of the state sector has increased. Something similar happened during the earlier period of state-owned enterprise transformation, in the early 1990s (Asian Development Bank, 2001). However, transformation has been concurrent with the rapid growth of the private sector, which explains why the relative size of the state sector, as a proportion of the Vietnamese economy, is declining steadily.

### New reform efforts

Recognizing that the transformation of state-owned enterprises is proceeding more slowly than anticipated, several reform initiatives have been undertaken (box 3.1). Others are currently under consideration.

One of the potential explanations for the slow rate of transformation is the lack, until recently, of an appropriate legal framework to convert state-owned enterprises into companies operating under the Enterprise Law. While important regulations concerning the valuation and sale of state equity were issued between April and July 2002, there has been insufficient time for them to really have an impact on the rate of equitization. Further, the knowledge that legislation was about to be amended temporarily slowed down the process. Understandably, stakeholders in state-owned enterprises slated for transformation wished to examine the new decrees and their implementing guidelines before moving ahead with important decisions.

**Box 3.1: New regulations for state-owned enterprise reform**

The year 2002 witnessed a raft of legislative changes with respect to the transformation of state-owned enterprises. The principal instruments are:

Decision 58/2002/QD-TTG of 26 April categorizes state-owned enterprises. It stipulates that the state shall hold full ownership in a wide range of areas deemed strategic. The state will also retain full ownership in businesses that are essential for production development, and for the enhancement of living conditions in rural mountainous and remote areas. By exception, Decision 58 further specifies some of the industries where enterprises are to be equitized, handed over to employees or sold. It also draws up criteria for General Corporations. Those failing to meet industry, size, profitability and modernity criteria are to be reorganized towards merger or dissolution.

Decree 64/2002/ND-CP of 19 June replaces Decree 44, regarding the equitization of state-owned enterprises. It gives the right to buy shares to both Vietnamese and foreign organizations and individuals. Outsiders, including foreigners are now entitled to buy up to 30 percent of the charter capital of a company. A number of financial benefits are also introduced for equitized enterprises.

Guidelines for the valuation of enterprises to be equitized are set out in Circular 79 of the Ministry of Finance, dated 9 September. This valuation determines the share structure. It is based on the enterprise's books of account at the time of equitization, on the quantity and quality of its assets, on the assets' specification and market price, on the value of the land use rights, and on the value of the business goodwill. Enterprises supplying services, rather than tangible products, are to be valued using discounted cash flow methods.

Decree 69/2202/ND-CP, issued on 12 July, instructs state-owned enterprises to settle their outstanding debts. Those that have large unrecoverable debts are to be liquidated or declared bankrupt.

In Circular 80 of 12 September, issued by the Ministry of Finance, priorities are established regarding the parties to whom shares should be sold, including employees (at a concessionary price), producers and suppliers of raw materials in agriculture, forestry and aquaculture enterprises (at a concessionary price as well) and outsiders. Among the latter, preference is given to investors with advantages in technology, market access and managerial skills. If the shares allocated to insiders are not sold within two months, they can be sold to outsiders. The circular also provides guidelines for the auctioning of shares to outsiders and underwriting. It includes provisions for the participation of financial intermediaries

Proceeds from selling state capital accrue to the Fund for State-owned Enterprise Restructuring depending upon the authority that had been responsible for the enterprise in question. Priority in the use of such proceeds is given to the payment of workers' severance, support for re-training, investment in enterprises where the state is the dominant shareholder, settlement of the overdue debts of insolvent enterprises, repayment of enterprises whose proceeds from share sales is insufficient and, lastly, financial support to enterprises that change their technology, improve their competitiveness or expand their business.

*Source:* Vietnam Official Gazettes.

Another potential explanation for the slow pace of transformation is resistance by insiders, among them workers in state-owned enterprises. To address this concern, a social safety net for redundant workers was set up in April 2002. A fund, managed by the Ministry of Finance, provides compensation above what is established by the Labor Code. It also deals with severance pay as foreseen by the Labor Code and with wage arrears when the enterprise is unable to meet its obligations.

Other stakeholders may also lose as a result of enterprise transformation. Directors, in particular, are not entitled to compensation by the social safety net fund. They are offered another job in the public sector instead. Quite often, their efforts have been oriented towards gaining control of the equitized companies. Others do not start the ownership transformation process when requested. Some are faced with problems that cannot be resolved. The valuation of the company, the issues of surplus labor and assuming new responsibilities are new to them. Confronted by a host of unknowns and uncertainty, many directors find the process too daunting. Some do not complete it for reasons that remain unclear. To an outside observer, the difference between diffidence and vested interest is difficult to discern.

A new state-owned enterprise reform plan is in preparation. The current practice is for provincial authorities, line ministries and General Corporations to submit annual transformation plans for the enterprises for which they are responsible. In 2001, for the first time, these authorities were guided by Decision 58, indicating which enterprises should be kept within the state sector and which ones should be divested. For 2003, the names of the enterprises to be transformed will be published, indicating the timetable for the transformation.

The monitoring and enforcement of the transformation process, however, may remain weak. Binding constraints do not fit well in a wholly consensual process. There is a clear gap between having a mandatory equitization program, and creating a framework where state-owned enterprises can transform if they wish to.

Excessive large debts are another obvious reason why ownership transformation may be slowing down. The enterprises equitized or sold so far were probably the ones with the highest potential. But many others are burdened by huge debts and payments arrears. Few buyers could be interested in acquiring their shares. A new mechanism is now being considered whereby the government would trade these debts at a discount price. However, many uncertainties remain regarding this proposed mechanism. There is a risk that it could be used to write off the debts of enterprises that are not bound to be transformed, thus raising the prospect that new debts will be contracted only to be subsequently written-off. Design specifics are key to avoid a further expansion of bad loans and to minimize fiscal risk.

**Corporate governance**

With roughly 2,700 enterprises to remain in state hands by 2005, mechanisms to create a favorable environment for them to prosper, and not to interfere with private sector development, are essential.

The Action Plan stated that the accounting auditing and reporting regime should be reformed to provide more information and to disclose the business and financial information of an enterprise. However, it did not specify a short-term action to achieve this. The information available on state-owned enterprise performance remains patchy, unconfirmed and often outdated. This holds back the improvement of corporate governance in the state sector and tends to confirm speculation about its poor performance.

A series of diagnostic audits and operational reviews being conducted on large state-owned enterprises sheds some light on their current situation and prospects. It appears that Vietnam's accounting standards afford some scope for discretion in what to count as profits, making them a poor indicator of performance. Audited (and unaudited) accounts are not generally available.

Financial performance thus escapes the scrutiny that it would attract in a market economy. General Corporations tend to get involved at a detailed level in the enterprises that report to them, inhibiting the ability of management to work effectively. On the other hand, management is able to pursue diversification activities that do not contribute to the core businesses of the enterprise. Last but not least, marketing and managerial skills are low, and the use of information technology very limited.

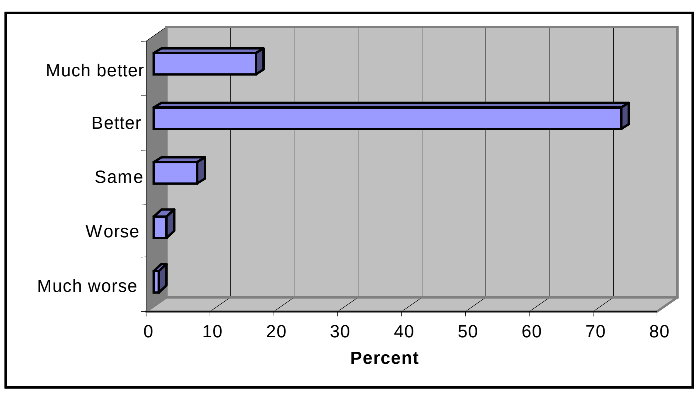
The development of corporate governance in state-owned enterprises is essential to increase government oversight and assess financial risks. The Ministry of Finance is working on new accounting standards to be issued in 2003. Their adoption would go a long way towards improving transparency. Better information would strengthen accountability and potentially attract private investors. But the effectiveness of the new corporate governance regime will crucially depend upon the disclosure requirements to be specified, the accounting standards to be chosen, and the enforcement mechanisms to be adopted.

**Performance before and after equitization**

Despite the shortcomings of the state sector, the commercial success of many state-owned enterprises is an established fact, as evidenced by their export performance. Enterprises in textiles, in particular, have proved able to restructure their work force both in terms of total employment and in terms of contractual relations, and have managed to spearhead the textile and garment sectors' export drive in Vietnam without direct cash subsidy (Thoburn, Nguyen Thi Thanh Ha and Nguyen Thi Hoa, 2002). In other sectors, the ability of state-owned enterprises to compete if and when import tariffs are lowered is more questionable. But this does not imply that all state-owned enterprises perform badly.

Until recently it was difficult to determine how equitized enterprises would fare after divestiture. But some of them have now been outside the state sector long enough for an assessment to be feasible. A recent study focused on 422 enterprises equitized prior to 2001 (CIEM, 2002). Quantitative responses were obtained from 31 percent of these and qualitative responses from a further 38 percent. The study reveals that sales in these enterprises are growing at almost 20 percent per year, employment at 4 percent, wages at 12 percent, and assets at 21 percent. The average annual increment in profitability is a little over 2 percent. On a qualitative basis, respondents consider that the performance has improved substantially (figure 3.2).

**Figure 3.2: The performance of equitized enterprises**




*Source*: CIEM (2002).

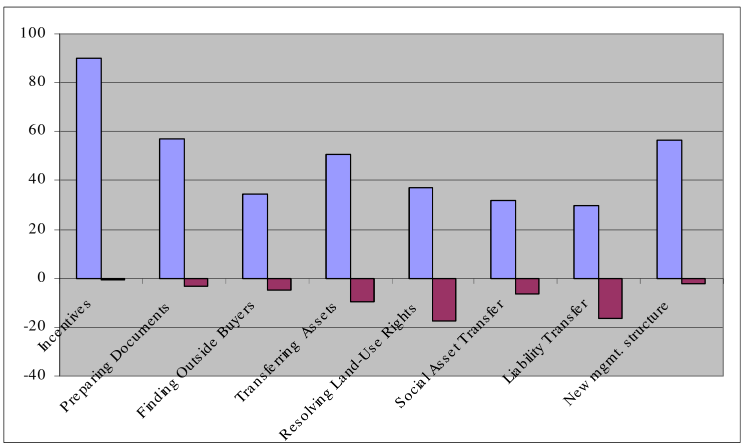
These findings are more positive than what most observers would expect. However, this may be partly due to the fact that the best-performing enterprises were transformed first. In an environment where management and workers basically opt for equitization, a degree of self selection is to be expected. Insiders who do not anticipate a commercially successful future are less likely to go for ownership transformation. Similarly, before the new safety net was in place, enterprises that required significant labor downsizing were probably more reluctant to equitize.

Despite their success, equitized enterprises report problems in accessing credit from banks, in securing land use rights documentation, and in obtaining government licenses and permits. In these ways their experiences are similar to those of private sector companies that do not have a state sector past.

Another study of equitized enterprises in the fishing sector reached similar conclusions (Svendsen, 2002). Although these enterprises have some distinctive features, such as more frequent managerial changes and greater participation by non-employees in share ownership, the findings were broadly similar to those reported above.

For all equitized enterprises, memories of the ownership transformation process are still fresh. Their managers were therefore able to report what had helped and what had hindered equitization the most (figure 3.3). Problems with the equitization process would be better addressed by speaking to those who did not manage to complete it. However, the answers of those who did are still revealing. Dealing with the transfer of liabilities, and resolving issues related to land-use rights, were reported to be the biggest problems.

**Figure 3.3: What helped and what hindered equitization**




*Source:* CIEM (2002). Positive figures indicate the percentage of respondents who declared that a specific factor helped the equitization process. Negative figures measure the percentage declaring that the factor hindered the process.

## 4. CREDIT AND BANKING

Since the late 1980s, important changes have occurred in the structure, the regulation, and the operations of the Vietnamese banking sector. Four large state-owned commercial banks still account for 73 percent of the total assets in the system. But they are now complemented by a number of joint-stock banks, joint-venture banks, and branches and representative offices of foreign banks. Over the past decade the four large state-owned commercial banks slowly have started to evolve from specialized policy lending vehicles to more commercially-oriented financial intermediaries, with the greatest progress seen in 2001 and 2002 (World Bank, 2002c).

The past decade also witnessed a rapid deepening in the level of monetization of the Vietnamese economy. The ratio of bank credit to GDP increased from 13 percent in 1990, to 27 percent in 1995, and further to 44 percent in the year 2000. The growth of the non-banking financial sector, and especially of the insurance business, has been remarkable as well, even if the size of the sector remains small in absolute terms.

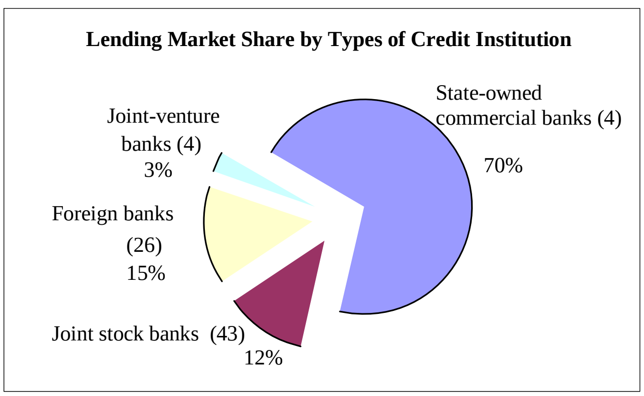
This transformation has happened in some areas at a managed pace, in others with some fits and starts. But the change has not come about without cost. Continued policy lending practices through the 1990s, and limited credit assessment skills in the wake of rapid credit growth, have led to the accumulation of non-performing loans. To address this concern, the government has embarked on an important overhaul of the banking system through a multi-year restructuring and recapitalization program.

**A segmented credit market**

Despite the measures taken to start deregulating financial and banking services, the playing field is not yet level across different types of financial institutions. For example, foreign banks are not allowed to mobilize deposits in domestic currency. But there is no such restriction applied to foreign insurance companies. Barriers to entry remain considerable. The State Bank of Vietnam controls quite tightly the granting of banking licenses, both for the establishment of new banks as well as the provision of new banking services by established institutions.

Also, despite the development of joint-stock banks, joint-venture banks, and branches and representative offices of foreign banks, the sector continues to be dominated by the large four state-owned commercial banks (figure 4.1).

**Figure 4.1: Lending market shares**




*Source*: Estimates by World Bank staff, as of end 2000. The number of institutions in each category is reported in parenthesis.

While the bulk of the bank credit is still channeled to state-owned enterprises (table 4.1), a pattern of segmentation in the provision of credit by type of institution prevails. As of September 2002, 50 percent of the loan portfolio of state-owned commercial banks was made of loans to state-owned enterprises. Foreign banks seem to be mainly engaging in providing financial services to the operations of multinational corporations in Vietnam rather than getting into competition for services to domestic corporations, either state-owned or private. Joint-stock banks appear to still be the primary source for serving the domestic private sector, which accounts for the bulk of their market share of bank credit. These patterns may to a certain extent reflect the historic roles of the different credit institutions, or they could reflect their comparative advantage. But they could also be due to the lack of a level playing field and regulatory anomalies.

**Table 4.1: Credit to State-owned Enterprises**

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002e |
|---|---|---|---|---|---|---|
| Trillions of dong | 31.0 | 38.1 | 54.3 | 69.9 | 79.7 | 86.9 |
| In percent of credit to the economy | 49.6 | 52.4 | 48.2 | 44.9 | 42.1 | 39.6 |

*Source*: State Bank of Vietnam. Estimates for 2002 are as of end September.

In the rural credit market, formal and informal finance exist side by side. The formal sector is led by the Vietnam Bank for Agriculture and Rural Development, which accounts for an overwhelming share of outstanding loans. Other formal institutional lenders, such as the Vietnam Bank for the Poor, have a smaller influence on rural financing. The informal sector includes money lenders, distributors, rotating savings and credits associations, relatives and friends.

The formal sector is the main source of finance for households in rural areas, accounting for 80 percent of total loans (Pham Bao Duong and Izumida, 2002). The Bank for Agriculture and Rural Development alone, accounts for 65 percent. The formal sector is specialized in lending for production whereas the informal sector's lending purposes are quite diverse. At the household level, total farming area and total value of livestock are the main determinants of borrowing from formal financial institutions.

### The non-banking financial sector

A new Law on Insurance Business became effective in April 2001. As of end-2002, there were 18 insurance companies operating in Vietnam  Although the private sector's market share is on the rise, the state-owned insurer remains the dominant player, with non-life and life market shares of approximately 47 and 55 percent respectively. Coverage is low, with annual insurance premiums amounting to 1 percent of GDP. But premiums have grown at an average rate of 30 percent per year, reaching an estimated amount of 4.9 trillion dong (approximately 321 million US dollars) in 2001.

Vietnam also has eight finance leasing companies, three of which are either joint ventures with foreign investors or wholly foreign owned. Five are subsidiaries of state-owned commercial banks.  In 2001, the value of leased assets amounted to 2 trillion dong, or 131 million US dollars.

Trading for equities and bonds on the Securities Trading Center is still limited. After over five years of meticulous planning the Securities Trading Center opened in July 2000, in Ho Chi Minh City. Currently 19 companies and 18 bonds are listed, with a total market capitalization of 1.6 trillion dong, or about 105 million US dollars. The companies listed are all former state-owned enterprises transformed into joint-stock companies. The trading was upgraded in December 2001, and a clearing and settlement system consistent with best international practices will be introduced by 2005.

### Banking reform

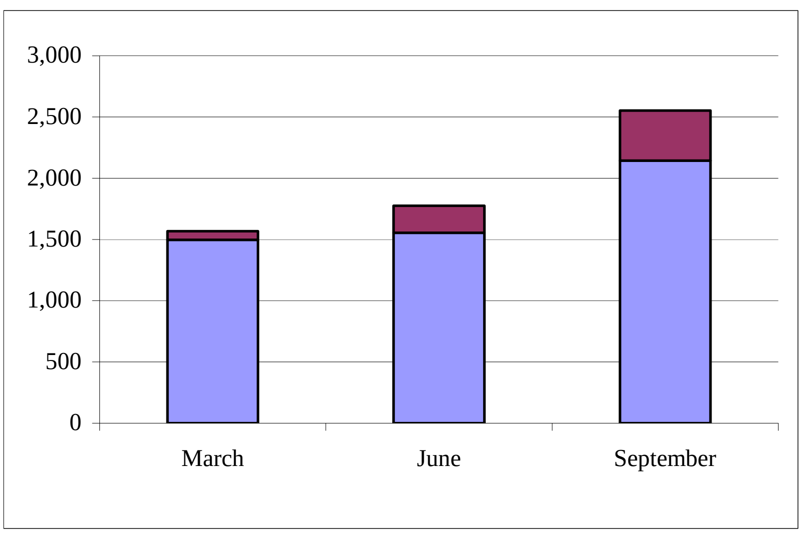
Efforts to transform the banking sector into a commercially-based operation are still in their early stages. The  measures taken to date include deregulating the interest rate regime, putting in place restructuring plans for state-owned commercial banks, establishing bank-based asset management companies to resolve non-performing loans, phasing in a re-capitalization plan, and phasing out directed policy lending by the state.

The liberalization of interest rates started in 1996, for deposits in domestic currency. It expanded to foreign exchange savings mobilizations in 1999, to foreign exchange lending rates in 2001 and, very recently, to lending rates in domestic currency. While direct state control has been eased with these steps, there is little experience yet on what the true impact of the commenced rate liberalization will be to banks' behavior in setting rates, and thus their future profitability. For now, differentiation between banks and types of borrowers remains limited.

Deposit rates do not appear to be fluctuating much, and it is not entirely obvious why this is so. Rapid growth in monetization, the banks' reluctance to compete on rates, and occasional intervention by the State Bank of Vietnam may all have contributed to the observed stability. Rates in domestic currency have not really responded to increased demand, whereas rates in foreign currency have remained substantially below comparable international market rates. Even compared to very competitive regimes, the interest rate margins of Vietnamese banks remain low. In the case of state-owned commercial banks, this is somewhat surprising, given their need to increase general provisions for non-performing loan resolution.

Progress in the resolution of old non-performing loans has been slow but steady (figure 4.2). The main difficulty is with loans without collateral, mainly to state-owned enterprises. State-owned commercial banks find it difficult to meet their resolution targets, owing to delays in state-owned enterprise reform. Although progress in the resolution of non-performing loans varies across the four large state-owned commercial banks, a first round of re-capitalization provided resources to each of them. It is not clear, however, that the portfolio of the banks is seeing significant improvement.

**Figure 4.2: Resolution of non-performing loans in 2002**




*Source:* State Bank of Vietnam. Figures correspond to the four large state-owned commercial banks, and represent cumulative amounts, in billion dong. The bottom portion of the bars represents loan with collateral, and the top portion loans without collateral. Figures are in trillion dong.

To separate policy lending from commercial lending at state-owned commercial banks, a Social Policy Bank was established, with an initial charter capital of 5 trillion dong. The Social Policy Bank has a branch network in all provinces. It enjoys privileges such as having its liquidity and solvency guaranteed by the government, and being exempt from deposit insurance and tax regimes.

**The road ahead**

Some of the most difficult challenges ahead concern the large stock of non-performing loans. Ideally, mechanisms for the resolution of loans without collateral and debts among state-owned enterprises should be implemented. Whether the mechanism that is currently being considered to trade the debts of state-owned enterprises bound to be equitized will actually play that role is an open question. In the meantime, the lack of a timely resolution process for non-performing loans hampers the creation of a credit culture of repayment.

At present, even the size of the non-performing portfolio of the four large state-owned commercial banks is controversial. The uncertainty is partly due to differences between Vietnamese and international accounting standards regarding loan classification. For instance, Vietnamese standards count as non-performing only the overdue installments, not the entire loan. Specific actions to assess the non-performing portfolio and measure progress in its resolution now include audits based on international standards, leading to a reclassification of the loan portfolio and a timetable for provisioning based on the new classification.

However, the adoption of international accounting standards could weaken the position of some of the banks and thus there is a need for a plan to address their re-capitalization. To avoid a future deterioration of the loan portfolio, re-capitalization should be more strictly based on performance and compliance with the milestones of the restructuring plans. This would introduce an incentive for state-owned commercial banks to follow more strict lending rules, including credit and risk analyses, and the use of explicit government guarantees for lending to state-owned enterprises.

Regulation and supervision of the banking sector is being reviewed to promote more commercially-oriented practices and enhance transparency. The examination function is one of the tools used in the supervisory process. It allows the supervisor to review the operations of an institution to ensure that it is acting consistently with the rules and regulations for the industry. In Vietnam, the inspectors' main duty is to check whether the laws on monetary and banking operations have been observed by the financial institution. Evaluation of asset quality and other risks in the banks' operations are not yet among the routine tasks.

Going forward, the State Bank of Vietnam should concentrate more clearly on its core central banking and bank supervisory functions. It currently plays a role in the state-owned commercial banks that would normally be deemed inappropriate for a supervisor. This potentially impacts the value and quality of examinations.

To concentrate on its core functions, the State Bank of Vietnam would need to embark on an exercise to evaluate its role, mission and vision in the development of the financial system. This would require it to review its legal powers, organizational structure and work processes.

A practical guide to the modernization of the banking sector is provided by the Basel Core Principles. To date, nine of these principles have been assessed in Vietnam (box 4.1). The most significant weaknesses identified relate to the lack of consistency, transparency and accountability in the banking system and in the bank supervision process.

**Box 4.1: Limited Basel Core Principles Assessment**

*Principle 1*. The State Bank of Vietnam should define the objectives and responsibilities of each agency involved in supervision. This includes putting in place arrangements to share information between supervisors and establishing operational independence with respect to other State bodies.

*Principle 3***.** The licensing process leaves room for excessive subjectivity. It should include: an assessment of the ownership structure, directors and senior management; clear operation and internal controls plans; and projected financial conditions (including capital base).

*Principle 6***.** A minimum capital adequacy ratio (8 percent) is in place, but compliance is hindered by the use of local accounting standards. This is particularly evident regarding loan classification and provisioning, which have a decisive impact on the computation of the ratio.

*Principle 7***.** The task of State Bank of Vietnam inspectors is very much oriented towards checking compliance with laws and regulations. It does not involve sufficient judgment in the evaluation of a bank's policies and procedures related to the making of loans and investments.

*Principle 8***.** State Bank of Vietnam evaluate asset quality based on a matrix of overdue periods, rather than on the risk profile of borrowers. Evaluation is made more difficult by a legal environment that hinders the enforcement of creditor rights, thus reducing the value of collateral.

*Principle 14***.** The general principles of corporate governance, laid down in the Law of Credit Institutions, are not followed. The duties and powers of the internal control unit are focused on compliance rather than risk.

*Principle 16.* State Bank of Vietnam inspectors do not perform forward-looking risk assessments. On-site inspections manuals exist but need to be implemented. Off-site supervision is not forward looking either and is not in a position to assess risk-based profiles of credit institutions.

*Principle 21.* Accounting practices and policies are rather ad-hoc. Differences with International Accounting Standards include loan classification, loan loss provisioning, and accrual versus cash accounting of interests and expenses.

*Principle 22.* The State Bank of Vietnam has given its inspectors a wide range of sanction powers. But no meaningful track record exists to confirm the effective use of these powers.

*Source***:** World Bank staff based on documents produced by the Basel Committee on Banking Supervision, Feb 2000 and World Bank Review (forthcoming a).

The Vietnam-US bilateral trade agreement, and the announced plan to join the WTO imply that regulatory discrimination against foreign institutions will eventually need to be abolished. Therefore, a strategy for liberalization should be discussed. Ideally, the strategy should involve the strengthening (but not the tightening) of the regulatory and supervisory regimes.

### Widening the access to finance

The government of Vietnam has expressed its intention to widen the access to bank finance to the private sector, and to small and medium enterprises in particular. However, different segments of the market have different needs in terms of the nature of their relationship with the banks (box 4.2). They also vary in the type of funding and services they require. Further, their ability to provide the banks with good financial information on their repayment capacity, and when necessary to back their borrowing with collateral, differs significantly.

**Box 4.2: Postal savings**

The Vietnam Postal Savings Service Company (VPSC) was established in 1999, which makes it one of the youngest postal savings schemes in the world. Its main goal is to provide formal savings instruments to underserved segments of the population. It currently has 539 branches and plans to expand to 600 branches by the end of 2002. There are presently nearly half a million deposit accounts with the VPSC. Cumulative collection amounts to seven billion Dong in deposits, with current outstanding deposits at 3.8 billion Dong.

In a country where three quarters of the population live in rural areas, the VPSC has the potential to reach wide and deep. Its geographical base is not driven by profitability considerations. The VPSC appears to be preferred by rural customers who have no previous exposure to financial services, especially since it appears to offer an implicit government guarantee.

The VPSC has provided an avenue to access to limited financial services that have been missing in a number of areas. As it continues to grow it will benefit people throughout the country by providing them with a savings vehicle that will permit withdrawals almost everywhere in Vietnam. As it stands today, VPSC is a valuable resource, but care is needed going forward, especially regarding the use of the mobilized funds.

*Source*: World Bank staff.

To facilitate lending to the private sector, and to small and medium enterprises in particular, the operational environment of the banking system has to be enhanced. Strengthening the functions of the Credit Bureau and Registry of collateral, and clearly defining what can be pledged as collateral, are key steps in the process.

A Registry Center has recently been set up under the Ministry of Justice, which should in principle reduce future disputes among creditors on claims on secured transactions with movable assets. The registration process has the potential to increase the transparency of lending transactions and of the ownership of the underlying collateral. The use of the Center has been limited, but in October 2002 the State Bank of Vietnam issued a directive that should increase it. On the other hand, the Registry Center does not yet have an electronic filing system capable of tracking, recording and providing information on a timely basis. All filings for the entire country are done manually, and all requests for information on liens rely similarly on a manual process.

A Credit Information Center was also established, to provide information on borrowers to creditors. This Center is at an early stage of operation as well. But it could become a crucial tool for banks to reduce risk of their future lending. One possibility would be to make it a separate legal entity owned by the credit institutions, with a fee structure that would make it profitable. The related rights and duties of the pertinent parties involved should be clearly backed by legislation with adequate sanctions for breaches, thus protecting the collected data from unwarranted uses.

# 5. A LONG WAY TO GO

A significant shift in attitudes toward the private sector occurred, with the enactment of the Enterprise Law in 2000, and more recently with the formal endorsement of the private sector following the Fifth Plenum of the Ninth Party Congress, in March 2002. The Enterprise Law effectively represents the change from a business license system where the government perceives its role as restraining and directing private sector activities, to a business registration system where the government sets the ground rules for the private sector to operate.

Growth in the private sector will be of critical importance in Vietnam, especially for job creation. There are 1.2 million new entrants to the labor market each year. The state sector can not be expected to be a net provider of employment opportunities, as previous trends have shown, and even less so as it implements the reforms needed to increase its efficiency. Beyond employment, a stronger private sector will create the competitive pressures required to improve the performance of state-owned enterprises. A vibrant private sector will also provide an important source of investment and could play a role in the provision of basic services, such as utilities and education. But to accomplish all these objectives, further improvements in the business environment are necessary.

### A good start, but…

The private sector response to the recent policy and legislative change has been dramatic. Between January 2000 and October 2002, almost 50,000 new enterprises were registered, the vast majority of which are fully privately owned (table 5.1). This is equivalent to nearly three quarters of the total number of enterprises registered in Vietnam today. Most newly registered private firms are relatively small in scale. Those registered so far in 2002 have an average capital of 1.35 billion dong, or roughly 90 thousand US dollars.

**Table 5.1: Newly registered enterprises**

| | 2000 | | 2001 | | 2002 1/ | | Total to 2002 | |
|---|---|---|---|---|---|---|---|---|
| | Enterprises | Capital | Enterprises | Capital | Enterprises | Capital | Enterprises | Capital |
| Private enterprises | 6,412 | 2,817 | 7,087 | 3,873 | 4,871 | 3,095 | 18,370 | 9,785 |
| Limited liability companies | 7,304 | 7,968 | 11,038 | 14,080 | 9,162 | 13,453 | 27,504 | 35,501 |
| Shareholding companies 2/ | 726 | 3,066 | 1,534 | 7,552 | 1,565 | 7,112 | 3,825 | 17,730 |
| Total | 14,442 | 13,851 | 19,659 | 25,504 | 15,598 | 23,660 | 49,699 | 63,016 |

*1/* Data for 2002 are as of October 10.

2/ In addition to newly created private companies, this category may include equitized state-owned enterprises, newly created joint-stock companies with some state ownership, and shareholding companies established under the Law on State Enterprises.

*Source*: Ministry of Planning and Investment. Refers to companies registered under the Enterprise Law. Capital is measured in billion dong.

The industrial output of the nascent private sector increased by almost 19 percent in 2001, compared to 13 percent for the state sector. But despite all this progress the formal domestic private sector in Vietnam is still tiny and relatively fragile. As of 2002, it accounted for less than 4 percent of total GDP, 6 percent of output in manufacturing, and about 3 percent of total employment. In this respect, the private sector still has a long way to go.

### Leveling the Playing Field

The present playing field in Vietnam is far from level. Different enterprise groups, whether they be state-owned enterprises, foreign enterprises, formal private enterprises or household businesses, are each governed by separate legislation and regulations. Either on the basis of enterprise type, activity or location, firms are eligible to benefit from special schemes, such as credit facilities or tax holidays. The government has indicated its intention to unify the legal framework for all enterprise types, but needs to accelerate this effort.

Access to key factor markets of land and capital also varies according to enterprise type and results in different enterprise behavior. For example, private firms, many of which lack land-use rights or other form of acceptable collateral, have to rely more on connections and personal relations than their state sector counterpart to access capital (table 5.2).

**Table 5.2: The importance of connections**

| | Private firms (percent of responses) | | State-owned enterprises (percent of responses) | |
|---|---|---|---|---|
| Degree of importance of personal relations for: | Moderately important | Very important | Moderately important | Very important |
| Source of capital | 30 | 49 | 27 | 22 |
| Bargaining with banks | 31 | 32 | 23 | 20 |

*Source:* Asia Pacific School of Economics and Management and CIEM (2002).

The prioritization of state-owned enterprises also constrains private sector development and growth in firm size. Recent regulations, such as Decision 58, concerning the scope of state-owned enterprise activities, reflect the government's determination that the state remain dominant in various commercial sectors, such as the production of machinery and equipment for agriculture, forestry, fishery, production of electronic equipment, information technology, cement, construction, and important consumer goods and processed food.

Perceptions matter as well. While official and public attitudes towards the private sector appear to be improving, private firms are still not regarded equally. State-owned enterprise directors often voice their envy of the relative freedom and autonomy afforded to their private counterparts, and what they regard as unequal enforcement, for example, by tax collectors. On the other hand, two thirds of private enterprise managers claim that preferential treatment of state-owned enterprises is an obstacle to their business, and 43 percent see it as a major one. Uneven treatment leads to different business responses and practices, especially regarding the recourses enterprises use to resolve conflicts. Thus, 76 percent of state-owned enterprise directors declare that they resort to the government for contract resolution, compared with only 44 percent of private enterprise managers (Asia Pacific School of Economics and Management and CIEM, 2002).

## The role of the government

The role of the government needs to change from planner and provider to regulator and facilitator. At present there is not enough clarity regarding the obligations and responsibilities of different government agencies and levels of government. Streamlining of bureaucratic procedures would reduce the rent-seeking opportunities and transaction costs faced by businesses in dealing with the government. For instance, entrepreneurs are still required to go through a 10-step registration-operation process which takes about 68 days and costs 35 percent of the annual per capita GDP (box 5.1).

The granting of business licenses is a case in point. While progress has been made in reducing their number, the process has been far from steady. On February 3rd, 2000, a total of 84 licenses were revoked. An extra 27 were revoked on August 11, 2000, when 34 were modified as well. Similarly, on June 4, 2002, five licenses were revoked and 10 modified. At that point, seeking clarity, the Vietnam Chamber of Commerce and Industry sent a list of 226 licenses to ministries and government agencies for clarification. It turned out that 51 of those licenses no longer existed, but 21 new ones were identified, implying that 194 licenses were still in effect.

**Box 5.1: Ten steps (and 68 days) to get started**

The following are the procedures that an entrepreneur needs to go through in order to start operations, using the example of registering a Private Limited Liability Company (cong ty trach nhiem huu han), with a capital of 3,900 US dollars in Hanoi.

*Step 1: Obtain a business registration certificate from the local Business Registration Department,* Time:15 days. Cost: 220,000 Dong.

*Step 2: Obtain a seal-making license from the Ministry of Public Security.* Time:7 days. Cost: 260,000 Dong. This is done at the Administrative Department for Social Order, Municipal Public Security Service. Present legitimate documents (an Identity Card of the legitimate representative, establishment permit, business license certificate, and proposal letter). Most of business transaction documents must be signed and sealed to before they are considered valid and legal. Without a seal, an enterprise cannot register with the tax department, open a bank account and apply for operating facilities and services (e.g. telephone, electricity and water supply, office leasing, etc.) On average, two office visits are required before a company can obtain a seal. The seal-making license should be granted within 7 days of receipt of the application by the Department of Public Security.

*Step 3: Make a company seal.* Time:12 days. Cost: included in previous procedure. The entrepreneur takes the license to the seal maker designated by the public security office to order the seal. The seal-maker indicates a date on which the applicant may pick up the seal from the public security office.

*Step 4: Pick up company seal*. Time : 1 day Cost : free. The seal maker takes the finished seal to the public security office for pickup.

*Step 5: Open an escrow account.* Time: 1 day. Cost: free. A minimum deposit is required by the Vietcombank as a prerequisite throughout the operational period of the company, the fixed amount being 5 million Dong for an account in Dong and 500 US dollars for an account in US dollars. An application dossier includes: an application letter, documents certifying legality of the company establishment, chief accountant appointing decision, letter for registration of authorized signatures and the company seal.

*Step 6: Publish announcement in a daily newspaper* Time: 7 days. Cost*: 750,000 Dong.* In the case of New Hanoi, 9x4 cm. Details to be made public: name and type of company; headquarters and business objectives; charter capital; names and addresses of promoters; name and address of the legal representative and place of business registration.

*Step 7: Register for taxes at the Hanoi Municipal Taxation Department and pay business license tax.* Time: 10 days. Cost: 850,000 Dong. Required documents are: a declaration of tax registration; a certified business registration certificate. This procedure registers the company for all necessary taxes. After issuance of the business registration certificate, the company goes to the Hanoi Taxation Department for declaration of relevant taxes and the accounting system. A taxation code for the company will be available within 8 business days after accomplishment of the company tax declaration. Taxes and the applied accounting system connected to operations of the company (business license tax, VAT, corporate income tax, personal income tax, etc) are to be declared.

*Sep 8: Register with an enterprise social insurance fund to pay social insurance contributions at the City's Social Insurance Office.* Time: 7 days. Cost: free This procedure applies to firms with 10 or more employees. The company lists employees that it must be registered with social insurance [name, date of birth, salary (as stated in the labor contracts)]. It then approaches the City's Social Insurance to register for the company's insurance code. After receipt of the insurance code, it will pay social insurance contributions regularly at the local district social insurance agencies.

*Step 9: Register with the Health Insurance Office to pay health insurance premiums for employees.* Time: 7 days. Cost: free. Can be done simultaneously with procedure 8. This procedure applies to firms with 10 or more employees. The company lists employees that it must be registered with health insurance [name, date of birth, salary], together with the establishment decision, business license, registration letter, and notarized copies of labor contracts]. It then approaches the City's Health Insurance to pay health insurance contributions. Health insurance certificates will be issued within 1 week.

*Step 10: Establish a trade union with the City's Trade Union. Time: 1 day Cost: free.* This procedure is compulsory for a company with at least 10 employees, and must be done within 6 months after start of operation. This first trade union is provisionary, and its term of office is 1 year. Upon expiry of the aforementioned term and according as the presence of some conditions legally required, the provisional trade union unit shall be transformed into an official grassroots trade union unit.

*Source*: World Bank staff.

**The local dimension**

The growth in the number of registered enterprises has been uneven across the country. The private formal sector is largely concentrated in the main urban areas and a few nearby provinces. These areas have over one formally registered private enterprise per thousand people. Next, there are a few provinces in the mid-range, with a formal private enterprise every two thousand people. But the vast majority of Vietnam's provinces only have about one formal private enterprise for every four thousand people, certainly not enough to make a meaningful contribution to job creation.

Regional disparities in the depth of private sector development are certainly related to disparities in location, infrastructure and population density. But they may also reflect different attitudes and capabilities of local governments. The Vietnamese administration is increasingly decentralized and from the perspective of private entrepreneurs, it is the local government that is most relevant to the success of their business (box 5.2).

Local governments have a direct influence on access to factor markets and operating licenses. For example, the provincial People's Committees and the provincial level departments have the authority to approve all domestic investment projects and most foreign direct investment, except for very large projects. These same units grant land-use right certificates and deal with the leasing of land plots, except for the largest ones. They also handle all formal enterprise business registration under the Enterprise Law. They decide and prioritize the infrastructure facilities that are available to the private sector, such as water, sewage, telephone and electricity. They conduct enterprise level on-site inspections for compliance with regulations, and even act as arbitrators in case of contract dispute. As for district governments, they have relatively little influence over formal private enterprises, but are of critical importance for household businesses.

In addition to these key interactions, private entrepreneurs, typically require other "approvals" from local government. The nature of these approvals depends on their sector and scale of operations. But no clear list of requirements exists, and enterpreuners are forced to "do-the-rounds" of governmental agencies just to determine which agencies' permission is required.

Some provincial governments recognize these problems, and are taking steps to reduce the costs of dealing with the bureaucracy. Dong Nai, for example, followed up on complaints from the private sector about the frequency of "inspection visits". In March 2001, the provincial government issued a circular requiring all departments wishing to "inspect" a particular enterprise to register with the state inspectors, who would then coordinate activities under the form of one visit per year. In contrast, entrepreneurs in one province in the central region received, on average, 15 inspections per year from the police and tax authorities alone (Asia Pacific School of Economics and Management and CIEM, 2002). The on-line business registration system introduced by Ho Chi Minh City is another example of efforts at the local level to streamline the bureaucratic processes.

The central government is well aware of the importance of the local government for the effective implementation of its private sector development policies in general, and the Enterprise Law in particular. Directive No.17/2002/CT-TTg, issued in August 2002, outlines local governments' responsibilities in implementing the Enterprise Law. Instructions include the revision of any local licenses or provisions that are contrary to the Law, and the amendment of plans that are contrary to promoting a level playing field and stimulating private investment. This Directive, with its focus on implementation at the local level, is a welcome step. It is to be hoped that it will be rigorously enforced.

**Box 5.2: The Binh Duong experience**

Binh Duong was a poor province before it separated from Song Be, in early 1997. Today, it is one of the most successful in terms of economic growth, foreign direct investment, exports and employment. Between 1997 and 2001, the industrial output of the foreign-invested sector grew 45.9 percent per year. The corresponding figures for the private domestic sector and the state sector were 29.7 and 8.0 percent respectively. Exports grew 27.9 percent per year during the same period. Based on a local standard, the poverty headcount fell from 8.7 percent in 1996 to 3.0 percent in 2002.

The determination of the local authorities to develop the business environment, and to foster trust between government and business, may be one of the main reasons for this success. There are regular opportunities for local leaders to meet, discuss and solve the problems faced by the business community. The People's Committee also established a consulting council for investment under the management of its Vice Chairman. This council meets every Thursday to help investors and businesses overcome the difficulties they face.

To attract foreign direct investment, a simplified registration procedure was established, allowing licenses to be granted within three days. If consultation with central government agencies is needed, licenses should be granted in no more than 15 days.

A one-stop shop policy was also adopted, allowing to obtain a license within seven days for private enterprises, and within five days for household enterprises. Individuals and businesses can transfer land-use rights faster than regulated by the existing legal framework. The process is five days shorter, on average, than stipulated in current regulations.

*Source*: Steering Committee for State Administrative Reform (2002).

**Institutions for a market economy**.

In Vietnam, like in other economies in transition, old rules and institutions need to be replaced with new. Some of these institutions exist, although at the infancy stage; others are still missing. Institutions critical to a smooth functioning market economy include the legal and juridical system to protect property rights, ensure contract enforcement and prosecute those who step beyond the legal boundaries. They also include the regulatory framework for private utility and social service providers, such as monitor codes and norms for consumer protection, market-monitoring institutions, and accounting and legal services that reliably scrutinize firm performance with respect to clearly defined indicators. Without a committed effort to rapidly develop these new institutions, corruption and bad business practices may become entrenched.

Corruption is now openly discussed and widely reported in the media. Many in Vietnam acknowledge that corruption is relatively widespread. But the predominant attitude is accepting it as the way business is conducted, rather than perceiving it as a major problem. In a recent survey of private enterprise managers, more than half of the interviewees did not see corruption as an obstacle, compared to only 8 percent who saw it as a serious problem.

In contrast to the domestic view, Vietnam scores very poorly in international comparisons. While the methodology of corruption indexes is questionable, they tend to put Vietnam at the bottom of the league, among countries it may not want to be compared to. Perceptions of this sort can damage the ability of the country to attract more foreign direct investment, and need to be addressed. Reducing unwarranted discretionary power of officials, and increasing accountability and transparency can be powerful ways to do so.

**Involving civil society**

Worldwide, entrepreneurs are increasingly being recognized as having a social and environmental responsibility towards society. Consumers increasingly look for products untainted by exploited labor or poor environmental practices. In many countries, non-governmental groups have emerged that generate information about enterprise performance, and use this information to set up incentives for socially responsible behavior, and draw media attention to environmental, social and labor issues within a globalizing economy (box 5.3).

**Box 5.3: Corporate social responsibility**

Corporate social responsibility refers to a company's economic, social and environmental practices that go beyond legal compliance in ways that are both good for business and good for development. With regard to the workplace, those practices are about creating and maintaining decent jobs.

Engagement by the private sector on social issues often results from pressure exerted on large multinationals by consumers and non-governmental organizations in industrial countries. This pressure is partly due to concerns regarding the ability of developing country government to enforce labor. In Vietnam, 300 labor inspectors are faced with monitoring a rapidly expanding private sector, including the almost 50 thousand.

Hours of work are a case in point, as they affect a worker's health, safety and overall quality of life. Most of the multinational footwear companies operating in Vietnam have developed codes of conduct based on internationally recognized labor standards and local laws. The International Labor Organization recommends that a week of work not exceed 60 hours, including overtime. The Vietnamese Labor code is more stringent, with approximately 52 hours per week or a maximum of 200 hours per month. Codes of conduct are imposed on the supplier factories, who are monitored regularly by the multinational firms themselves and through independent auditors

Codes of conduct are only one form of corporate social responsibility. Another market-based approach to improving working conditions is certification by independent auditing agencies. The certification process is similar, in nature, to that followed by companies that meet specific product quality standards. More recently, companies frustrated by the same challenges that government inspectors face in attempting to enforce labor codes, are focusing their efforts on worker empowerment as a way to address concerns related to working conditions.

*Source*: World Bank staff.

Organizations such as consumer protection groups can help enforce product quality standards, and environmental groups often play a crucial role in enforcing environmental protection rules. More effective trade unions can better protect workers' rights and help enforce labor laws. And open information flows and an independent media are also important for promoting responsible enterprise behavior.

Further strengthening the dialogue between the government and the private sector, through vehicles such as the Vietnam Business Forum or business associations, can help understand and address concerns from both sides. Formal consultative mechanisms and opportunities for interest representation do currently exist for business associations, mainly through discussion forums with relevant government officials and in the country's legislative process. During the 1990s, some business associations have had the opportunity to recommend changes to draft laws, and recently their representatives have even participated in drafting committees. To date, however, these opportunities are usually limited to only the largest or most well-known associations and to laws expected to have a broad national impact.

The government can also support efforts to promote private sector development by producing reliable business-related statistics. This requires regular and reliable data collection from enterprises. But there are a number of constraints in this area, related to problems with the wider statistical system in Vietnam. At the moment, enterprise data are collected through censuses and there is little use of survey sampling techniques that reduce sample sizes and enable adequate quality control measures in data collection. This, in turn, leads to a lack of trust in the statistics by users. Many different government agencies collect detailed data from selected enterprises, but there is little evidence of coordination, and not much of the information is being used. A tendency to treat statistical information as something to be distributed only with special permission remains, whereas statistical information is best viewed as a public good, and made available easily to everyone who is interested, as long as confidentiality is protected. The proposed statistical law may lead to improvements in this area.

# II. Inclusive Development

# 6. ROOTED IN LAND

Land has been an integral part of Vietnam's economic reform process almost from the beginning. Land is also one of Vietnam's more scarce resources. While 80 percent of the population live in rural areas, there is barely more than 1,200 square meters of agricultural land per person, one of the lowest levels in the world.

The allocation and distribution of land-use right certificates to most agricultural land is one of the biggest achievements of Vietnam. It has been at the basis of a major increase in agricultural production. It has also underpinned a pattern of growth with equality, and dramatic poverty reduction. But important challenges remain ahead, including the slow pace of allocation of land-use right certificates in urban and forest areas, and distortions in urban land markets leading to very high land prices.

Completing the allocation of land is necessary for efficiency reasons. But the poverty alleviation impact of land reform is probably reaped by now. Among rural households, those who engage only in farming are the poorest. While access to land certainly boosted their level of consumption, it is nowadays insufficient to ensure a sustained growth of consumption. Rural households who engage in off-farm activities do better. Moreover, if not done carefully the allocation of land in mountainous areas could adversely affect ethnic minority groups. The development of an urban land market may be more favorable to the poor, by making urban housing more affordable.

Overall, the remaining agenda in terms of land reform will not introduce a strong pro-poor bias in the new phase of growth in Vietnam is about to enter. Taking poverty reduction for granted this time would be a mistake.

**Land and poverty**

Land reform was arguably the single most important step in Vietnam's path to rapid growth and poverty reduction in the 1990s. Agricultural land reform began in earnest in the late 1980s, contributing to the sustained, rapid and equitable growth of the rural economy that has marked *doi moi*. While all of Vietnam's land belongs to the state, the rights to its use have been assigned to individuals and firms through land-use right certificates starting in 1993. These certificates legalize their owners' rights to the long-term use of allocated land and to transfer, exchange, lease, inherit and mortgage the land-use right.

Agricultural land reform had a remarkable impact on poverty alleviation in Vietnam. Land-use right certificates extended the lease term for land, thus encouraging investments with longer maturity. By allowing farmers the possibility to mortgage their land rights, they probably made access to credit easier. And they may also have led to increased efficiency in land allocation, because they are tradable. There is evidence that farmers in provinces where registration of land use certificates proceeded at a faster pace invested more in multi-year crops and devoted more resources to irrigation (Do Quy Toan and Iyer, 2002).

Moreover, the allocation of land across households was carried out in a very pro-poor way. Data from the 1993 round of the Vietnam Living Standards Survey can be used to compare the impact of this reform on household consumption with the impact of alternative, hypothetical allocations (Ravallion and Van de Walle, 2001). One such alternative would have been to give each household in a commune the same per capita amount of land, taking land quality and access to irrigation into account. The poverty impact of such an allocation would have been pretty much the same as that observed in practice. On the other hand, the actual allocation better protected the poorest groups and had more impact on inequality than the hypothetical allocation that would have been achieved by free markets.

The distribution of land was a one-time intervention, however, leading to a change in the level of consumption, but not necessarily to sustained growth in consumption. Having land today is not enough to escape poverty. Farm-only households remain the poorest in Vietnam. Among rural households, a strong association is observed between poverty and lack of deversification into wage and self-employment activities (Van de Walle and Cratty, 2002).

While further liberalization of the land market is needed to increase efficiency, vulnerable groups may be adversely affected. Ethnic minorities have over centuries developed complex farming systems and indigenous practices and knowledge that are well-adapted to their agro-economic environments. They are settled in more remote areas, and engage in different production and land tenure practices, often specializing in the cultivation of non-traditional (and sometimes illegal) crops. Controlling for other possible influences, it appears that ethnic minorities exploit their land more productively than the Kinh majority (Van de Walle and Gunewardena, 2001). But there is a risk that the gradual move away from traditional land allocation mechanisms, operating at the community level, will undermine this higher productivity, thus leading to lower consumption and higher poverty.

**An unfinished agenda**

Land-use rights in the form of certificates that can be traded and mortgaged provide several benefits. They are a source of security. They are the foundation for formal property markets, and they can be used as collateral. But to fully reap those benefits it is necessary to complete the issuance of land-use right certificates, their initial registration, and that of subsequent changes.

Land-use rights allocation remains incomplete. Many land users do not yet possess secure land-use right certificates or tenure contracts. By 2002, only 18 percent of households in urban areas, and 50 percent of households in upland areas possessed them. Furthermore, although 90 percent of agricultural land users have been granted certificates, the demand for their re-issuance or amendment is growing. This is partly due to the consolidation of fragmented land parcels that has taken place informally (Childress and Nguyen The Dzung, 2002).

Land and property markets are underdeveloped. Although the number of households engaged in land transactions has increased significantly over the last decade, most transactions are informal. Reportedly, between 70 and 85 percent of transactions in urban areas fall into this category. Also financial instruments are seldom used. For instance, 85 percent of house purchases are financed from family savings.

The existing land market is highly distorted, limiting ownership opportunities for the poor. The price of land on the edge of Hanoi and Ho Chi Minh City has reached 444 US dollars per square meter, which is more than the average annual income per capita. In prime locations, the price is in the order of 4,000 US dollars and it is still 2,444 US dollars at a distance of one kilometer from the center (CPLAR, 2001). These figures reflect a highly distorted market situation (JBIC, 1999). They suggest that a country determined to become a market economy lacks an efficient market for one of its key factors of production.

**Low land**

In the agricultural sector, land-use right certificates have been issued to 10.6 million households on 5.9 million hectares. By comparison, only 18 percent of households were covered in 1993, and 24 percent in 1998. However, throughout Vietnam there is a need for farmers to adjust their landholdings and land use in accordance with their aspirations, resources and market opportunities. At present, there are an estimated 100 million plots held by 11 millions farmer households.

The government's response has been to promote the voluntary exchange of parcels among farmers, with the aim of consolidating land into larger blocks when several plots are held by a single household. Whether consolidation can substantially increase agricultural productivity remains an open question (box 6.1). Care needs to be taken to maintain the risk-mitigating benefits of spatially dispersed plots in different agro-ecological areas. In any event, this measure is essentially an one-off intervention. There already exist bottom-up processes of consolidation and land accumulation through informal channels, including land exchange, and the rental and sale of land-use right certificates (Do Kim Chung, 2000, and Kerkvliet, 2000). But these informal processes need to be complemented by market mechanisms that provide more adaptability and flexibility for households.

**Box 6.1: Land consolidation and productivity**

The link between land consolidation and improved productivity is somewhat under-researched in East Asia. One study using household data from China found that efficiency gains were modest. A second study from China reported considerable economies of scale from effective consolidation through contracting of farmland to expert farmers In the Mekong Delta, labor productivity appears to be higher in large farms, but land productivity does not depend on farm size. The global literature on land consolidation suggests that there are efficiency gains decreasing transportation, supervision and other lumpy input costs when the number of initial plots is high. However, many of these gains can be achieved through rental markets or through effective cooperative or voluntary arrangements.

*Source*: World Bank staff based on Akram-Lodhi (2001), Binswanger and Elgin (1998), Wan and Cheng (2001), and Zhou (2002).

Numerous administrative constraints over land-use allocation and land use remain. There is administrative influence over crops to be grown, even if it is now being eased with the 2001 revisions to the Land Law. There are constraints on land leasing as well. The family leasing land must be in poverty, have taken up another occupation, or lack the capacity to work its land. There are also ceilings on land holdings, on duration of land-use rights, and on land transactions. Ceilings on land holdings are set at levels below what is economically optimal, given experience in neighboring countries. The length of the period of land use is also low. It is currently set at 20 years and 50 years for agricultural land and forest land, respectively. Lengthening these periods would encourage long-term fixed investments in both agricultural land and upland.

The process for transferring land in agricultural areas is also cumbersome and costly. It requires two layers of administrative approval (commune and district People's Committees) and three layers of documentation (the two People's Committees and the district Land Administration Office). As in urban areas, the establishment of a unified, service-oriented and single-stop land registration system, with simple procedures for transfer and registration would expedite transactions in the formal rural land market.

### Upland

Land allocation and the issuance of certificates for upland areas have progressed slowly. Land-use right certificates currently cover only about 450 thousand households on 2.1 million hectares, out of 11 million ha of total upland (forest) land. Disputes are common in the uplands and some have become sensitive political issues. This is further complicated by the land-use rights and responsibilities of state-owned forest enterprises, which control about 40 percent of the total forest land. These enterprises have been slow to adopt measures to improve their land use through the involvement of local people (Geiger, 2002). In addition, there are conflicts over land rights and land use between ethnic minorities, who use traditional land tenure systems, and recent immigrants. Those conflicts can potentially lead to social problems and environmental degradation.

It is apparent that progress in upland land allocation and issuance of certificates must proceed in close cooperation with broader reforms in forest management and land-use planning. These reforms include reconsideration of the role of state-owned forest enterprises and their land holdings. They also require participation of communities in land-use planning and classification, and strengthening the human resource and technical capacity of the state at all levels to understand, plan and monitor upland and forest resource use.

Issuing certificates to communities is one option to explore, particularly for ethnic minority groups that do not traditionally recognize the land rights of individual households. It would also be worthwhile to develop further land classification methods based on actual and planned use, different demarcation methodologies, and public education on the meaning of land allocation. All of these ideas are consonant with an extension of community-based natural resource management, which is still in its infancy in Vietnam. But their implementation would require additional investments (e.g. on mapping data and instrumentation) at the level of provincial governments.

**Urban land**

Vietnam's cities are under acute pressure. They are expected to accommodate 33 percent of the total population in 2010, and 45 percent in 2020, compared to 22 percent in 2000. Demand for land and housing is outpacing supply in most areas. The average floor area of urban housing has increased significantly in the last 10 years, from 8.2 to 10.4 square meters per person. But there is still a serious housing shortage (Asian Development Bank, 2002b). Recent limitations on the conversion and transfer of land in peri-urban areas of Ho Chi Minh City and Hanoi, including revoking the allocation of "unused" land, could relieve some pressure, but they do not address the underlying causes of scarcity.

Effective land classification and land use planning provide a more systematic approach to dealing with the increased demand for serviced land for urban expansion, sitting new investment, and environmental protection. The current system of land classification and land use planning is rigid and works poorly because of a lack of information about the plans and widespread non-compliance. A land-use planning system characterized by greater public openness, flexibility and functional zoning could contribute much to more rational urban expansion.

Making the formal documentation and registration of land transactions more acceptable to the urban population is not an easy task. Acceptance could be improved by lowering transaction costs, involving the community in the land registration process, issuing provisional or qualified land-use certificates where problems exist, and accepting existing building and urban design standards as a reality to be improved upon over time, where necessary.

Issuance of urban land-use right certificates could actually be speeded up by mixing systematic and ad hoc techniques. Cadastral mapping of existing parcel boundaries could be extended across urban areas with appropriate standards of accuracy. New areas of development could have combined building ownership and land-use right certificates issued to all initial land users. Older urban areas, where formal documents are often lacking, could receive certificates on demand through a community-based process where residents themselves provide the impetus for issuance.

The provision of a unified registration system for all land and building transactions would be essential to support the development of new systems of housing finance. Abolishing levies, lowering transfer taxes and providing clearer legal definitions of condominium ownership and responsibilities would also help. Revenues foregone by reducing fees and levies for first registration and transfers could be made up from a broader tax base on land use rights' holders in the future.

**Protecting the vulnerable**

The introduction of market mechanisms would probably lead to a higher correlation between land ownership and household attributes such as education. On the other hand, the correlation with attributes such as household size, or being part of a minority group, can be expected to fall. As a result, land ownership could become gradually more concentrated in the hands of wealthier households (Ravallion and Van de Walle, 2001). At the same time, it is recognized that rural poverty reduction requires the expansion of non-farm employment. But this expansion will be slow in the absence of rural land market liberalization.

Land market liberalization must therefore be accompanied by measures that redress inequalities and protect the vulnerable. One important concern is to mitigate the effects of distress sales, which result in landlessness. The general perception is that the number of rural households with no or little land has increased, particularly in the Mekong delta. According to the General Statistics Office, 37 percent of rural households in this area had less than 0.2 hectares of cultivable land, compared to 28 percent in 1994. A lower figure is reported by a recent study, which estimates the fraction of rural households with less than 0.2 hectares at 8.7 percent as of 1997 (Nguyen Dinh Huong, 1999). The study also found that one third of landlessness cases was caused by land sales or mortgage losses. Other reasons for landlessness were households dividing (21 percent of the cases) and inherited landlessness (27 percent).

So far, initiatives to counteract distress sales have been taken mainly at local level. They include measures as diverse as the provision of loans to redeem land, support for land reclamation, restrictions on mortgage and sale of agricultural land, the promotion of off-farm employment, tax exemptions, and the provision of transfers and subsidized social services.

National policy options that mitigate adverse consequences of land market liberalization are just beginning to be discussed and piloted in Vietnam. Insurance schemes, land purchase programs by the government, progressive land taxation, and disaster mitigation are among the options considered. But the effectiveness of these tools remains under-researched. In the CPRGS the government proposes new measures to reduce vulnerability, related to building the assets of poor households and increasing their ability to manage risk. Two of the measures proposed are improved access to agricultural extension, to help diversify farm incomes, and improved access to affordable health care. Additional measures such as enhancing access to savings facilities, would also be essential.

Vietnam's farmers suffer often from natural disasters, mainly floods and typhoons, and the effects of sharp fluctuations in commodity prices, such as those that affected rubber and coffee in the last three years. These shocks put the land-use rights of rural households at risk. Agricultural land-use right certificates are used to guarantee about 60 percent of the 75 trillion Dong (or 5 billion US dollars) in annual lending for agriculture extended by the Vietnam Bank for Agriculture and Rural Development, the main provider of formal rural credit. In such transactions, the certificates are simply held as security by the Bank. The certificates of delinquent borrowers are not sold, but embargoed until a solution to the delinquency is found. But this is only a temporary solution. In the long run, rural financial institutions need to develop new products to help rural households and enterprises cope with the risks they face.

**Next steps**

The current systems of land classification and land use planning are too rigid to address the needs of agricultural and urban development. They are not effective in promoting the management of natural resources either. Public consultation, better information about planning designations, and more pragmatic approaches are necessary. Given Vietnam's growing experience in participatory processes, piloting community-driven approaches in land classification, land-use planning and functional zoning would be a critical step ahead. Lessons from these pilots could later be consolidated and mainstreamed into relevant instructions to re-orient land management and administration, particularly in rural upland and urban areas.

Whichever course of action is chosen, the capacity of local governments to issue land-use right certificates and to register transactions needs to be upgraded. Strengthening capacity is thus another important step. The role of the government in land management and administration in a market-oriented economy needs to be clarified. Given the extensive cross-sectoral linkages, a multi-ministerial land policy board could help coordinate policies and oversee their implementation (SwedeSurvey, 2002).

Almost 10 years have elapsed since the Land Law was introduced and numerous incremental changes have been made since then. The general trend of this evolving body of legislation is to increase land and property rights. But despite this trend, the needs of the emerging land markets are not easy to address within the current legal framework. On the other hand, the piecemeal expansion of legislation has led to great implementation complexity. Today, a clear need exists to introduce an updated and comprehensive regulatory framework.

Another immediate step is to put on action the right for gender equality in accessing and controlling land and other properties. Local authorities, land departments and land right users, particularly those in rural areas, should be given clear guidance and support to issue land-use right certificates under the name of both spouses (box 6.2).

**Box 6.2: Gender and land-use right certificates**

Land-use right certificates issued in the early-1990s provide space for the name of just one household member. Typically, this is the eldest male or the husband, lowering the security of the land use-rights of women. Certificates that show joint spousal use rights would significantly reduce gender asymmetries over property control and probably increase gender balance in intra-household decisions.

Recording the names of both spouses is now a legal obligation. Effective in October 2001, government's Decree No. 70/2001/ND-CP, on the implementation of the Marriage and Family Law states that all documents registering family assets, including land-use rights and house ownership, should be under the names of both husband and wife. However, there is a lack of awareness among rural populations and authorities. The General Department of Land Administration, responsible for rural land titling, was unable to provide all provinces with instructions and support for this conversion to ensure timely compliance. While land-use right certificates were changed in urban areas, more guidance is needed in rural communes. In the CPRGS, the government of Vietnam has committed to have the names of both spouses on land-use rights certificates by 2005.

*Source*: World Bank GenderNet (2002).

# 7. CHALLENGES IN EDUCATION

Expansion of school enrolment in Vietnam has been very impressive. Enrolments in primary education have steadily increased nationwide and have been characterized by equal access for boys and girls. Expansion has also been remarkable for the next two levels of education. Over the last five years, there has been a two-fold increase in enrolment in lower secondary education, and a four-fold increase in enrolment in upper secondary education.

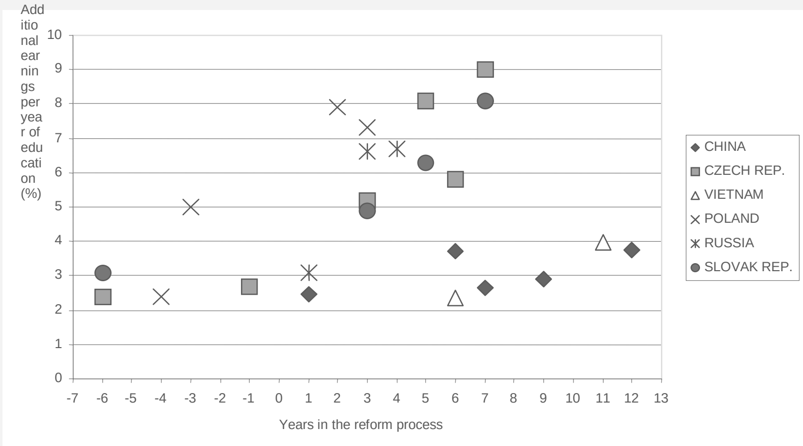
However, the challenge of getting the last group of children into primary school is quite significant, given that these children often come from poor and remote areas. To move forwards full primary enrolment, the CPRGS proposes to improve the system of exemptions for all education costs to poor households. Also, the proportion of primary school pupils with low achievement in mathematics and reading is sizeable. This is a cause for concern and suggests that Vietnam has a big task ahead. Improving the quality of the teaching and learning of these groups of pupils is necessary to build a strong foundation for universal lower secondary education, targeted for 2010.

A high and evenly distributed level of education will be key to make the new growth phase of the Vietnamese economy sustainable in the long run. Further integration into the world economy will necessitate an increasingly skilled labor force. Shortages of qualified workers, technicians and managers are already apparent in the most dynamic economic centers, and especially in Ho Chi Minh City. From this perspective, there is a clear link between education and efficiency.

There is also a link between education and equity. In the early stages of transition to a market economy, earnings did not vary much with schooling. But an upward trend in the labor market returns to education was already visible in the 1990s. As the economy further integrates with global markets, the skill premium will probably increase (box 7.1). Current inequalities in enrolment and achievement will therefore translate into bigger inequalities in opportunities and earnings.

**Box 7.1: The skill premium in transition economies**

The distribution of labor earnings is more compressed in centrally-planned economies than in market economies. One of the consequences of the transition is therefore to widen the earnings gap between workers with different characteristics, and especially with different education levels. Various studies have tried to estimate the average contribution of one additional year of schooling to labor earnings in transition economies, at different stages of their reform process. Although the results are not strictly comparable across studies, they reveal a steady upward trend. Under central planning, the typical premium to one additional year of education is about 3 percent. In Central Europe and the former Soviet Union, the premium was comparable to that of an industrial country barely five years later. In China and Vietnam, the process has been slower, but it has been upward nevertheless. If this trend were to continue, as of 2002 an additional year of education would raise labor earnings by 5 to 6 percent in Vietnam. The compounded effect of these changes can be considerable. For instance, if the premium is 2 percent, a person with a university degree would on average earn 22 percent more than someone with primary education. But the average gap would reach 79 percent if the premium increased to 6 percent.




*Source*: Rama (in press b). The observations for Vietnam were originally computed by Bales and Rama (2002), using data from the 1993 and 1998 rounds of the Vietnam Living Standards Survey.

## The accomplishments

Enrolment in primary education has expanded, especially in rural areas (table 7.1). Some regions, including the Central Coast, Central Highlands and the Mekong Delta, still lag behind. Their enrolment rates are lower than in more affluent regions, such as the Red River Delta (including Hanoi) and the South East (including Ho Chi Minh City). But these lagging regions are also those where progress has been more considerable.

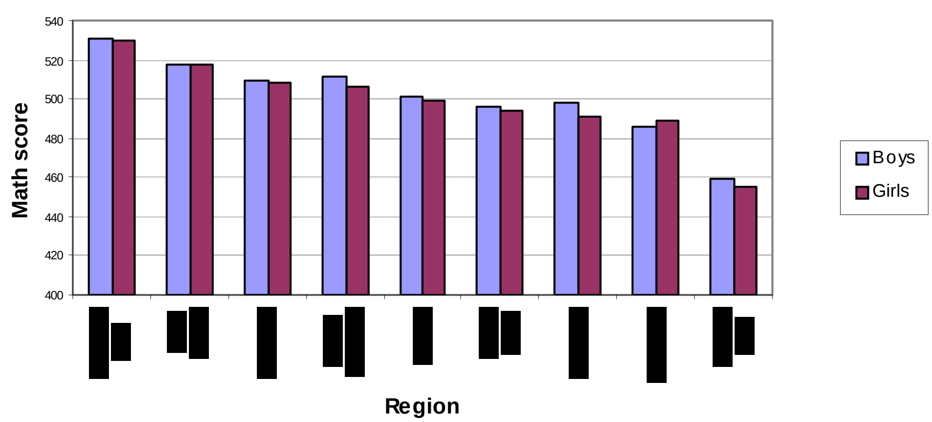
**Table 7.1: Net enrolment rates by region**

| | Primary | | Lower-secondary | | Upper-secondary | |
|---|---|---|---|---|---|---|
| | 1993 | 1998 | 1993 | 1998 | 1993 | 1998 |
| Vietnam | 86.7 | 91.4 | 30.1 | 61.7 | 7.2 | 28.6 |
| Urban | 96.6 | 95.5 | 48.5 | 80.3 | 17.3 | 54.5 |
| Rural | 84.8 | 90.6 | 26.3 | 57.9 | 4.7 | 22.6 |
| Regions | | | | | | |
| Northern Uplands | 85.7 | 94.1 | 22.2 | 56.4 | 5.6 | 22.2 |
| Red River Delta | 95.1 | 95.6 | 46.5 | 83.2 | 10.3 | 45.2 |
| North Central Coast | 88.1 | 92.5 | 30.6 | 62.3 | 5.8 | 29.6 |
| Central Coast | 84.4 | 88.1 | 38.1 | 64.2 | 11.6 | 31.8 |
| Central Highlands | 67.8 | 80.2 | 15.0 | 43.9 | 2.0 | 10.5 |
| South East | 93.5 | 93.4 | 35.2 | 71.7 | 9.7 | 36.3 |
| Mekong Delta | 79.0 | 86.9 | 19.4 | 45.0 | 3.6 | 17.4 |

*Source*: Nguyen Nguyet Nga (2002). Figures are in percent of the population aged from 6 to 18.

The overall high enrolment rate in primary education is accompanied by equal access to education between boys and girls. Nationwide, the difference in enrolment between the two sexes is small. In some provinces, girls enrolled in the highest level (grade five) of primary education represent 45 percent of all children enrolled. Nevertheless, in terms of learning outcomes, there is no observed disparity across sexes, as revealed by a recent study of Grade 5 pupil achievement through tests of mathematics and reading comprehension (figure 7.1).

**Figure 7.1: Boys, girls and mathematics**




*Source:* World Bank (forthcoming d). Figures are average mean scores per region and sex, standardized nationally and across all geographical regions, with a mean of 500 and a standard deviation of 100.

Aiming to make education more relevant, Vietnam has officially launched its new basic education curriculum for the primary and lower secondary levels. The nationwide implementation of the new curriculum in the first grade and sixth grades started in September, 2002. The objectives of the new curricula are to provide Vietnamese students with ability to learn effectively, competencies essential for being a full member of a modern economy, and life skills and values for good citizenship. One important challenge is ensuring that the large teaching force has the knowledge and skills to deliver the new curricula.

**The challenges**

While the enrolment statistics are encouraging, there is still a large unfinished agenda with respect to reaching the last group of children not yet in school and keeping it in schools throughout the basic education cycle (table 7.2). About 2.6 percent of children never go to primary school (Glewwe, 2002). For the remainder, the drop-out and repetition rates have been reduced and the transition from primary to lower secondary is increasing. But the retention and completion rates are still low. This is inefficient and has prolonged the average time that the system takes to produce one graduate to more than six years, for a five-year cycle of primary schooling.

**Table 7.2: Dropouts and repetition**

| | 1990/1991 | 1995/1996 | 1997/1998 | 1999/2000 |
|---|---|---|---|---|
| Primary dropout rate | 12.35 | 7.14 | | 2.79 |
| Primary repetition rate | 8.77 | 4.79 | | 4.67 |
| Survival or retention rate | 47 | 70 | 75 | 71 |
| Transition to lower secondary | 78 | 87 | 88 | 94 |
| Completion rate | 49.1 | 61.3 | | 70.2 |
| Percent not enrolled in school | 14.79 | | | 6.76 |

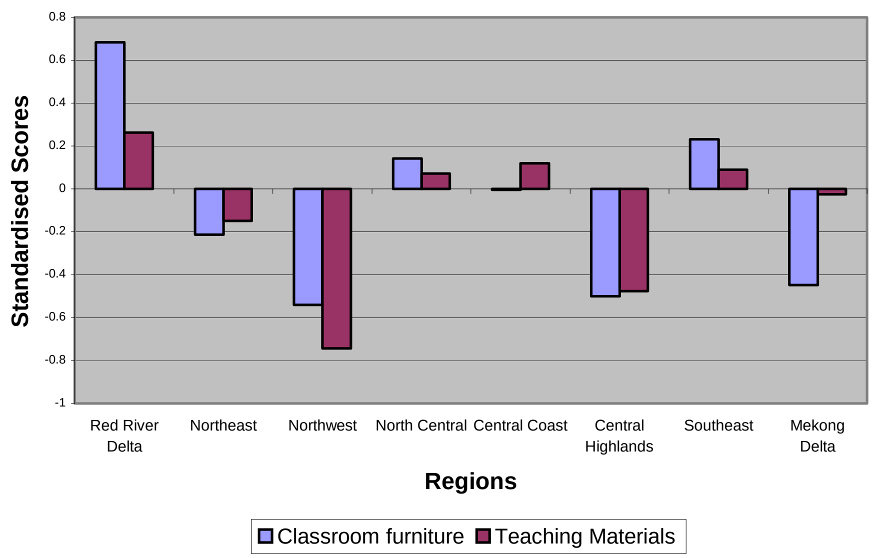
*Source*: World Bank staff based on data from the Ministry of Education and Training. All rates are in percent. Survival or retention rates are estimated based on the ratio between fifth and first grade. The transition to lower secondary is estimated based on the ration between sixth and fifth grade. This approach may over-estimate the retention rate as cohorts are getting smaller. The percent not enrolled in school refers to the age cohort 6-14.

Disparities in enrolment between the Kinh majority and ethnic minorities are another important source of concern. While gaps have narrowed over time, they remain considerable in absolute terms. In 1998, less than two thirds of ethnic minority children had entered lower secondary education school, compared to 83 for children of the Kinh majority. The corresponding figures for upper secondary school were 25 and 54 percent (Glewwe, 2002).

Regional disparities are sizeable as well, especially in term of student performance. On average, pupils in the Mekong Delta, whether boys or girls, have a learning performance that is half a standard deviation less than the national average (about 50 points). International educational research often finds that a difference of 20 points already represents an important difference in learning.

There is also a wide disparity in school resources (figure 7.2). The North West, the Central Highlands and the Mekong Delta are below the national average in terms of classroom furniture and materials. At the other end, the Red River Delta is the best-endowed region. High resource levels tend to go along with a higher level of student achievement. This poses the challenge of how to redirect resources across schools.

**Figure 7.2: Classroom resources by region**



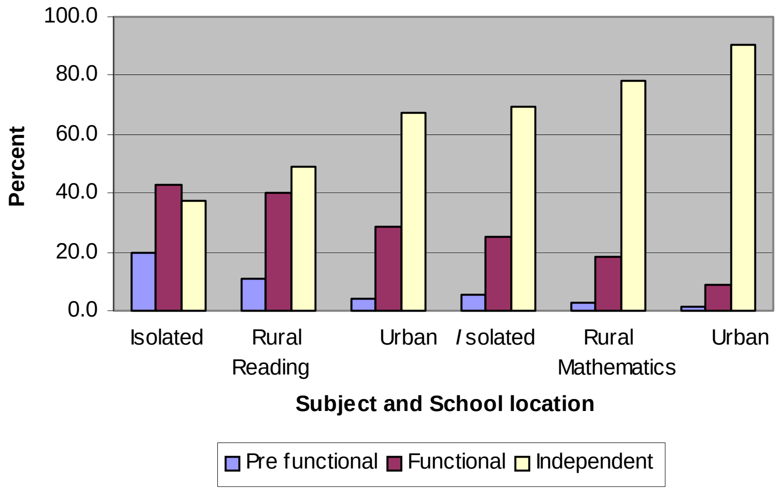

*Source:* World Bank (forthcoming d). The figures are deviations from the national average. Regions with more resources display positive values whereas those with less resources display negative values.

Ultimately, what students learn is the most important achievement measure of any education system. Learning can be assessed by classifying pupils in a few groups, defined based on the level of student knowledge and skills for each subject. The results show that in mathematics just over one quarter of grade five students master knowledge and skills at the highest level. This level entails solving mathematical problems with time, length, area, volume, three dimensions and in particular interpreting data, graphs and tables. The Mekong delta region has only 13 percent of its students reaching this level of mastery. In reading comprehension, 13 percent of students reach the highest level. This level necessitates that the reader be able to identify author's purposes, attitudes, values, beliefs, motives, unstated assumptions; the student should also combine with outside knowledge to infer various meanings. Student performance varies across regions, with the Red River Delta well ahead of the national average, and the Mekong Delta, the Central Highlands and the North West regions performing below the national average. (World Bank, forthcoming d).

Benchmarking is another way of assessing student performance. Two benchmarks are considered in what follows. The first one is based on a pupil's ability to use a set of mathematical and reading skills needed to function in Vietnamese society. Those below this benchmark are described as "pre-functional". A second benchmark is based on an estimation of a pupil's ability to cope with the reading and mathematical tasks in the next grade of education. Pupils who perform above the second benchmark are described as "independent" as they demonstrate the skills that are desirable in order to learn on their own at the next level of schooling.

For both mathematics and reading comprehension, the percentages of pupils who are "pre-functional" and "functional" decreases as one moves from the isolated schools to rural and finally urban school (figure 7.3). The relationship between school isolation and achievement is especially strong in the North West, the Central Highlands and the Mekong regions. It is also clear that there are more pupils reaching the "independent" level of learning in mathematics than in reading. But the proportion of "pre-functional" pupils is not small and the percentage of pupils who are only "functional" is sizable.

**Figure 7.3: School location and level of achievement**




*Source:* World Bank (forthcoming d). "Pre-functional" means that pupil performs below the lowest benchmark of a pupil's ability to use a set of mathematical and reading skills needed to function in Vietnamese society. "Functional" is for a performance below a second benchmark, based on ability to cope with the reading and mathematical tasks in the next grade of education, above the first benchmark. "Independent" is for pupils who performed above the second benchmark

### The underlying problems

While primary education is free, household survey analyses and participatory poverty assessments reveal that financial contributions remain the difficulty many families face when sending their children to schools. Families pay for textbooks and learning materials, for school building maintenance costs, and for other costs such as transportation and uniforms. These payments and contributions place proportionately heavier burdens on poor families (Pradhan, 2002).

In the CPRGS the Government committed to improve the system of exemptions for education costs. But removing the financial burden on the poor requires a clear strategy. For example, making textbooks and learning materials free to poor children increases the education cost, but requires minimal change in the current institutional arrangements. Exemption for the building maintenance fund is different. It requires that funds be channeled from the central or provincial levels to schools to offset for the lost contributions. This, in turn, necessitates both increased public expenditures and a better mechanism to ensure that the funds reach the schools.

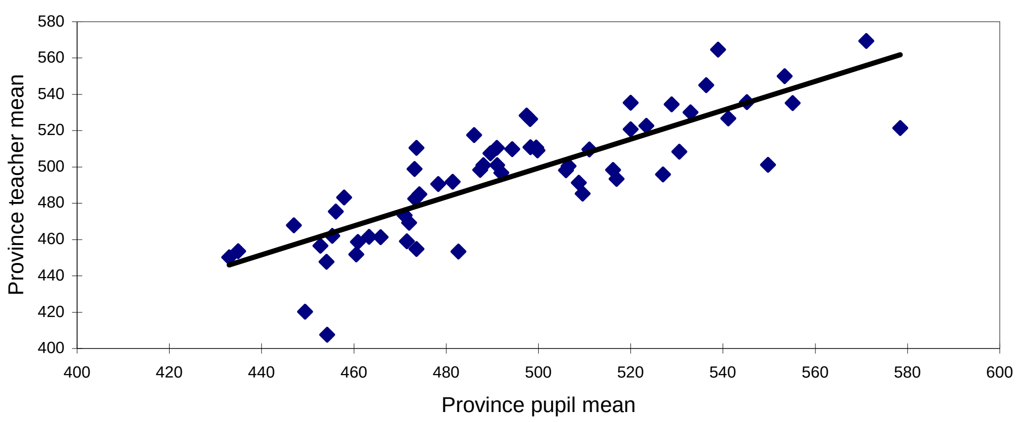
The large variation in resources available at the school level is partly due to differences in the level of financial resources available at the local level. Provincial governments enjoy a considerable discretion with respect to spending allocation across sectors and within sectors. As a result, richer provinces tend to collect more revenue, and also to spend substantially more on education. In contrast, provinces who rely exclusively on the central subsidies are much more constrained in their actual spending for education.

Tracing the spending for primary education across all levels sheds light on how provinces, districts and schools allocate their resources to schools (DFID, 1999). At the national level, the allocation norms, albeit outdated, include factors such as geographical isolation and income, thus favoring the poorer provinces. Norms are often adjusted by the provincial governments themselves, to reflect their capacity to finance their education systems. The gap between provinces remains modest, however. As the funds are transferred down to the district level, further fine-tuning takes place. By using its locally collected resources, a well-off district might allocate as much as 35 percent of its spending to non-salary expenditures, whereas typical districts often allocate only 10 percent of their expenditures for that purpose. When it comes to the school level spending, differences between schools become wide. Many urban schools manage to collect more contributions, while most rural and isolated schools face great difficulty in mobilizing additional funding. The end result is such that an urban school often is able to spend twice as much as a rural school in a poor area. More importantly, out of this total spending, the urban school's expenditures on non-salary items may be as much as ten times those of the poor school.

The recently approved Decree 10/2002/NS-CP, giving autonomy to revenue generating public institutions, educational institutions included, has to be assessed in this context. Managers of schools should receive the clear and consistent message that free primary education for the poor is a government priority. Decree 10 will do little to redress the imbalance between urban and rural or poor schools in their funding of basic education. The impact at higher levels of education could be positive.

The staffing of schools is also of critical importance. There are roughly 350,000 primary school teachers in Vietnam. While provinces have implemented training programs, there is considerable variation in terms of qualifications and knowledge. This variation matters because of the strong correlation between teacher performance and pupil achievement in mathematics (figure 7.4). Children with higher scores in mathematics tend to have teachers whose knowledge of mathematics is better. This correlation suggests the need for remedial programs and pedagogical support for teachers whose knowledge and skills are limited. Additional incentives may also be required to attract better qualified teachers to more remote schools.

**Figure 7.4: Teacher knowledge and level of pupil achievement**




*Source:* World Bank (forthcoming d).

# 8. UNHEALTHY INEQUALITIES

Vietnam has made impressive gains in its health indicators during the last decades. It has reduced child mortality and maternal mortality to levels typically observed in countries whose income per capita is two to three times higher. Malnutrition among children, although still high by international standards, fell considerably during the second half of the 1990s. If the pace were to be maintained, Vietnam could reach one of the Millennium Development Goals, namely cutting the 1990 malnutrition rate by half as of 2015 (Vietnam Poverty Task Force, 2002).

At the same time, there is a growing inequality in health outcomes between the poor and the better off. Reliance on out-of-pocket payments is noticeably high by international standards, putting a heavy burden on the poor. Self-treatment has become more common, potentially escalating the level of antibiotic resistance among the population. Coping with a developing HIV/AIDS epidemic is a major challenge as well. These trends are partly associated to the gradual introduction of market forces in the health system after *doi moi*, and to important changes in its financing. They are also due to policy decisions that are beyond the traditional scope of a health ministry. Overall, they suggest that health status may be another source of increasing inequality in the new phase of growth.

Vietnam has committed to attaining the Millennium Development Goals. Through the CPRGS, it has also committed to improving access to health services by the poor. The current trends indicate that major challenges lie ahead. The financing of health services and the allocation of health spending across provinces are key in this respect.

**Overall progress**

Child mortality, one of the most sensitive and all-encompassing measures of health status, has declined steadily over the last decade. This is all the more impressive given Vietnam's relatively good starting point. By 1990 the infant mortality rate was certainly less than 40 per thousand; by the end of the decade, it had probably fallen below 30 per thousand. Moreover, despite a high abortion rate, Vietnam has seen major improvements in recent years as regards reproductive health, including impressive declines in maternal mortality (World Bank, 2001, and Vietnam Poverty Task Force, 2002).

Trends in these indicators are consistent with information on disease-specific risks. Vietnam experienced a major epidemiological shift starting in the late 1980s. In 1986, communicable diseases accounted for around 60 percent of all deaths. By 1997 the figure was below 30 percent. Thanks to the rapid adoption of an expanded immunization program in the 1980s, deaths from vaccine-preventable disease have fallen dramatically in recent years. This progress was sustained during the 1990s. Deaths from diphtheria fell by nearly 80 percent between 1990 and 1996, to 20 per thousand. During the same period, measles deaths fell by three quarters, to 10 per thousand. Polio is all but eliminated. Vietnam has also been highly successful in reducing malaria. Between 1990 and 1997, malaria cases declined by nearly 60 percent, while malaria deaths per case declined by nearly 90 percent.

Nevertheless, recorded tuberculosis incidence grew during the 1990s. This may have been due to worsening air pollution, overcrowding, and drug resistance. There has also been an increase in the incidence of dengue fever, although improvements in case management led to a sustained reduction in the case fatality rate. HIV/AIDS has spread rapidly. At an estimated 0.29

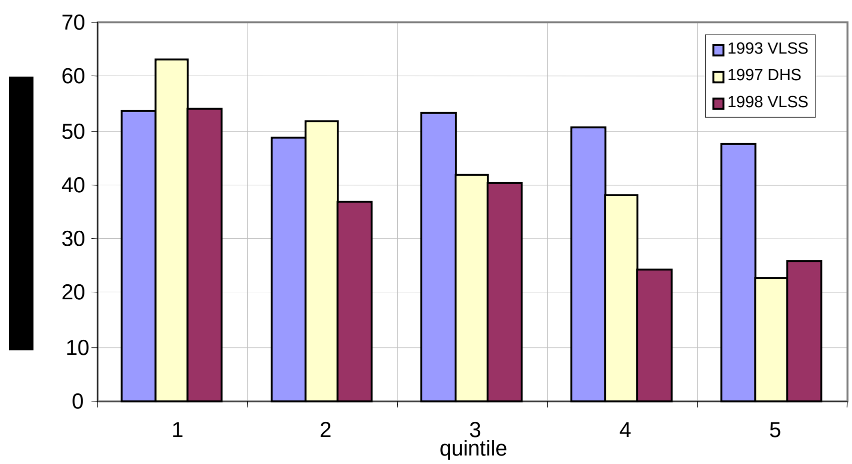
percent prevalence rate among the adult population in 2000, the HIV infection rate is considerably lower than that in Thailand (2 percent). But there are no signs that the rate of increase has been slowed.

In contrast to child mortality, malnutrition among children in Vietnam is relatively high by international standards. For example, the proportion of young children who were underweight in Vietnam in 1995 was four times that in Thailand (World Bank, 2001). However, malnutrition among children fell significantly during the second half of the 1990s.

**Uneven achievements**

While health status has improved at a more than satisfactory pace, progress has been uneven within the population. Some regions have led the way. The most rapid decline in child mortality occurred in the Mekong River Delta and the slowest in the North Central region. But the sharpest and most worrisome differentials are observable between groups defined according to average income. For instance, the children of the poorest fifth of the population saw no improvement in their survival prospects in the 1990s (figure 8.1). This slow progress jeopardizes Vietnam's chances of achieving the child survival Millennium Development Goal.

**Figure 8.1: Improvements, but not for all**




*Source:* Wagstaff and Nguyen Nguyet Nga (2002). VLSS stands for Vietnam Living Standards Survey and DHS for Demographic and Health Survey. Quintile "1" is the poorest and quintile "5" the richest.

As with child survival, improvements in child nutrition have been least pronounced among the poor. The rate of malnutrition, measured by weight, fell by 28 percent between 1993 and 1998 in the poorest quintile of the population, but by as much as 52 percent in the richest quintile. A similar picture emerges with respect to malnutrition among adults. The rate fell overall during the 1990s, but the poorest quintile saw little change (Bhushan et al., 2001). This gap is partly due to increased inequalities between the poor and better off in commune-level influences on child malnutrition (Wagstaff, van Doorslaer and Watanabe, 2002). The lack of comparable commune-level data over time makes it difficult to be identify precisely what these are. However, it is noteworthy that between 1993 and 1998 the proportion of community leaders citing lack of health facilities as a problem increased in poor communes but decreased in better-off communes.

## Financing health

Health financing changed dramatically since the beginning of the economic transition. The first important break with past policy actually preceded the introduction of *doi moi*. In 1986, the government authorized private medicine. By 1998, 34,000 licensed private facilities were operating in Vietnam. In 1989, the pharmaceutical sector was deregulated as well. One important consequence of this deregulation was to increase the supply of medicines, and reduce their cost. Between 1993 and 1998, the average price of basic drugs declined by 30 percent in real terms.

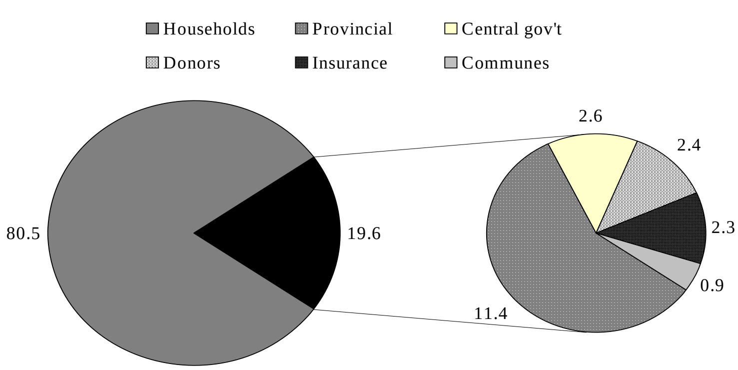
A dramatic change was the introduction of user fees in the public health sector, in 1989. This departure from longstanding practice had quick impacts on health financing because user fees were not just nominal co-payments. They were set high enough to become a crucial revenue source during the 1990s when budget support barely grew, and for some types of hospital actually fell (World Bank, 2001). The establishment of social health insurance, mainly for formal sector workers, was another key change in the financing of health.

An important reform affecting the health sector was decentralization. Provinces were given considerable authority to raise revenue and allocate resources across and within sectors. Provinces now account for about 60 percent of government health spending, drawing on a number of locally-managed sources. Large disparities in government health expenditure per capita across provinces are a worrisome consequence of these reforms. Health spending per capita in the richest seven provinces is nearly three times that in the poorest quintile. Decentralization received further impetus in 2002, with the issuance of Decree 10/2002/NS-CP, which grants hospitals and other public sector institutions levying fees an even greater financial autonomy.

These developments brought a rapid rise in revenues from user fees and health insurance reimbursements. As a result, large changes occurred in the funding of a typical Vietnamese hospital. In 1994, the state budget accounted for 76 percent of revenues; by 1998 the corresponding figure was 47 percent. User fees, on the other hand, climbed from 9 to 30 percent, and health insurance from 8 to 15 percent (World Bank, 2001). As a result of all these changes, as much as 81 percent of health spending in Vietnam was paid out-of-pocket in 1998, up from 71 percent in 1993 (figure 8.2).

**Figure 8.2: Sources of health financing**

**Sources of health financing (% of total expenditure on health contributed by each source), 1998**

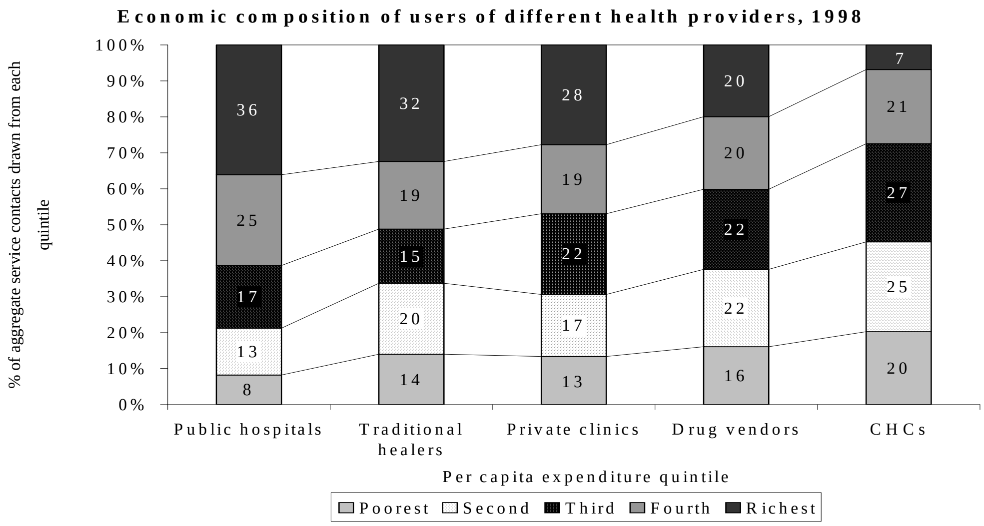


*Source*: World Bank (2001). The right-hand side circle disaggregates the non-household sources of health financing, which are lumped together in the left-hand side one.

## Health care and the poor

Differences in the health providers used by the rich and the poor are considerable in Vietnam. Not surprisingly, the richest quintile of the population is over-represented among hospital users, whereas the poorest quintile is over-represented among the users of community health centers and heavily relies on self-treatment (figure 8.3). One of the obvious reasons underlying this inequality is the concentration of hospitals in urban centers, which provides easier access to the better-off.

**Figure 8.3: Users of different health providers**




*Source*: World Bank (2001).

More worryingly, the use of health providers became more unequal between 1993 and 1998. The larger out-of-pocket costs associated with hospital use, due to more specialized and higher-quality treatment, are an additional reason for limited hospital use among the poor. The spread of health insurance among the better-off matters as well, as it largely reimburses hospital costs but not community health center costs.

Waivers and ceilings were introduced to protect the poor from user fees, but they have not led to the desired results in terms of free access to curative health care. If out-of-pocket health spending could have been set equal to zero in 1993, the extreme poverty headcount of Vietnam would have been 4.4 percentage points lower. It would have been 3.4 percentage points lower in 1998 (Wagstaff and van Doorslaer, 2002). These figures are far from negligible. They correspond to 3 million Vietnamese in 1993 and 2.6 million in 1998.

On the surface, out-of-pocket health expenditures have become less of a burden over time. The share of household expenditures devoted to health care declined from 5.7 percent in 1993 to 5.4 percent in 1998 (Narayan et al., 2000; Wagstaff and van Doorslaer, 2001). Health expenditures also became less regressive. In 1993 the poor spent a larger share of their income on health care than the better off, while in 1998 spending was broadly proportional to total expenditures in both cases.

However, these figures should be interpreted with caution as they refer to total expenditures, and not the amount health care services received. Changes in total spending result from changes in prices and changes in quantities. In the case of pharmaceuticals, the decline in their real price may have led to higher use (Gertler and Litvack, 1998). But higher out-of-pocket payments for health services should lead to lower demand. From this perspective, the relative decline in health expenditures is a worrisome development. There is evidence that many Vietnamese, and especially the poor, have dramatically switched away from professional health care to cheaper providers, such as drug vendors and traditional healers (World Bank, 2001).

**Looking ahead**

Redressing the imbalances in health outcomes will require changes in the financing of health. The overall allocation of resources across sectors should be reconsidered. For instance, total central recurrent health spending is determined based on the projected growth of recurrent expenditures and the share of health in those expenditures. Such incremental budgeting is not sensitive to health goals and priorities.

Allocation of resources between health care facilities and levels matters too. The large share of hospitals in the public health budget has important equity implications, as a disproportionately large share of hospital users is from the better-off segment of the population. More emphasis on preventive care (relative to curative care) and on primary care is necessary, especially at provincial level.

Another imperative is to address the persistent inequalities in health outcomes that are linked to reliance on provincial revenue sources. One approach would be to improve the targeting of central government transfers and donor assistance. But this would help only marginally, because of the relatively small amounts of resources involved. Different approaches are actually needed.

The Health Care Fund for the poor is of interest in this respect. Decision No. 139/QD-TTG, which took effect in November 2002, makes provincial Peoples' Committees and cities responsible for setting up and managing the Fund. Provinces and municipalities need to allocate at least 70 thousand dong for each poor patient per annum. The central government will finance 70 percent of the total cost, with the remainder coming from local and foreign resources. Local authorities can use the funds to buy medical insurance cards for each poor resident, or to pay directly for their medical services. Financing of the Health Care Fund for the Poor, currently on an even basis for all provinces, should take the regional diversity of poverty rates into account.

However, a more equitable distribution of resources across provinces would necessitate a more radical change. There has to be a shift away from the current system, in which provinces rely largely on their own resources, towards a system involving more sharing of resources between provinces. One option would be for provinces to pay a "solidarity tax" to a central fund which would then allocate resources according to various "need" criteria. These might include per capita income, poverty rate, morbidity and mortality rates, remoteness, and ethnic composition. It may also be the time for Vietnam to review its health insurance system (box 8.1).

Given the strong decentralization of health care financing and provision, the Ministry of Health should become more involved in providing guidance and regulation. Its roles should include acting as a cross-fertilizer of ideas and best practices garnered from the provinces; serving as a steward with respect to quality, regulatory practices, pricing, labor conditions, and auditing standards; and being a source of technical assistance on a selective basis. Current functions and instruments do not support such roles.

**Box 8.1: Health insurance, the poor and the non-poor**

The Vietnam Health Insurance agency, established in 1993, compulsorily enrolled most formal sector workers and civil servants. Contributions are paid on salaries and enrolees are covered against the costs of inpatient fees, as well as drugs and fees (but not drug costs) incurred in receipt of outpatient care. Later a voluntary insurance scheme was introduced aimed at family members of compulsorily insured members, informal sector and agricultural workers, school children and students, among others. In 1998, six million Vietnamese were enrolled compulsorily, and a further 4.7 million were enrolled voluntarily. Overall, they represented around 15 percent of the population (World Bank, 2001).

Health insurance has generally not benefited the poor. Only six percent of the population in the poorest quintile of the population, and 10 percent of the population in the second poorest, are enrolled. And among those enrolled, out-of-pocket payments for health care have not been reduced.

Insurance-based financing relies on costing norms, user fees and provider reimbursement rates which have not kept up with price changes. As a result, the program's credibility and viability face several risks. Rates may be set so low that insured patients are discriminated upon. A switch to a fee-for-service reimbursement system took place in late 1995. But then financial problems arose, because of uncontrolled growth of insurance reimbursements.

Decree 10 will inject market forces into health matters to an even greater extent than before, and thus could add new and higher user fees and other burdens on not just the poor but the non-poor as well. Health insurance providers should be ready to offer attractive products which are sound from a business perspective. The challenge is to build a system which is sustainable in financial and actuarial terms while being attractive to the poor. Coverage among the non-poor could actually help in this respect, as it leads to better risk pooling, hence to lower average costs per person insured.

Coverage of the non-poor could also inject countervailing pressures into the private health care market. Decree 10 will further expand the private care domain, requiring strong policy responses at different government levels. An active insurance industry purchasing services competitively can help develop a suitable regulatory framework.

In this regard, attention is needed to why voluntary health insurance has been slow to take root. Prospective purchasers of voluntary insurance probably compare their per capita consumption after out-of-pocket payments under the two alternatives: insure versus self-insure. They take into account their likely utilization patterns under each alternative, expected expenses on fees, drugs, as well as transport costs, and any forgone income incurred while travelling and waiting. They also factor in non-financial differences between the two alternatives, including convenience and the quality of the care received under each alternative. Framed in this way, simulations suggest that only the top two quintiles can expect a substantial decrease in out-of-pocket payments through insurance coverage.

In short, the low take-up of voluntary health insurance seems to be a rational response from the Vietnamese population. This is so for the poor especially, but even for the better off. Policy thus needs to encourage efforts to draw the non-poor into health insurance schemes. One possible direction is the encouragement to the Ho Chi Minh City and Hanoi municipal governments to develop alternative ways of achieving full coverage.

*Source*: World Bank staff.

There are health-related areas in which action beyond the scope of the Ministry of Health is required as well. Policies towards people with disabilities are one case in point (box 8.2).

**Box 8.2: Living with disabilities**

Official statistics on the prevalence of disabilities are lacking in Vietnam. A 1994-95 survey by the Ministry of Labor, Invalids and Social Affairs (MOLISA) found that 1.8 percent of the population have severe disabilities. Surveys done by the Ministry of Health for a community-based rehabilitation program put the figure at 5.2 percent. A 1998 study by UNICEF and MOLISA suggests that about one million children under age 18 are disabled. Discrepancies are partly due to the fact that disabilities cover a wide range of conditions from complete paralysis, blindness, deafness or Down's syndrome all the way to missing part of a finger or having shrapnel embedded in a bone. Defining what is and what is not a disability can lead to widely varying estimates. The low visibility of the disabled, who are often kept at home because it is too difficult to get out or because of embarrassment, makes it easy to ignore the problem.

More complete data on disabilities, their types, causes and the distribution across the population will result from the National Health Survey, which is currently being implemented by the Ministry of Health and will be disseminated in 2003. Preliminary results, subject to revision, indicate that the fraction of people with easily identifiable disabilities increases with age, from less than one percent at birth to more than ten percent after age 60. A clear correlation between disability and poverty exists. The main cause of disability is illness. A small fraction of disabilities are from war-related causes including direct conflict and post-war effects of mines and bombs. Over time, road accidents will become an increasingly important source of disabilities.

In Vietnam, MOLISA is assigned responsibility for social welfare, vocational training, employment creation, social rehabilitation, direct support, and direct care of people with disabilities. The main strategy, approved in 1989, is community-based rehabilitation, whereby people with disabilities should be assisted within their communities, by the institutions located there. In 1995, responsibilities for training and education of children with disabilities were transferred to the Ministry of Education, combining inclusive education with training in special schools for the disabled. Increasing concern from policymakers about disabilities is evident in the promulgation of the 1998 Ordinance on the Disabled, which lays out the rights and responsibilities of disabled people, and in the establishment of the National Coordinating Council for Disabilities in 2001.

In addition to government services, several organizations have been set up to provide services and advocacy for people with disabilities. Charity organizations also help to raise funds to help families with disabled people. About 20 international non-government organizations are working in this area in Vietnam.

Despite the legal framework and existing efforts, much needs to be done. There is not enough awareness of disabled people and their needs. The Coordinating Council needs to be strengthened so it can play a stronger role in monitoring the implementation and enforcement of policies designed to help the disabled. Greater efforts are needed to help schools, especially rural schools, to streamline disabled children into the classroom through teacher training and awareness programs in communities. Appropriate occupational training for the disabled are needed as well. Physical access to buildings and facilities, as well as curb cuts in sidewalks, should be introduced at the planning stage of infrastructure projects. Fund raising and support to families facing a heavy burden from disabled members should be strengthened. Restrictions and barriers to registration for organizations for persons with disabilities need to be lifted and assistance provided so these organizations can better serve the needs of their members.

*Source:* World Bank staff based on data from Ministry of Health and on Hanoi School of Public Health (2002).

Another case is HIV/AIDS. The epidemic still seems far from having matured in Vietnam. Based on detected cases, there were 122 to 130 thousand people with HIV/AIDS in the year 2000, for a prevalence rate of 0.29 percent. Of these 14 to 21 had developed AIDS. Drug users and sex workers were groups with high and increasing prevalence rates (Vietnam Poverty Task Force, 2002). A rough forecast method puts HIV prevalence at 0.5 to 1.0 percent of the adult population as of 2005. This trend can be expected to continue over the next few years if no resolute action is undertaken. But Vietnam has the opportunity to prevent the occurrence of an epidemic of the size observed in Cambodia and Thailand. Increasing its funding on preventive programs is critical in this respect. The measures needed include behavior-change communication activities, condom promotion, treatment and care of sexually-transmitted infections, and screening for HIV in all blood banks. These policies would be much more effective if the government changed its attitude towards sex workers and treated HIV/AIDS like a disease, rather than a "social evil".

# 9. ENVIRONMENT

Vietnam's rapid growth has been accompanied by the damaging of natural resources and declines in environmental quality. Land degradation continues, while biodiversity is under threat. Forest cover has improved marginally, but its quality remains a concern. In cities and towns air, water and solid waste pollution need to be addressed, while environmental services fall short of demand. Coastal and marine resources are also severely affected. Environmental degradation is disproportionately affecting poor people, through impacts on their health and livelihoods. The poor are also often the most vulnerable to natural disasters.

Recognizing these problems, as well as their linkages to poverty, the government of Vietnam has started identifying policies and measures aimed at improving livelihoods while simultaneously protecting the environment. Environmental commitments were made under the National Strategy for Environmental Protection, 2001-2010, and the CPRGS (box 9.1). The task of implementing these commitments falls under the newly created Ministry of Natural Resources and Environment.

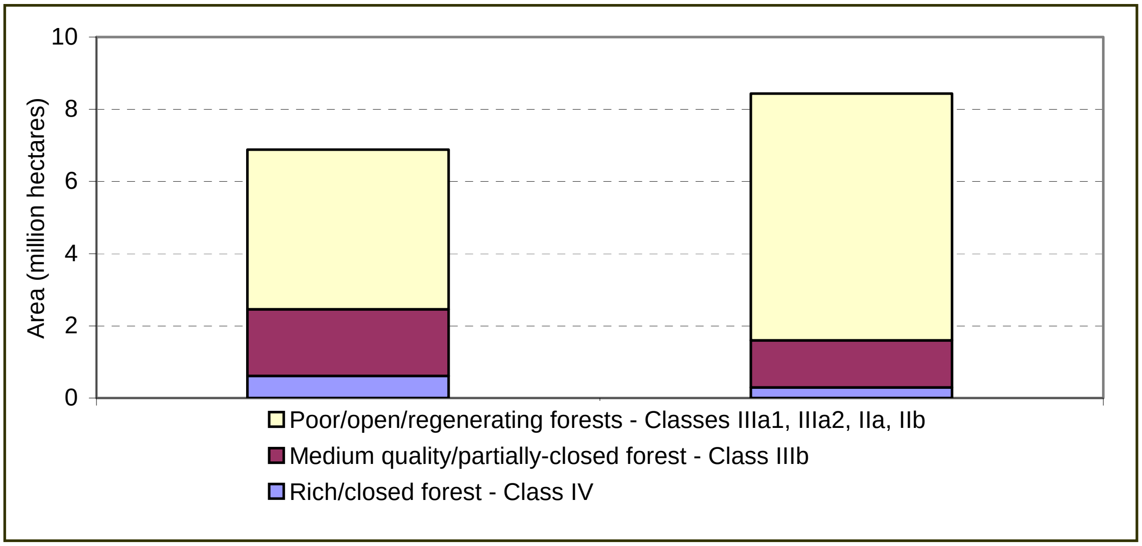
**Serious degradation**

Clear trends are observable in resource-based degradation of land, forests and coastal and marine resources. There are also declines in environmental quality associated with air, water and solid waste pollution (World Bank, 2002b).

Land degradation is caused by urbanization, insecure land tenure, poor logging practices, drought, salinization and acidification. Steep slopes, especially in the highlands and northwest regions, are very susceptible to soil erosion during heavy rains.

Unlike most of its neighbours, Vietnam has in all probability stopped the decline in its forested area and the country's total forest coverage also compares favorably with that of almost any other country. However, Vietnam has not been successful in protecting its rich and closed forests (figure 9.1). Habitat loss has led to a rise in the number of threatened species. No coherent strategy is in place to protect even the small remaining area of highly bio-diverse forest.

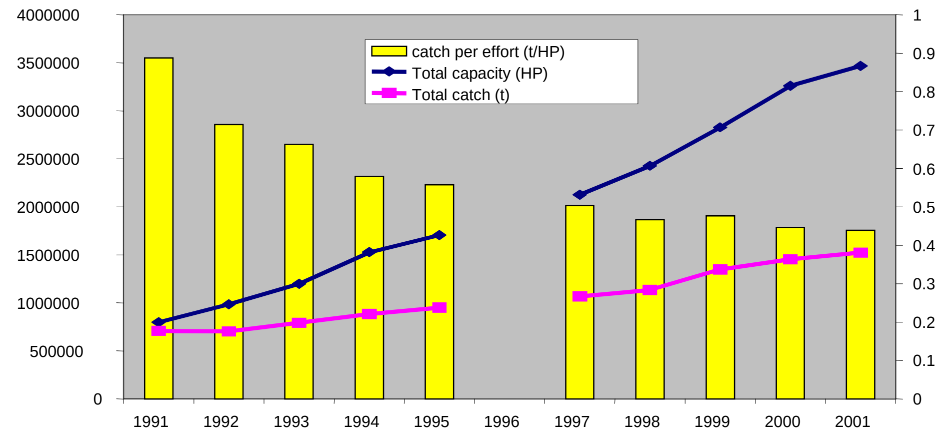
**Figure 9.1: Trends in the composition of the forest cover**




*Source*: World Bank (2002b).

Rich and diverse coastal and marine ecosystems are also under threat. Over the last five decades, Vietnam has lost more than 80 percent of its mangrove forests, with shrimp farming being one of the leading causes for this destruction. About 96 percent of Vietnam's coral reefs are severely threatened by human activities, including destructive fishing methods, over-fishing, and pollution. Over-fishing and the destruction of coral reefs and mangroves have led to a steep decline in the fish catch per effort, threatening the sustainability of the marine fisheries sector (figure 9.2).

**Figure 9.2: Marine catch**




*Source*: World Bank staff based on data from the Ministry of Fisheries. Catch is measured in tons (t) and capacity in horse power (HP).

Burgeoning urban populations are overwhelming municipal infrastructure and causing environmental problems such as unmanaged landfills, transport-related air pollution, untreated hospital and hazardous waste, and raw sewage flowing in open channels. Sedimentation and pollution are affecting the health of rivers. Air quality in nearly all urban and industrial areas is affected by particulates, lead and nitrous oxides, sulfur dioxide and carbon monoxide emitted by sources including vehicles, factories, power plants, and households. Waste generation is on the rise, while household collection efficiency remains low. Most of the collected waste in Vietnam is disposed in dumps and open landfills.

**Poverty and environment**

Environmental degradation has a disproportionate impact on the poor, who tend to be more exposed to water and land pollution. In urban areas, they tend to be more exposed to air pollution as well. All of this translates into increased mortality and morbidity from respiratory disease and diarrhea (World Bank, 2002b).

Poor people are also more dependent on the direct use of natural resources, and are therefore most severely affected when the environment is degraded or access to natural resources is limited or denied. In Vietnam, many ethnic minorities live on steeply sloped areas in the northern highland regions. Their livelihoods are consequently vulnerable to soil degradation and deforestation.

The poor are the most exposed to environmental hazards as well, and they are also the least capable of coping when they occur. Vietnam is a country prone to natural disasters, particularly floods, typhoons, and drought. An average of more than one million people need emergency relief each year due to natural calamities (Poverty Task Force, 2002a;b).

A series of participatory poverty assessments conducted in 1999 suggest that poor people also view themselves as being more intrinsically linked to their environment. Throughout these assessments, poor people highlighted their perception of natural resources as a safety net (World Bank/DFID, 1999). Preliminary results from a more recent study reveal a link between the environment and poverty in the context of fragile soils and indoor air pollution (Dasgupta et al., 2002).

**Progress made**

The main environmental challenges faced by Vietnam faces include creating incentives for changing behavior, involving communities and citizens more fully, improving institutional effectiveness, and diversifying sources of financing for priority programs. Addressing these challenges is important to achieve the ambitious targets set out by the government regarding environmental sustainability.

Empowering communities by increasing their access to information is one way to create incentives for better environmental behavior (box 9.1). The government is also encouraging community-based management of natural resources, as a way to ensure greater local accountability. Several donors have been actively working with local communities on integrated watershed management. In addition, a growing number of national and international organizations are working on projects relating to community forest management.

While several environmental laws, decrees and ordinances addressing environmental protection have been passed, their enforcement is more problematic. A preliminary review of staffing in ministries and departments with environment functions indicates inadequate capacity and over-extended staff.

**Box 9.1: Public disclosure in Hanoi**

The National Environmental Agency is implementing a program to disclose the environmental performance of enterprises in Hanoi.

Based on similar initiatives in Indonesia and Philippines, the program developed a color-coded rating system to disclose the performance of enterprises to the public. There are five color-codes: gold, green, blue, red and black. Each represents a different level of performance of the participating enterprises, gold being the best.

50 enterprises participated on a voluntary basis in two rounds of the program. Their performance was disclosed by the Deputy Prime Minister at two public functions held in February and June of 2002. The results do not reveal a bright start, but show an improvement in performance.

| | *Gold* | *Green* | *Blue* | *Red* | *Black* |
|---|---|---|---|---|---|
| *February* | *0* | | *5* | *29* | *16* |
| *June* | *1* | *1* | *10* | *24* | *14* |

*Source:* World Bank staff.

In August 2002, in an effort to improve institutional effectiveness, the government established a new Ministry for Natural Resources and Environment. This new Ministry brings together the General Department of Land Administration, the General Hydro-Meteorology Department and the National Environment Agency. This Ministry is in charge of land, water and mineral resources and environmental protection, while other conservation functions such as forestry and protected areas are expected to be transferred to it in later years.

Environmental budgets remain low, however, with core expenditure at just under one percent of total public expenditure. New ways of diversifying sources of funding are being explored. In June 2002, the Vietnam Environment Protection Fund consisting of 200 billion dong (or about 13 million US dollars) as an initial capital was set up by the Government to finance environmental protection activities. User charges for providing sanitation services have been introduced in Danang, Haiphong and Ho Chi Minh City. However, these charges are still a far cry from economic instruments such as pollution fees and fines.

## Charting the way forward

The environmental vision has been defined, medium term environmental objectives have been identified, and immediate priority environmental actions set in the context of poverty reduction have been formulated. But progress with respect to the medium-term agenda is still falling short.

A three-pronged agenda could be considered to foster implementation. It would involve mainstreaming, by ensuring higher environmental standards and enhancing environmental objectives and components in projects. It would also include building capacity and assisting in the decentralization of environmental functions. Last but not least, it should rely on analytical work, to deepen the analysis of the links between poverty and environment, and to support regulatory reform.

# 10. COPING WITH SOCIAL IMPACTS

While economic reforms can be expected to increase output and reduce poverty, they may also have differential impacts across population groups and may thus create winners and losers. Given the priority attached by the government to socially-inclusive development, appropriate mechanisms need to be found to assist those who stand to lose. In some cases, identifying the potential losers is feasible, and mechanisms to redress the damage can be considered. In other cases, however, the impact is more defuse so that targeted approaches need to be ruled out.

In Vietnam, there is widespread concern that the adverse impacts from further trade liberalization could be considerable, but much less consensus regarding who the potential losers are. Formal sector workers in protected industries, household enterprises and farmers in specific sectors, and illegal migrants to urban areas are often mentioned. A careful analysis of the evidence is needed to dispel the concerns when they are unjustified, and to address them effectively when they have merit.

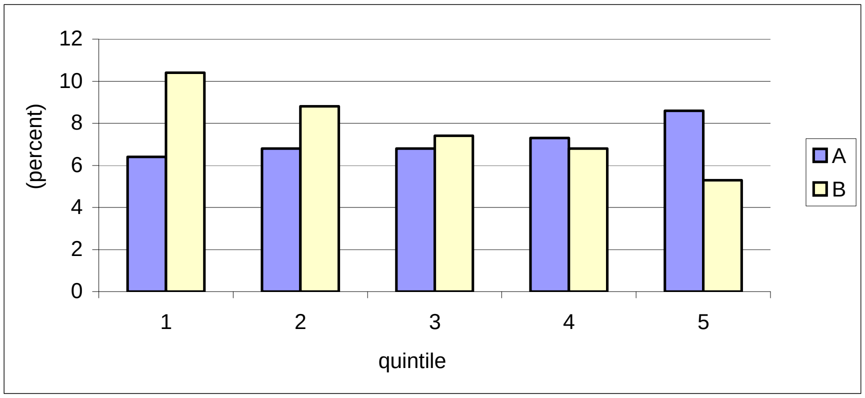
**Growth and the poor**

Vietnam is probably about to enter a new phase of rapid economic growth. Whether this growth will "lift all boats" or will rather leave some of the population behind remains an open question. One way to address this question is to look at the consequences of the previous phase of rapid growth, before the East Asian crisis. The impact of rapid growth on poverty and inequality over that period can be assessed thanks to the availability of detailed data from two rounds of the Vietnam Living Standards Survey, for 1993 and 1998.

On the surface, Vietnam's economic growth before the East Asian crisis was accompanied by an increase in inequality. The Gini coefficient for consumption per capita increased from 0.33 in 1993 to 0,35 in 1998 (World Bank, 2000a). While this increase is not very large, it would suggest that the poor in Vietnam did not benefit from economic growth as much as have better off households.

An equally misleading impression results from estimating the growth rate of consumption per capita for households in each quintile between 1993 and 1998. It then appears that the consumption of the poorest group increased by 6.4 percent per year, compared to 7 percent for the groups in the middle and 8.6 percent for the wealthiest one. This would confirm the finding that inequality in Vietnam is slowly increasing (figure 10.1). However, a comparison of consumption per capita for the same households reveals that on average the poor did not fall behind the rich, and in one sense they did better than the rich (Glewwe and Hai Anh Dang Hoang, 2002). The growth rate of consumption for households who were in the poorest quintile in 1993 was 12.9 percent per year. The corresponding rate for households who were in the wealthiest quintile in 1993 was 4.1 percent. The gap becomes somewhat narrower after taking into account possible measurement error when classifying households. But still, the growth rate of consumption for the poorest households (10.4 percent) was about twice as large as that of the wealthiest households (5.3 percent).

**Figure 10.1: Annual growth rates of consumption**




*Source:* Glewwe and Hai Anh Dang Hoang (2002). Growth rates are for the period 1993 to 1998, based on data from the Vietnam Living Standards Surveys. "A" stands for quintiles defined as of each survey, "B" classifies households according to their quintile in 1993. Quintile "1" is the poorest and quintile "5" is the richest.

Two caveats apply. First these upbeat results refer to nation-wide averages, whereas a substantial regional diversity has been observed. The Mekong Delta, in particular, had a much worse performance in terms of poverty alleviation, despite being the "rice basket" of Vietnam. The reasons for slower consumption growth in this region are not well understood yet, but distance to the nearest road appears to be one of them, which stresses the importance of rural roads for poverty alleviation.

A second caveat relates to the unusually favorable conditions for poverty reduction in the phase of rapid growth that preceded the East Asian crisis. The distribution of land to rural households as a result of the *doi moi* introduced a pro-poor bias in the growth pattern of the 1990s. Poverty was, and still remains, much higher in rural areas. The transfer of one of Vietnam's most valuable assets to the population in these areas was one of the driving forces behind the remarkable decline in poverty observed before the East Asian Crisis.

The distribution of land was a one-time intervention, however, leading to a change in the level of consumption, but not necessarily to sustained growth in consumption. Having land today is not enough to escape poverty. Farm-only households remain the poorest in Vietnam. Among rural households, a strong association is observed between poverty and lack of diversification into wage and self-employment activities (Dominique van de Walle and Dorothyjean Cratty, 2002). In the new phase of economic growth Vietnam may be about to enter, no force comparable to the one-time distribution of land will be at play. Hence the need for social policies.

### Identifying the losers

In some cases identifying those losers from economic reforms is relatively easy. The reform of state-owned enterprises is a case in point. If these enterprises were to operate as profit-maximizing units, they would employ a much smaller number of workers. On average, as much as half of their workforce could be redundant, although the fraction could be negligible in sectors such as garments, or footwear, and much higher in coal mining or transportation (Patrick Belser and Martin Rama, 2001). The restructuring of state-owned enterprises does not imply that half of their workforce will become redundant. Workers will gain control of many of them, implying that employment will remain one of their objectives, alongside with profits.

Moreover, a considerable portion of the redundancies can be handled through natural attrition and early retirement. But job losses could still be considerable. In the absence of assistance, the workers affected by downsizing would certainly experience a welfare loss (box 10.1).

**Box 10.1: A fund for redundant workers**

The restructuring plan for state-owned enterprises could lead to about 250 thousand job separations between 2002 and 2005. Decree 41/2002/ND-CP, of April 2001, established an assistance fund to support the workers made redundant because of the reform program. The fund gets its resources from the government budget and from concessional external resources provided by donors. It became fully operational in October 2002, after the corresponding regulations were issued.

The fund is intended to assist redundant workers who were on long-term contracts when the restructuring of state-owned enterprises was launched in 1998. Assistance takes the form of a compensation package and support for re-training. In order to mitigate the adverse impact on the workers and to encourage voluntary separations, the package is much more generous than the one stipulated by the Labor Code. The obligations of state-owned enterprises towards their workers are not modified. But the fund provides additional support amounting to one month of basic salary per year of service, a lump sum of 5 million Dong, and an additional six months of basic salary for seeking a new job.

This package was designed based on an analysis of the earnings of workers who are “similar” (in age, skills, region of residence etc.) to those in state-owned enterprises, except that they are self-employed, or work in the private sector. The lump-sum component, in particular, was aimed at favoring female workers, who tend would otherwise get much smaller packages than makes because of their lower salaries, despite having lower basic salaries than males more to lose from job separation (Rama, in press a). Funding for re-training for up to six months is provided as well. Workers rehired in state-owned enterprises have to reimburse the assistance they received to the fund. The fund also assists workers who opt for early retirement.

The assistance package does not vary depending on whether the enterprise is equitized, sold or liquidated. It is also available for redundant workers in enterprises that remain in state hands, provided that these enterprises are included in the restructuring list under the government’s reform program. The fund can also be used to assist workers who become redundant during the first 12 months following equitization. This is to encourage private sector participation in the equitization process, even in the case of heavily over-staffed enterprises.

Twenty state-owned enterprises applied for support from the fund within its first month of operation. Among the enterprises which had submitted all the documentation required, the average redundancy rate was 25 percent. But it ranged between 13 and 67 percent depending on the enterprise. A survey of separated workers is scheduled to take place after the first year of operation of the fund, to assess their situation as a result of job loss and to evaluate the adequacy of the assistance provided.

*Source*: World Bank staff.

Identifying those who stand to lose from economic reforms is more difficult in other cases, and especially when those affected are not part of the formal sector of the economy. One commonly voiced concern is that trade liberalization may have an adverse impact on rural households. Exposure to world markets could lead to higher variability in the price of their products, hence affect their earnings.

It must be noted, however, that trade barriers usually protect the manufacturing sector, and penalize the agricultural sector, so that liberalization could turn to the advantage of rural households. Rice provides an interesting case. From 1993 to 1998, the average domestic price of rice increased 29 percent relative to the consumer price index. Part of this increase stemmed from the relaxation of a rice export quota. Out of concern for domestic food security, the

Vietnamese government began administering a rice export quota in 1989. By 1997 this export quota was no longer binding and Vietnam was fully exposed to the international price of rice.

A recent study found large reductions in child labor associated with the increase in the price of rice (Edmonds and Pavnick, 2002). Child labor was defined as doing household chores for seven or more hours per week, or working in agriculture, wage employment, a family business or as a domestic servant for one or more hours per week. The study estimated that rice price increases alone accounted for almost half of the decline in child labor that occurred in Vietnam in the 1990s. The extra household income from higher rice prices particularly benefited older girls, who experienced the largest declines in child labor and the largest increases in school enrollment.

**Industrial restructuring**

Unlike rural households, urban households whose members work in sectors protected by trade barriers could be adversely affected by economic reforms. Drawing from interviews conducted in Hanoi and Ho Chi Minh City, a study assessed the impact of restructuring in the textile industry on the livelihoods of textile workers. Workers who were retrenched as a result of international competition were interviewed as well (Nguyen Thi Hoa et al., 2002).

Workers who had migrated to Hanoi or Ho Chi Minh City viewed textile employment as much preferable to the alternative of agricultural work in their home areas. However, some 40 per cent of textile workers interviewed complained of long hours or occupational health problems. The predominant, three-shift system was unpopular. Despite these complaints, two-thirds of textile workers interviewed regarded their household status as "average" compared to their neighbors, and less than a third thought of themselves as poor.

Retrenchment, though psychologically damaging to those involved, had not generally pushed households into dire poverty. Although nearly a half of the households affected regarded themselves as poor or worse, their household incomes were mostly well above the 2001 urban poverty line, thanks to a combination of compensation payments, pensions, and informal income-earning opportunities. Because there is a concentration of older workers, often with health problems, among those retrenched, formal sector re-employment is difficult. Such re-employment turned out to be easier for retrenched men, who typically worked in technical and mechanical jobs, than for women, who typically had only textile industry-specific skills.

A parallel study focused on the employment implications of industrial restructuring as seen from the enterprise perspective (Thoburn et al., 2002). It showed that textile employment fell sharply over the 1990s despite a substantial increase in output. The employment decline was the result of rising labor productivity, associated with restructuring and new investment. The study also suggests that future expansion of the textile industry, if it leads to net employment creation, is unlikely to draw its workers directly from the poor. This is because textile employment usually requires secondary educational qualifications that the poor lack.

**Transfer programs**

Except when losers can be easily identified, as in the case of the restructuring of state-owned enterprises, indirect mechanisms are required to mitigate the adverse impacts of economic reforms. In principle, safety net programs have the potential to play that role. Some programs select their beneficiaries based on consumption or income indicators, thus favoring those who fall below a certain threshold. Others implicitly operate as insurance mechanisms, and provide transfers to those who experience an adverse shock, even if they do not become poor in absolute terms. The question is whether safety nets in Vietnam play that mitigating role in practice.

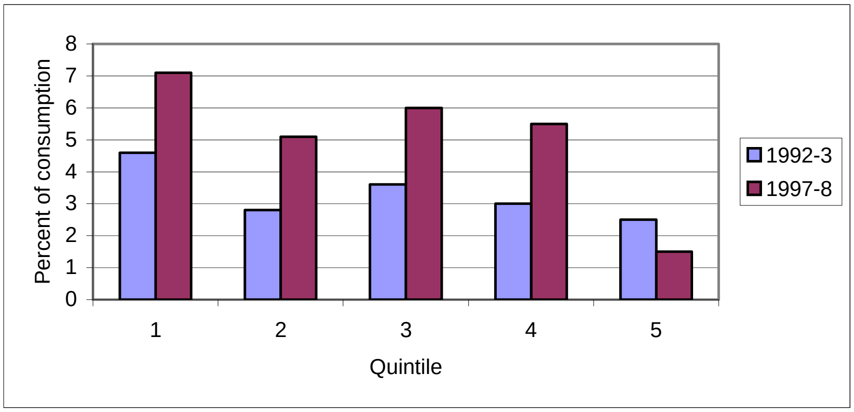
By poor country standards, Vietnam has an extensive safety net. The social security system provides pensions and other employment-related social insurance benefits to workers in state-owned enterprises and in the formal private sector. The Social Guarantee Fund for Regular Relief targets assistance to those unable to support themselves. There is also a central Contingency Fund for Pre-harvest Starvation and Natural Disasters, and a number of national development programs targeted to poor and remote communes. In 1996, a Hunger Elimination and Poverty Reduction program was introduced to coordinate existing and new efforts.

Not only is the number of programs large, the volume of resources channeled through them has also increased substantially over time. For some programs, transfers more than doubled between 1993 and 1998.

The size of the transfers actually received by households is very much determined by the large extent of decentralization that characterizes Vietnam. Resources allocated by the central budget appear to be quite redistributive, aiming to equalize resources across provinces. But the redistributive process often breaks down at this level. Provinces distribute resources to districts based on criteria that vary widely from one province to another. And similarly, districts distribute to communes in disparate ways. Decentralization also implies that those in need partly rely on resources from their own communities. As a result, poor people living in poor areas fare much worse than poor people living in well-off areas.

One way to assess whether these combined transfers have the potential to mitigate adverse shocks is to compared them to the consumption level the household would have attained in the absence of the transfer (Van de Walle, 2002). That consumption level is not directly observable, but it can be estimated. The results show that the social safety net of Vietnam is progressive indeed, thus implicitly helping those whose consumption falls (figure 10.2). Poor households receive bigger transfers, in percentage of their consumption, than rich households. And the system became more progressive with the increase in the volume of resources it channeled. But the small size of the transfers, as a proportion of household consumption, suggests that a safety net of this sort cannot, on its own, make a big dent on poverty and inequality.

**Figure 10.2: Transfers from all social programs**




*Source:* Van de Walle and Cratty (2002). Figures are measured in percentage of consumption in the absence of the transfer. Quintiles are defined based on average consumption per capita of each household between 1993 and 1998.

The safety net system of Vietnam has several weaknesses. It suffers from the lack of national norms to identify its target population, from poor monitoring and from limited integration between programs. The high level of decentralization also makes it difficult to provide adequate protection against geographically concentrated shocks, such as natural disasters or environmental degradation. Adequately addressing these challenges, and the potential widening of inequality between urban and rural areas, will require a greater level of risk pooling nationally, through greater reliance on transfers mediated by the central government.

# III. Modern Governance

# 11. TOWARDS THE RULE OF LAW

As Vietnam enters in a new phase of rapid growth, the expansion of economic activity could well outpace the modernization of the legal framework. Secure property rights, an independent judiciary and legal transparency are needed to keep attracting investment and generating jobs. The right for citizens to complain and get their grievances addressed are essential to improve public service delivery in areas such as health and education. Effective law implementation is key to avoid abuses and corruption. In all of these areas, much remains to be done.

Vietnam's legal development has been shaped by the transition from a centrally planned economy to a market economy with socialist orientation. Economic liberalization, integration with the rest of the world and a social agenda underlie the legal reform process observed in practice. In less than 10 years since the 1992 constitution was enacted by the National Assembly, an entire legal edifice covering almost all aspects of public and private rights, activities and relationships has been built up. But this edifice has important shortcomings.

An important foundation for further legal reform is a comprehensive review conducted in 2001 and 2002 (Inter-Agency Steering Committee for Legal System Development Needs Assessment, 2002). This review, identified as the Legal Needs Assessment in what follows, contains initiatives which could fundamentally reshape the legal system. Its key principles are that citizens can do anything that is not explicitly prohibited while state institutions and officials can do only what is specifically permitted by the law. These key principles were enshrined in the constitution in December, 2001.

The Legal Needs Assessment is also impressive in terms of candid problem identification and problem coverage. Many of the reforms it advocates, such as the promulgation of the Competition Law and the revision of the Bankruptcy Law, are already on the legislative agenda. Other reforms are part of detailed action plans, to be submitted to the Prime Minister, and after his approval to the Party. Implementation remains a challenge, however.

**Key components**

The Legal Needs Assessment identifies five key areas where action is needed: legislative and law-making reform, judicial reform, effective and efficient law implementation, legal information and transparency, and legal education and training.

*The legal framework and the law-making process.* This component includes objectives such as strengthening the law-making capacity, ensuring that laws are consistent with the requirements of a market-based economic structure and with international integration, exploring the potential of customary rules, court decisions and other sources of law, and revising of the legal framework for penal law and law-making.

There is currently a lack of technical means to ensure uniformity and consistency of normative legal documents such as officially-sanctioned legislative drafting manuals, or uniform legislated definitions. New laws supersede old laws where there is a conflict, not in their entirety. This leaves the legal system open for wide interpretation and overlap. A systematisation and codification of legal normative documents are envisaged to assure the uniformity and hierarchy of laws and regulations.

A related development was the strengthening of the National Assembly. In 2002 the number of deputies was increased from 450 to 498 and the number of permanent deputies from 100 to 125. Most importantly, the National Assembly was mandated to request votes of confidence on ministers and to perform a stronger role on budget oversight. It is thus moving closer to a full-fledged independent law and policy making institution.

*Judicial independence and access to justice.* Judicial reform focuses on courts, other dispute settlement tribunals, law-enforcement and legal aid agencies, prosecutors, lawyers and bar associations, and public registers for rights, secured transactions, and enterprises. In practice, it necessitates that courts and judges be independent. An efficient court and out-of-court system is crucial not only to foster business development, but also to ensure observance of basic human rights standards. In Vietnam, however, the quality and independence of the judiciary needs to be further enhanced.

Legal aid to the poor stands as a particularly important issue with regard to access to justice. It is critical to ensure that legal institutions work for the benefit of the vulnerable and deprived segments of society. Vietnam has come a long way as legal aid offices have been established and made operational through nearly all 61 provinces. However, budgets and human resource allocations remain weak.

Legal aid offices are currently within the jurisdiction of the Ministry of Justice. To ensure their independence from the executive branch, a state public defender's office could be established. Such office would plead for poor people in criminal cases.

*Effective law implementation.* Vietnam has promulgated an extensive and impressive list of laws, in part as a response to the evolving requirements from economic reforms. However, implementation has been impeded by vague responsibilities, slow progress in administrative agencies, and limited people's voice on the process. To increase people's participation, the Grassroots Democracy Decree should be scaled up and implemented nationally, a law on associations should be passed, and an amendment of the Law on Complaints and Denunciations should be undertaken. These three initiatives could bring quick and tangible benefits in terms of participation, development of a genuine civil society, and service delivery. In the absence of these initiatives, civil society associations must rely on a variety of legal documents and cumbersome administrative procedures, which are overlapping, outdated and contradictory (box 11.1).

*Legal information and dissemination.* Until now, enabling people to make informed choices transparency has not been seen as an integral part of the law-making and implementation process. In addition there exists no formal and regular means by which those affected by laws and regulations can participate in the law-making process.

The Legal Needs Assessment outlines concrete steps to increase transparency. It proposes that laws, decrees, decisions, rules and administrative procedures become legally effective and enforceable only after they have been published in the Official Gazette. It also proposes regular and systematic publication of decisions, judgments, opinions and guidelines by the Supreme People's Court.

*Building capacity.* Legal reform will require a parallel process of legal education and training of staff in the judicial branch. Up to now capacity has not been able to match the requirements neither at the institutional nor at the individual level.

Enhanced human resource capacity in the legal institutions and law-enforcement agencies are key to deliver effective implementation in the other four areas. A training program for law-enforcement officials in the police, customs, tax administration and so would also be a prerequisite for a well-functioning legal system.

**Box 11.1: Establishing a business association**

There are still no clear rules to establish a business association in Vietnam. The basic procedures are as follows:

***Creating a preparatory board***

Representatives of enterprises wishing to establish an association need to create a preparatory board, which must be approved by the Ministry of Home Affairs for national business associations and by Provincial People's Committees for provincial business associations. The application materials for approval must include:

- same, objective, purposes, and scope of activities of the association;
- provisional location of the head office;
- time estimated for preparatory activities;
- draft statutes of the association;
- list of the preparatory board members and their curriculum vitae certified by the local authority in their area of residence;
- recommendation from the state agency overseeing the field in which the association will operate (i.e., the relevant line ministries for national associations, and local departments of line ministries for provincial associations).

After receiving permission from the competent authority, the board has to carry out preparatory activities such as mobilizing members, refining its application for establishing the association, seeking a recommendation from the relevant state agency, and preparing a list of members of the management board.

***Application for establishing an association***

The preparatory board then submits an application for establishing the association to the competent state authority. Again, the Ministry of Home Affairs is the competent authority granting permission to national business associations, and Provincial People's Committees serve as the authorities granting permission to provincial associations. The application materials must include:

- name, objective, purposes, and scope of activities of the association;
- statement on the necessity for establishing the association;
- location of the head office;
- sources of funding and assets of the association;
- draft statutes of the association in compliance with Article 99 of the Civil Code;
- report on preparatory activities;
- an action plan;
- list of the preparatory board members and their curriculum vitae certified by the local authority in their area of residence;
- recommendation from the state agency overseeing the field in which the association will operate.

***Approval and inaugural congress***

Current regulations do not provide a maximum time limit for considering the application, and the procedures for appealing a negative decision are complex. A petition can be addressed to the agency, which issued the denial. If this authority refuses to change its decision, a petition may be filed at a higher administrative level or at administrative courts.

After receiving permission from the competent authority to establish the association, the preparatory board proceeds by organizing an inaugural congress and reporting to the authority as to the content, agenda, time, and location of the congress. The congress proclaims the formal establishment of the association, adopts its statutes and program of action, elects its management board and adopts the resolution of the congress.

The leaders of the association must complete all documents of the congress and report the result to the competent authorities. The association's statutes come into effect upon the approval of this authority.

*Source:* Do Son Ha (2000), Nguyen Van Thanh and Dinh Duy Hoa (1999), Nguyen Phuong Trang et al. (2002).

### What comes first?

The Legal Needs Assessment is remarkable for its all-encompassing and holistic approach to the legal reform process. However, it contains 27 sub-programs and more than 250 specific policy actions. To make implementation realistic, a sequencing of the proposed reforms is required, with a special view to facilitating economic development and protecting the poor and vulnerable groups. An initial list of 18 priorities has been identified. They include the establishment of an effective management mechanism, and 17 other priorities that can be clustered into the five key components of the legal system (table 11.1).

**Table 11.1: 17 priority actions… out of 250**

| The legal framework and the law-making process | Judicial independence ad access to justice | Effective law implementation | Legal information and dissemination | Building capacity |
|---|---|---|---|---|
| • To improve and complete key procedure laws--i.e. a Civil Procedure Code, an amended Criminal Procedure Code, an amended Ordinance on Procedures for Settling Administrative Cases, an amended Ordinance on Organization of Criminal Investigation, and a Law on Execution of Judgments.<br>• To strengthen legal departments in ministries, ministerial and people's committee level state agencies, and enterprises.<br>• To strengthen capacity for implementing laws and regulations on Intellectual Property Rights<br>• To strengthen capacity for drafting and examining legal normative documents to ensure their legality and constitutionality: To ensure the transparency of legal system by amending the Law on Promulgation of Normative Documents and to promulgate the Law on Promulgation of Legal Normative Documents at Local Levels.<br>• To research whether to add court decisions, traditional customs, and/or principles of Professional Associations as sources of laws.<br>• To perfect the laws and regulations on environmental protection<br>• To set up and complete the legal framework in order to create legal bases for uniform and consistent establishment and operation of institutions in the socialist market economy and international economic integration | • To renovate the operation of judicial and quasi-judicial agencies: improve capacity and professional skills of, and increase the quality of legal services provided by, lawyers, public notary officials, legal aid officers and expert witnesses.<br>• To strengthen capacity to implement the new Law on Organization of People's Courts, especially for transferring judicial administrative management of local courts from the Ministry of Justice to the Supreme People's Court. | • To strengthen the role and capacity of the administrative courts.<br>• To continue strengthening democracy and people's attitude of respect to laws, concentrating on amending the Law on Complaints and Denunciations.<br>• To strengthen supervision role and activities of National Assembly regarding implementation of laws and regulations. | • To complete legal information system and dissemination by promulgating a Decree on the Official Gazette and a Decree on the functions, duties, organization and operation of the National Legal Information Center; To establish a special periodic publication in order to publish and disseminate all judgments and decisions by the Supreme People's Court<br>• To set up the National Legal Information Center<br>• To set up the National Program on legal dissemination and education | • To renovate programs textbooks and teaching methods.<br>• To strengthen the capability of teachers in training institutions |

*Source*: LNA Newsletter (June 25, 2002).

The policy actions laid out so far could be better interpreted as a list of objectives. Considerable efforts will be required to transform them into concrete projects. But it should not be assumed that there will be a one-to-one relationship between actions and projects. Some of the actions might be combined with others in one project, and some are so complex that they might need to be separated into two or more projects. The Vietnamese authorities face the issue of deciding how projects can best be prepared and implemented. If the management structure is not well designed and appropriately resourced, the action plan may fall short of meeting its objectives. It is therefore encouraging that one of the 18 priorities is the strengthening of the management mechanism for the legal reform process.

Two options are being considered in this respect. In the preferred one, a national steering committee for legal reform would bring in the strategic guidance from the political elite. The State President would be its chairman, and there would also be an active involvement of the Party. Given that legal reforms will affect a number of vested interests, such an involvement could prove crucial.

Under the steering committee, there would be an inter-agency working group and a secretariat. The working group would be responsible for overseeing the program. It would also review plans and activities to make sure they are consistent with the Legal Needs Assessment. And it would ensure that activities are being coordinated effectively, and that stakeholders and beneficiaries are being meaningfully involved. The secretariat would be in charge of carrying out the decisions and directions of the higher levels.

The political leadership, commitment and vision in the Legal Needs Assessment set the expectations high for future implementation. However, this will be needed as the reforms will fundamentally overhaul Vietnam's legal system and consequently affect the configuration of interest in state and society.

# 12. PUBLIC EXPENDITURE MANAGEMENT

Achieving a socially inclusive development will require sustained efforts to improve public expenditure management. The current management system of Vietnam has strengths as well as weaknesses. While the government has already made good progress in addressing the weaknesses, deeper reforms are needed. The government intends to conduct the process through its Public Financial Management Reform Initiative.

Integrating the planning of recurrent and capital expenditure within a medium-term expenditure framework focused on fiscal sustainability and pro-poor outcomes, and integrated with strategic performance management initiatives such as the CPRGS is one of the main priorities of the reform program. Other important priorities are clarifying the fiscal rules pertaining to sub-national administrations and spending units, and integrating and strengthening financial management information systems.

**Strengths and weaknesses**

Vietnam has earned a reputation for fiscal prudence, with relatively small budget deficits and low debt (both domestic and foreign). The existing Treasury system includes some effective mechanisms to prevent over-spending and misappropriation of resources.

Targeting of spending on public health and education, especially on education, has improved over time. Public social expenditures are now more equally distributed than household expenditures (World Bank, 2000b). The 1996 State Budget Law established clear and in many regards sound "rules of the game" for resource allocation and resource use.

Fiscal transparency has improved as well. Decision 182/2001/QD-TTg allowed for a more detailed publication of final accounts for 2000 and the budget plan for 2002. This decision also provided an enforcement mechanism to make communes post their budgets outside their offices.

Nonetheless, as a number of recent studies have shown, significant weaknesses remain (IMF-World Bank, 1999; World Bank, 2001; and Ministry of Finance, 2001;2002).

Fiscal sustainability is jeopardized by potential declines in oil-revenue, and a growing mismatch between increasing capital expenditure and declining non-wage recurrent expenditure. It is also at risk because of pressure for further civil service pay increases, and the uncertainties associated with extra-budgetary accounts, non-performing loans to state-owned enterprises and other contingent liabilities.

Processes for prioritizing expenditures remain ineffective. The absence of a credible multi-year fiscal framework means that expenditure planning is conducted without reference to medium-term resource constraints. Prioritization is carried out separately for capital spending (by the Ministry of Planning and Investment) and for recurrent spending (by the Ministry of Finance), with significant imbalances between the two. There is lack of clarity about the respective roles of sector ministries and provinces in prioritizing expenditures, with unrealistic centrally-specified norms laid down by sector ministries and then largely ignored by provinces.

Operational effectiveness is limited. Vietnam lacks even a basic mechanism for monitoring the actual outcomes of public spending and for feeding this information back into future resource allocation decisions. Weaknesses in transparency and accountability continue to exist, perpetuating corruption and waste.

Cutting across all these weaknesses are shortcomings in Vietnam's public financial management information systems (box 12.1).

**Box 12.1: Key shortcomings of financial management information**

- *The lack of a consolidated budget* makes it difficult to monitor total revenues and expenditures, as well as the true fiscal position. Extra-budgetary funds, on-lent official development assistance and much of commune-level spending are not consolidated into the budget.
- *The lack of common accounting standards* results in numbers which are inconsistent and hard to compare. At least three parallel standards exist within government: that of the "Treasury", that of the "State Budget Department", and those used by spending units.
- *The lack of integrated, electronic data recording and reporting* results in laborious manual consolidation and manipulation of data from multiple databases, and in financial reporting which is untimely and inaccurate. These deficiencies contribute to the poor flow of budgetary information between government ministries, provinces, donors and the public.

*Source*: World Bank staff

## Budget management

Building on the recommendations of recent studies, the government is developing reforms which have the potential, over time, to address many of these problems. In particular, a number of steps are being taken to strengthen budget management so as to promote prioritization and achieve poverty reduction and growth goals.

A fundamental step is integrating budget formulation. Much attention to date has focused on strengthening processes for the evaluation of public investment projects by the Ministry of Planning and Investment. The public investment program is often seen as the key mechanism through which the CPRGS will be implemented. And efforts to strengthen it are indeed a worthwhile interim solution. Socially inclusive development will require new investments and will have important implications for the allocation of capital expenditure. The government is increasingly aware, however, that Vietnam has to move beyond "dual budgeting" and recognize the importance of recurrent expenditure in development.

For the longer-term, moving beyond dual budgeting would involve integrating capital and recurrent expenditure budgeting within a single medium-term expenditure framework, with a single, forward-looking macroeconomic framework and a single, forward-looking set of development goals (box 12.2). A medium-term expenditure framework would help right the balance between capital and non-wage recurrent expenditure. It would bring fiscal constraints to investment planning, where they are currently almost entirely absent. It would bring policy analysis and development focus to a recurrent expenditure planning that is currently driven by norms rather than impact analysis.

More immediately achievable steps are also being considered. The government is piloting "bottom up" medium-term sector expenditure programs in a number of provinces and line ministries. The Ministry of Finance and the Ministry of Planning and Investment should also pilot a "top down" medium-term fiscal framework to include indicative totals for expenditure by province and sector.

The government should also develop the norms used to guide expenditures within sectors and to determine cash transfers to the provinces, with a view to making them at once more pro-poor at the aggregate level and less inflexible at the operational level (Ministry of Finance, 2000).

The introduction of the proposed amendments to the State Budget Law, which would make the Ministry of Finance the single agency in charge of preparing the overall budget, would be another step forward. The revised law would also require sector ministries and provinces to prepare annual and five-year expenditure plans, covering both recurrent and capital expenditure, and to submit these to the Ministry of Finance as an input to a future medium-term expenditure framework.

**Box 12.2: Objectives of a medium-term expenditure framework**

- Improving *macroeconomic policy* by developing a single, consistent and realistic resource framework.
- Improving the *allocation of resources* to strategic priorities between and within sectors by building budgets around a single, consistent and realistic set of policy objectives.
- Improving *coordination and balance* between capital and recurrent expenditures by integrating the planning for both of these within a single, forward-looking budgetary process.
- Increasing *commitment and predictability* both in policy and funding, so that ministries and provinces can plan ahead and programs can be sustained.

  Providing ministries and provinces with a *hard budget constraint* and *increased autonomy*, thereby generating incentives for efficient use of funds.

*Source*: World Bank staff.

The links between budgeting and performance management need to be strengthened as well. Increasing emphasis has been put on pro-poor policies, and on measuring the delivery of services and development outcomes. This is reflected in the sometimes quite specific performance indicators and targets established in the CPRGS. However, only towards the end of the CPRGS preparation process was attention given to methodologies for costing those targets (Lawson and Akroyd, 2002). This lag was almost certainly inevitable, given that this was the first exercise of its kind in Vietnam. Over time, however, methodologies for identifying and costing strategic goals need to be developed in a way which is fully-integrated with public expenditure management reforms.

For now, the Ministry of Finance and the Ministry of Planning and Investment could proceed gradually. At first, this is likely to be a question of "fitting" the existing goals together with existing expenditure programs within ministries and provinces. Subsequently, the challenge will be to forge processes which identify, cost and prioritize CPRGS goals in parallel with departmental and provincial expenditure programs, yet are simple enough to be made operational across the country.

**Devolving and delegating**

Further areas of public expenditure management reform involve clarifying the devolution of budgetary decision-making (within a hard budget constraint) to provinces, and clarifying the delegation of budgetary flexibility (again within a hard budget constraint) to spending units.

Over the years, the roles and functions of central and local governments in Vietnam have evolved to meet changing requirements. Expenditure decentralization, as measured by the share of local administrations in total expenditure, increased from 26 percent in 1992 to over 43 percent in 1998. Formally, provincial finance departments are still required to allocate their budgets in accordance with norms specified by the central line ministries. In practice, however, the budgets allocated to provinces have been insufficient to meet all of the obligations imposed on them by the center and provincial finance departments. Out of necessity, the provinces have had to use their discretion in allocating between sectors and spending units.

Amendments proposed to the State Budget Law will consolidate in writing the discretion that provinces already have. Recognizing this reality in the law would help clarify accountability and will form a basis from which to strengthen local transparency and accountability.

In parallel, the government is reviewing intergovernmental fiscal relations to see if new formulas for transfers to provinces can be devised which are more equitable. Currently, the logic on which norms are stipulated is questionable. For example, in the case of medical expenditures, population and the number of hospital beds form the basis for the allocative norms, whereas mechanisms transferring more resources to poorer provinces could be considered.

As increasing budgetary decision-making powers are devolved to provinces, similar power are increasingly delegated by the provinces themselves to the administrative and operational spending units that report to them. These units have often resorted to an adhoc array fees and contributions, in non-transparent and sometimes regressive ways (World Bank, 2000b).

The control regime that spending units had generally been obliged to follow involved very high levels of micro-management by the provincial finance department. Spending units had been required to agree their budgets with the finance department to sub-item detail and not been allowed to reallocate spending without formal approval.

However, recently promulgated decrees involve gradual delegation of budgetary flexibility within a fixed "block grant" to administrative spending units and service delivery units (Decision 192/2001/QS-TTg) and Decree 10/2002/NS-CP. There is new room to shift resources between recurrent budget lines and, crucially, to use savings derived from staffing reductions or reduced operational costs to finance salary supplements. This approach has been piloted over two years in selected spending units in Ho Chi Minh City, with positive results so far (box 12.3).

**Box 12.3: The "block grants" experiment in Ho Chi Minh City**

In 1999, the government authorized a pilot to introduce block grant budgeting in 10 selected administrative units (districts and departments) in Ho Chi Minh City. A recent evaluation concluded that the pilots had made significant progress against their stated objectives:

- Restructuring departments and streamlining administrative procedures. In most pilot agencies, restructuring and streamlining had already begun. The pilots gave a further boost to this, although scope for restructuring was limited by centrally prescribed functional obligations.
- Reducing administrative costs. Reported gross financial savings in the first year of the pilot ranged from 13 to 29 percent, based on administrative economies as well as staff reductions. Since savings were used for salary supplementation, as planned, net savings were zero.
- Reducing over-staffing. Most agencies reduced their staff by around 15 percent compared to their staff quota, and some made bigger cuts in staffing. Most staff were transferred rather than retired or retrenched.
- Raising incomes of employees by reapplying savings. Gross savings have been used to raise incomes, with 70 percent going to raise salaries, 20 percent going to a bonus fund and 10 percent to a staff welfare fund.
- Increasing levels of transparency. Various initiatives have been introduced to monitor service delivery standards and customer satisfaction. No evidence was found to suggest that service quality had declined in the pilot agencies.
- The government has plans to extend the pilots to 19 provinces and 164 spending units.

*Source:* Bartholomew and Lister (2002).

Nevertheless, two years is probably not enough to derive concrete conclusions regarding Vietnam's proposed new regime. Data is limited, and some of the savings achieved may reflect cost shifting and deferral of maintenance. Increased budgetary delegation, like devolution from the center to the provinces, will need to go hand in hand with increased transparency, accountability and oversight. As line-item controls are lifted, however, alternative checks and balances need to be put in place.

The bloc grants initiative should not be confused with the additional and separate proposal, also included in Decree 10/2002/NS-CP to give service delivery units more discretion over user fees. If this proposal is to be implemented, firm limits should be placed on the types and levels of charging that are acceptable. Well-designed user fees can contribute to economic efficiency. They can also contribute to poverty reduction if they reduce subsidies to the rich. Badly designed user fees, however, could aggravate inequalities across households and regions.

**Financial management information**

Reform of budget management in Vietnam has now reached the stage where further progress is jeopardized by inadequate financial management information systems. The mechanisms for information recording and reporting that do exist are fragmented, slow and unreliable. Strengthening and integrating financial management information systems are the critical next steps.

Poor financial management information distorts the perception of the true fiscal position, with potentially serious consequences for fiscal stability. It makes it impossible to assess how resources are being allocated in general, and to poverty alleviation in particular. And it also acts as an impediment to further devolution and delegation. Foreign donors who would like to give more by way of budget support and support for sector-wide adjustment programs, find this hard to justify in the absence of reliable information about planned and actual budget outlays.

An integral financial management information system is expected to replace the current myriad of recording and reporting mechanisms. But the new system will not be effective until the budget is consolidated, which requires a complete inventory of the various “off-budget accounts”. It would also be important that the financial management information system be compatible with international public sector accounting standards, and with IMF’s classification of financial statistics.

Strengthening public expenditure management has been the focus, to date, of Vietnam’s efforts to reform public financial management. However, expenditure is only one aspect of public finance. Over time, the government is committed to implementing reforms in four other areas: public debt management, management of fiscal risk from state-owned enterprises, revenue management; and state asset management. Reform in all these areas is to be taken forward as part of a Public Financial Management Reform Initiative, which is one pillar of the wider public administration reform program.

## 13. PUBLIC INVESTMENT

In Vietnam, the public investment program emerges as a compilation of national, regional, provincial and sectoral strategies and plans. Its preparation follows a complex process of consensus building designed to guide decision-making by all actors in the economy. The resulting document is a list of projects that may or may not be implemented over the plan period.

This process has several drawbacks. Priorities are not clearly set up. There is limited emphasis on economic efficiency in project appraisal, which allows investments in areas where the public sector has no particular advantage over the private sector. The poverty and equity implications of investment projects receive little consideration. Provinces are given a high degree of autonomy for investment approval, but this autonomy is not matched by clear requirements for accountability. The separation of the development of sectoral strategies from the resource allocation process makes it difficult to ensure priority programs are adequately funded. There is no effective linkage between capital and recurrent budgeting processes to ensure that recurrent spending needs of new and existing projects are adequately catered for. And there is no evaluation of the impact of investment projects.

Aware of the limitations of the public investment program, for the period 2001-2005 the government made considerable progress in terms of improving its project database. Public investment is now classified by region, source of funding, and sectors, allowing a better comparison between the actual investment program and the government’s priorities, as stated in the CPRGS. However, a live database of projects including an assessment of their economic rationale, and their priority in terms of their contribution to growth and poverty alleviation, still needs to be set up.

### The traditional approach

When Vietnam was a centrally planned economy, the role of the public investment program was to allocate new capital across all sectors. Thus, projects providing genuinely public goods, in areas such as infrastructure or public services, could be found side by side with projects aimed at commercially-oriented activities, such as manufacturing. Moreover, within those projects with no genuine public-good component, a bias existed in favor of capital-intensive activities, in which Vietnam is unlikely to have a comparative advantage.

A recent study assessed the impact of the public investment policies in the 1990s on growth and equity (Pham Thi Lan Huong, 2000). The assessment was conducted using a computable general equilibrium model of the Vietnamese economy, calibrated so as to simulate the public investment pattern observed between 1989 and 1996.

The study found that the economic and social rates of return to investment would have been much higher had the resources been invested in labor-intensive and export-oriented industries, rather than capital-intensive industries. Employment would have been higher as well. The same amount of investment would have allowed Vietnam to reach a significantly higher output level through making use of its comparative advantage in labor. Most importantly, the gap between the rich and the poor, and the rural-urban income gap, would have been narrower than was actually the case.

Despite the transition to a market economy, the public investment program for 2001-05 still supports public participation in commercially-oriented activities. All investments by large state-owned enterprises are included in the program. This would not be a concern if those enterprises operated in competitive markets and funded their investments out of their own resources. But this is not always so.

Projects are approved on a case-by-case basis, with the nature of the process depending on the size of the project and the source of financing. While a systematic assessment is not available, there are still cases of investments in capital-intensive industries, some of which are protected by trade barriers (Dapice, 2002).

The allocation of resources occurs in the context of annual plans. The Ministry of Planning and Investment, in consultation with the Ministry of Finance, matches the availability of resources with the demand, emanating from different levels of government. Resources are then allocated to sectors, provinces and enterprises. Historical allocations play an important role in this process. The size of the project matters as well, as it affects implementation requirements. The overall envelope for investment projects is influenced by official development assistance, and increasingly by the Development Assistance Fund that channels government credit (box 13.1).

**Box 13.1: The Development Assistance Fund**

The Development Assistance Fund was established in 2000. It is a quasi–independent entity in charge of providing subsidized government loans for medium to long-term investment. It also supplies post-investment interest rate support and investment credit guarantees. In 2002, it was assigned with the additional task of providing short-term export promotion credit. The Fund has branches in all 61 provinces. The central office is in charge of resource mobilization, project appraisal and credit approval, whereas the branch offices are responsible for loan disbursement and debt collection.

The Fund has a registered capital of 5 billion dong, provided by the government budget. Prior to 2002, resource mobilization was specified in an annual decision of the Prime Minister. The major sources of funding were the Social Insurance Fund, the Sinking Fund, the Vietnam Postal Service Savings Company, the government budget, loan repayments and official development assistance. The Prime Minister's decision specified the broad allocation of credit across windows, as well as the broad allocation across sectors. Since 2002, the Fund has to mobilize its own resources. It can still tap the same sources as before, but in negotiated terms, not as the result of a mandate. Because of the higher lending targets set for the Fund, it has increasingly relied on the issuance of investment bonds.

In principle, both private and state-owned enterprises are eligible to access the resources of the Fund, based on a range of commercial and policy criteria. These criteria include investing in difficult areas, in preferential sectors of activity, and in projects related to health, education, culture and sport. Projects funded through official development assistance are eligible as well. Lending from the Fund can be used to set up new enterprises or to expand existing ones.

About one third of total lending from the Fund goes to central ministries and General Corporations. Overdue debt accounted for 3 percent of total outstanding loans as the end of 2000. Credit from the Fund expanded by 40 percent in 2001, and by an additional 51 percent in 2002.

| | 2000 | 2001 | 2002e |
|---|---|---|---|
| *Year-End Outstanding Credit, (in billion Dong)* | *28.3* | *39.7* | *60.3* |
| Financed by domestic resources | 9.2 | 15.5 | 26.8 |
| Financed by official development assistance on-lending resources | 19.1 | 24.3 | 33.6 |
| As a share of Total Credit to Economy from Banking System, in percent | 18.0 | 22.0 | 27.0 |
| *Annual Loan Disbursement (in billion Dong)* | *13.9* | *14.0* | *23.6* |
| Financed by Domestic resources | 4.6 | 7.9 | 13.3 |
| Financed by official development assistance on-lending resources | 9.1 | 6.1 | 10.3 |
| As a share of GDP, in percent | 2.9 | 2.9 | 4.3 |

*Source*: World Bank staff based on data from Ministry of Finance.

### Investment and outcomes

If development goals like those specified in the CPRGS are to be achieved, it will be important that investments and recurrent expenditure at the national and provincial levels are aligned to the desired outcomes.

The public investment program for 2001-2005 made substantial progress in terms of grouping investment projects by sector, such as health, education or infrastructure, would already represent an important improvement. One of the main weaknesses of the public investment program is its disconnect from the management of current public expenditures. A classification of this sort is a first step towards establishing a link with the recurrent expenditures needed subsequently, for operation and maintenance. A sectoral classification of investment projects would also provide a simple, albeit rudimentary measure of the contribution of the program to development goals like those specified in the CPRGS. The experience of China and India indicates that public investment projects can have a dramatically different impact on poverty alleviation, depending on the sectors they are directed to (box 13.2).

**Box 13.2: Sector of investment and poverty in China and India.**

Two recent studies assessed the poverty impact of seven kinds of rural investments in China and India, ranging from irrigation to education to electricity. The assessments took into account the effects on agricultural production, rural non-farm wages, rural non-farm employment, and relative prices.

Results show that the biggest payoffs for reducing rural poverty came from investments in agricultural research and development, education and rural infrastructure. These investments also contributed most to increasing agricultural output.

| CHINA | Number of people lifted out of poverty per 10,000 yuan (1997 prices) | INDIA | Number of people lifted out of poverty per Rs 1 million (1993 prices) |
|---|---|---|---|
| Education | 9 | Roads | 124 |
| Agricultural research and development | 7 | Agricultural research and development | 85 |
| Roads | 3 | Education | 41 |
| Electricity | 2 | Rural development | 26 |
| Telephone | 2 | Soil and water conservation | 23 |
| Irrigation | 1 | Health | 18 |
| Poverty loans | 1 | Irrigation | 10 |

In both China and India, agricultural research brought substantial indirect gains through greater agricultural yields, which generated higher incomes for farmers, led to declines in food prices for consumers, and improved wages in non-farm activities. Education helped develop the skills of rural residents, enabling them to earn higher wages in non-farm employment and to adopt new farm and non-farm production methods and technologies. Roads helped farmers transport their goods to markets, gave them better access to higher-wage employment opportunities in the rural non-farm sector, and increased consumer's access to food markets.

The studies found that investment in poverty alleviation schemes, irrigation and health programs, while important to improve the lives of the poor, were not the best routes for achieving poverty and food security goals in the long run.

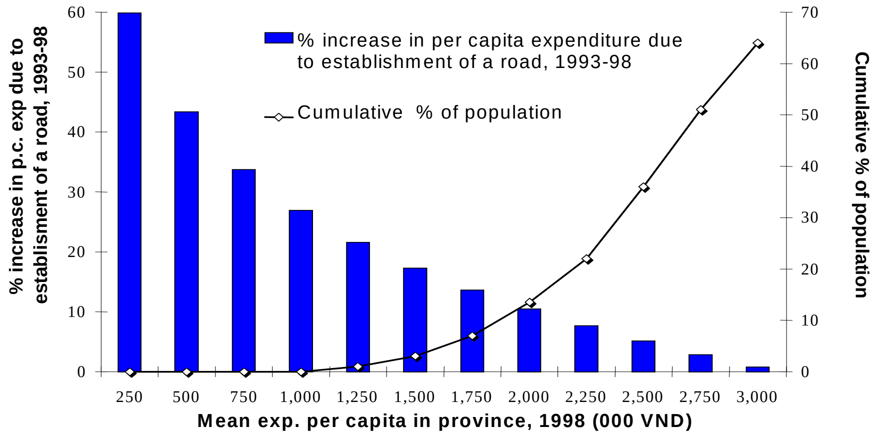
*Sources*: Fan et al (2000 and 2002).

## The impact on poverty

To what extent has Vietnam's decline in poverty been due to public investment and what kinds of investments have been most effective in this respect? A clear answer to this question could help Vietnamese policymakers to invest limited resources in ways that most benefit the poor. Research similar to that available for China and India has not been conducted in Vietnam. An assessment of the contribution of big infrastructure projects on poverty is not available either However, there is analytical work on rural roads (World Bank, 2001).

The poverty alleviation impact appears to be high. Between 1993 and 1998, rural roads raised household expenditure per capita by 30 percent (Deolalikar, 2001). As a result, they increased the probability of escaping poverty by 68 percent. Rural roads also increased school enrolment, especially at the secondary school level, as well as the use of government hospitals and inter-communal clinics. These positive effects were most pronounced among the poorest provinces (figure 13.1).

**Figure 13.1 Estimated impact of roads on living standards, 1993-98**




*Source:* Deolalikar (2001).

Poverty alleviation impacts can be assessed even before an investment project is undertaken even if only in an approximate manner. Recently, a method was proposed to prioritize rural road projects by identifying rural areas that score high on three key criteria: poverty, inaccessibility and economic potential. The implementation of this method could be done in three stages (Van de Walle, 2002). The first one involves the selection of criteria that must be taken into account in estimating expected efficiency benefits and social gains. In the second stage, all provinces produce proposals for their investment spending on roads, each proposal quantifying the benefits on the basis of the key criteria and on the basis of community consultations. Then, in the third stage, at the central level, the proposals are ranked according to the ratio between their (social) benefits and their cost, and money is allocated to provinces according to this ranking.

### A better approach

The current disconnect between public expenditures and public investment is a source of inefficiencies. The single most important reform that Vietnam could take in this area is to move beyond "dual budgeting". Taking into account the links between investment and recurrent expenditures would avoid waste and duplication. It would also be key to align the overall allocation of public resources to development goals, such as those identified by the CPRGS.

Regardless of the speed at which the unification of these two public expenditure mechanisms takes place, other measures are warranted to strengthen the public investment program. The first one is the introduction of an information system. This should be done as part of the governments' new Integrated Financial Management Information System. Steps in the direction of classifying projects by their source of funding, sector and region have already been undertaken for the 2001-05 public investment program. They should now be continued in the direction of producing a live database, allowing a systematic analysis of the program and its matching with recurrent expenditures.

A more fundamental measure would be the systematic appraisal of investment projects. A simple approach would involve asking a few key questions about each project (Devarajan et al., 1997; Suthiwart-Narueput, 1998). The first question concerns the counterfactual: what would happen in the absence of the project? In commercially-oriented activities, the answer is probably that the private sector would invest more. Displacing private investment is not a desirable outcome. For a public investment project to be justified, there has to be a market imperfection, such that in the absence of government intervention a good or service would be under-supplied. Most investment projects involving the creation of new state-owned enterprises would probably fail to pass this first question.

A second key question concerns the most appropriate mechanism for government intervention when markets are imperfect, or under-developed. Service delivery by the public sector is one alternative, but it is by no means the only one. Subsidies to or regulation of the private sector could be more effective in some circumstances. For instance, creating a new state-owned enterprise in a remote or mountainous area could be one way of spurring development and generating employment. But reducing the cost for private firms to settle in the area, through explicit subsidies or better infrastructure, could be a better alternative. Projects involving public sector delivery should not be retained for the public investment program when more effective way's to address the market imperfection exist.

Third, the impact of the project on output and poverty alleviation should be considered. Computing the internal rate of return is a standard method to assess the contribution of a project to aggregate output. But in a country with important market distortions, like Vietnam, this method could be misleading. For instance, it could suggest that investing in an activity operating under trade barriers is efficient, while in the absence of protection it would not be. It is therefore important to compute indicators such as the rate of return at border prices, and not at domestic prices. Other adjustments to rates of return must be considered as well. For instance, the consequences of traffic accidents, in terms of injuries and lives lost, should be factored in when estimating the returns to road construction projects. As for the social sectors, where rates of return are not easily applicable, indicators involving the relevant development targets should be considered. In the case of Vietnam, those targets are currently identified in the CPRGS.

As regards poverty, two projects making the same contribution to aggregate output could be viewed differently depending on who its direct and indirect beneficiaries are. Other things equal, a project benefiting the poor should score higher than one benefiting the rich. Methods like the one discussed for rural roads could be used to achieve this prioritization.

Applying systematic appraisal rules, either along the lines just described or based on any other reasonable criteria, to all type "A" (large scale) investment projects, across all government agencies and provincial governments, would lead to a more sensible public investment program. Instead of a compilation of regional and sectoral strategies and plans, it would be possible for the Ministry of Planning and Investment to compare and prioritize projects across regions and sectors.

Finally, the monitoring of the public investment program could also be improved. There is no system in place to report, on a regular and continuing basis, progress in implementation. Financial implementation should be monitored by the Treasury as part of the New Integrated Financial Management Information System, leaving the Ministry of Planning and Investment free to focus on monitoring physical implementation and on conducting impact evaluation.

## 14. PUBLIC ADMINISTRATION REFORM

Each country's path to good governance is different, depending upon culture, geography, political and administrative traditions, economic conditions, and many other factors. In the end, however, good governance is characterized by transparency, accountability, predictability and participation (Asian Development Bank, 1998 and 1999).

The public administration system of Vietnam, which is based on the traditional model, still suffers from many weaknesses. Inefficient and ineffective institutional set-ups, laws, rules, and regulations do not adequately support, and in many cases hinder the socio-economic development initiatives of the country. Organizational systems and structures are generally outdated, highly bureaucratic, and opaque. The civil service is characterized by cumbersome, ineffective, and inefficient management and administrative systems, structures, and modalities, leading to corruption. And the public finance system is ill-equipped to meet the complex fiscal and financial challenges of a fast-growing economy integrating into the global market.

Public administration reform is one of the key components of CPRGS. It has the potential to improve service delivery to people, including the poor. By enhancing overall efficiency and reducing transaction costs it may also contribute to a more favorable investment climate.

**A vision**

The government and the Party have given strong signals in recent years to reform the public administration system. The Public Administration Reform Master Program, approved in September 2001, envisages the reform of the entire public administration system by 2010. The agenda for reform and renovation is far-reaching and bold in vision (Asian Development Bank, 2002a). It includes replacing cumbersome administrative procedures with more simplified and transparent ones; reducing red tape and corruption; streamlining and better defining the mandates and functions of institutions; reforming provincial and other sub-national administrations and redefining their relations with the center; rationalizing the organizational structure of ministries; raising the quality of public officials; undertaking salary reform for public employees; reforming public financial management; and modernizing the public administration system through computerization and e-government initiatives.

While there is no quick fix for a public administration system, two years after its announcement the public administration reform agenda has not advanced as much as it should have. The key reasons seem to be related to the sensitive nature of the reform process, unavoidable legislative changes, and limited technical and financial resources.

Accomplishments so far include the approval of the reform program by the Prime Minister, the preparation of draft action programs, the review of functions and effectiveness of reform management and implementation mechanisms, the submission of the Legal Needs Assessment report, improvements in public service delivery through pilot schemes, decentralization through block grants in public expenditure management, a resolution on downsizing, and the setting up of a steering committee on salary reform. In 2002, the decision was made to borrow from the Asian Development Bank for the implementation of the public administration reform program, which shows the government’s strong commitment in this area. These are all encouraging actions, but the reform path is still long.

**Personnel issues**

The vision set by the reform program requires a civil service that is much more focused on achieving results, and is therefore concerned with its responsiveness and accountability, with improving performance and with serving businesses and people more effectively. For this to be achieved, the civil service has still to overcome many deficiencies in terms of professional capacity, administrative skills, and morality.

The contingent of public officials has many strengths, and an increasing share holds professional qualifications and degrees. But many public officials are even unaware of the professional knowledge and skills that will be needed in the new management environment. There is also a lack of effective human resource management policies. Training management needs to be renovated including through improvement of the training content and delivery system. A range of improvements in training and re-training are required as well.

Downsizing and salary reform are the other two personnel components of the reform program. The initial target was to reduce staff numbers by 15 percent. But the downsizing component is moving slowly, and has only affected about 3 percent of civil servants so far. To some extent, slow progress in this area should not be seen as a problem. Rather the opposite. Any program to reduce (or expand) the number of civil servants should be based on a comprehensive review of functions, roles and work processes across the administration (Rama, 1999). In the absence of such review, there is a risk of reducing personnel who are not redundant. A review of this sort is unlikely to result in a uniform level of over-staffing across all units. And such a review has not been completed yet.

Progress has been even slower regarding salary reform. One relevant concern in this respect is the huge volume of resources that could be needed to increase salaries across the board. In this respect, the government of Vietnam should be very cautious in choosing the right approach when trying to align civil service salaries with the market (box 14.1).

**Box 14.1: Are civil servants underpaid?**

How to align civil service salaries with the market? A commonly-used approach focuses on the salaries for private sector jobs whose description is similar to that of public sector jobs. But this method may produce biased results in developing countries, where "comparable" jobs are mainly or exclusively found in formal sector enterprises. Jobs of this sort might be the relevant alternative for civil servants at the professional and managerial levels. However, tracer studies of separated public sector workers suggest that the relevant alternative for the rank-and-file is self-employment, or casual work in informal activities.

Another approach compares the earnings of civil servants to those of similar workers in the private sector, regardless of whether they are employed in the formal or the informal sector of the economy. Similarity can be assessed in terms of individual characteristics such as educational attainment, work experience, gender and area of residence. If properly implemented, this approach amounts to estimating the earnings a civil servant would have if he or she were to move out of the public sector.

An assessment of pay in Vietnamese state-owned enterprises was undertaken using the two approaches. Samples of salaries in comparable jobs in the formal private sector suggested that public sector workers were underpaid by 50 percent or more. But earning estimates for similar workers, based on data from the 1998 Vietnam Living Standards Survey revealed that on average they were overpaid by 20 to 30 percent. Taking benefits such as old-age pension and health insurance coverage into account over-payment is probably larger. The relevant alternative for many public sector workers is in the informal sector, where benefits like those offered by the public sector are not available. The exact figures might have changed since 1998. But the discrepancy between the two approaches probably remains valid.

It does not follow that all public sector workers were overpaid as of 1998. The approach based on an earnings comparison reveals a high degree of heterogeneity across public sector workers, with under-payment being more common among the qualified, and over-payment more common among the least qualified. Given this heterogeneity, an initiative to increase public sector pay across evenly for all employees would fail to align pay with the market.

*Source*: Bales and Rama (2002).

### Information technology

Equally important are the measures and actions to review and streamline work procedures and processes. These measures and actions are necessary to ensure that the application of computers and related peripherals brings about more focused and effective results in terms of organizational and personnel performance. From this perspective, a landmark policy decision was the approval, in September 2001, of Prime Minister's Decision 112/2001 on state administrative management computerization. However, several important obstacles remain.

In the area of computerization, e-business and e-government, the key obstacles are related to the lack of cyber laws, including legislation on privacy, digital signature, certification, and authentication. An appropriate legal framework to permit effective development of e-government and public service delivery systems, and to protect the interest of both service providers and end users, is missing as well. The lack of adequate international standards of professionalism in information technology management, including strategic planning, system support, operation and maintenance, is another important problem area. Properly trained human resources for information technology management are still in short supply.

The government information network, CPNET, is still at an initial phase of development; it has not yet been able to resolve the crucial issue of integrating all ministries, agencies and local governments' networks. Lack of integration hinders the data interchange processes between government agencies. Expensive and less efficient telecommunication systems have adversely affected the growth of information technology applications in Vietnam, especially e-businesses.

On the whole the administrative modernization program will require a considerable technical and financial resources to accomplish its objective. It will also require that government agencies shift away from a culture of not sharing information.

### Service delivery

One of the strategic objectives of the public administration reform program is to improve the delivery of administrative services at the provincial, municipal and commune level. In recent years, significant improvements in administrative service delivery have been accomplished. Under the common heading of "One Door" or "One-Stop Shop", administrative services in several provinces, cities and rural districts have improved significantly in terms of accessibility, transparency, effectiveness and efficiency.

The One-Stop Shop approach aims to improve administrative service delivery. It involves a single entry point through which requests for different services of customers are received, processed (further routed to follow the appropriate administrative procedures within the professional bureaus or departments concerned) and returned to the customer.

One-stop shops represent one of the most visible achievements of public administration reform at the local level. Although different in scope and outreach, all one-stop shops serve a geographical administrative area, and tend to operate at the district level. The population covered varies between 100,000 and 300,000 persons per shop.

One-stop shops face operational problems too. The most frequently reported concern staffing, lack of training, and lack of cooperation from higher level of administrative services to delegate or give away their authority. In many cases their scope of operation is limited to citizen's advice, certification of war invalids and martyrs, notarization, and land registration (box 14.2). Moreover, one-stop shops may apply to only one step in an overall procedure that needs to be dramatically streamlined.

| **Box 14. 2: The One-Stop Shop (OSS) at a glance** | |
|---|---|
| *Strengths*<br>• OSS well established within municipal organization through sufficient commitment and support from people's committees;<br>• Service delivery has indeed improved significantly, particularly to the poor people living in mountainous communes;<br>• Clear comprehension of OSS concept and model by all stakeholders as well as citizens;<br>• OSS widely communicated among citizens through leaflets and information boards in the OSS;<br>• Wide range of services (social affairs, business licenses, notary, Land Administration, Citizens' complaint and denunciation handling) offered in one office; this induces efficiency gains;<br>• Staff of OSS is seconded, which safeguards proper co-ordination between OSS and Professional Bureau's;<br>• Good facilities | *Opportunities*<br>• The success of the OSS among customers and citizens induces further administrative reform;<br>• Organization of OSS in second phase could have positive influence on staff responsibility to job and its profession;<br>• In future, according to decentralization of Nho Quan, the head of the OSS could have more power and authorities (in business registration, transfer of land use right, notaries for certain papers and documents...);<br>• In the second phase of the organization, all staff members of the OSS will be work full time and under direct authority of the office of the people's committee, that will increase a sense of belonging and responsibility of OSS staff. |
| *Weaknesses*<br>• Some co-ordination problems between OSS service delivery (file reception and return, customer relations) and the actual processing of requests (determined by regulations and procedures);<br>• OSS staff has a dual position: OSS services counter and within the Professional Bureau's; this prohibits a sense of belonging among OSS staff to the OSS works;<br>• OSS staff not able to cover or assist their colleagues' work (in other service area) in case of absence or when one staff member is very busy;<br>• Unclear revenue and costs structure of the OSS;<br>• OSS located at the side of the municipal building; relatively difficult to find; not so high profile. | *Threats*<br>• Salaries of civil servants at the local level are too low;<br>• The staff members do not have any position in careers systems in the OSS office (as the district organization only allow to have 10 professional bureaus);<br>• Financial situation completely unclear due to lack of regulations, both at the national as well as on the provincial level. |

*Source:* Asian Development Bank staff.

### Local governance

Decentralization, one of the outstanding features of *doi moi*, could help improve governance, provided that it is carefully designed and implemented. However, decentralization also has important drawbacks. It is not a panacea and there are several requirements to turn the positive prospects into reality. The risk of local governance failure becomes high in the absence of balanced understanding of rights and duties. Care should therefore be taken not to avoid situations where a local elite may monopolize the benefits of decentralized governance at the cost of the majority.

The comparison between decentralization in Russia and China is interesting in this respect. It can be argued that in China local governments actively contributed to economic growth, whereas in Russia they more often stood in its way. One explanation of this difference lies in the degree of political centralization present in China, but not in Russia. In China, the central government has been in a strong position to reward or punish local administrations, reducing the risk of capture by local interest groups and the scope for competition for rents and bribes by local officials. In Russia, by contrast, the central government has been neither strong enough to impose its views, nor strong enough to set clear rules about the sharing of the proceeds from economic growth (Blanchard and Shleifer, 2001). This comparison suggests that decentralization of expenditure management can play a central role in development, provided that local governments are confronted with appropriate incentives from the center.

Decentralization is one of the biggest challenges in implementing the CPRGS. With a population of 78 million people, Vietnam has a three-tiered structure of local governance. In addition to the national level government, it has local governments for 61 provinces (tier 1), 598 districts (tier 2) and 10,500 communes and wards (tier 3). These various levels of local governments have a high degree of autonomy and authority in decision-making, but little accountability. One of the biggest challenges in implementing the CRPSG will be how to translate national goals into local actions in such a decentralized environment (box 14.3).

One interesting initiative is Decree 93/CP, which gave a special status to Ho Chi Minh City, including extensive management autonomy in the fields of socio-economic planning, land administration, infrastructure development, and civil service management. The new Land Law, and the process of issuing rural and urban land-use right certificates, will also move a whole set of new responsibilities to the district level. The block-grant system, where public sector agencies are provided a lump sum to cover salary and administrative expenditures, provides more independence to choose the right mix of inputs to provide better service delivery.

**Box 14.3: Decentralization and the CPRGS**

The CPRGS contains a number of goals set at a national level, for instance regarding improvements in health and education outcomes. Relieving the financial burden of basic social services on the poor is a key step towards attaining those goals. But this will primarily need to be tackled at local levels rather than by the central government. While the Ministries of Education and Health are in charge of setting priorities and goals for the country, they do not have control, or even adequate information, on the way provinces allocate their expenditures. For education, about 75 percent of total spending is at local levels (primary education is managed by districts and communes, while secondary education is managed at the provincial level) and for health, about 66 percent of total spending is at local levels. Even the amount that is allocated from the center to the provinces is provided in a very flexible way, so that local authorities have a considerable discretion on its allocation. Local authorities also have discretion on how much funding they raise locally, and from what sources, and how they allocate this funding.

The Grassroots Democracy Decree is potentially a powerful tool for improving local governance in such a decentralized setting and also in aligning national goals and targets with the priorities of people, especially of poor people. It seeks to improve transparency, participation and accountability at local levels and to improve the two-way flow of information between the government and the citizens of Vietnam. Participatory poverty assessments highlighted the people's demand for information on the nature and timing of public policies and programs that affect their lives, and their willingness to influence some of those policies and programs.

The Grassroots Democracy Decree was introduced as a pilot in May 1998, but it is time that it was scaled up and implemented nationally. Combined with other governance reforms, especially in the areas of public administration reform and public financial management reform, that would provide the right system of incentives for local authorities. The Grassroots Democracy Decree has the potential for better aligning the voices of the poor through a bottom up process with the national priorities articulated in the CPRGS.

*Source*: World Bank staff based on World Bank (1999).

## Grassroots democracy

To minimize the risk of local governance failure, empowerment, transparency and accountability are important. Civil society organizations can mobilize citizens and make their voices heard in decision-making. Mechanisms like the Grassroots Democracy Decree, and the envisaged steps to increase the jurisdiction of the administrative court system, could serve as safeguards in Vietnam's process of decentralization.

The Grassroots Democracy Decree defines a ground-breaking framework for consultation, participation, and transparency on a wide range of issues concerning people's lives at the commune level. It outlines detailed responsibilities of commune authorities and the modalities for consultation and participation of the population in implementing commune-level projects, including water and sanitation and other small-scale infrastructure. Success in implementing the Grassroots Democracy Decree has been modest, however (box 14.4).

**Box 14.4 Problems in implementing grassroots democracy**

Province and district levels have not delegated management responsibility to the commune level. Planning is still undertaken in a top-down manner, leaving the commune with only limited influence on policies. The reluctance from the higher administrative levels is often termed in the guise of limited capacity at the commune level. However, in most cases ingrained attitudes to poor have impeded a full-fledged implementation.

Civil servants at the provincial level have not been trained in changing the "top-down" mindset. Civil servants at the commune level have received little practical guidance on how to implement the decree. They also have limited incentives to do so.

According to the decree, and to Decision 13/2002/QD-BTC of the Ministry of Finance, on disclosure of state accounts, commune authorities are required to publish an easily understandable depiction of the budget for each fiscal year. However, the communes are only being audited on a random basis, approximately every third year. And there are no career rewards for the authorities if they publish the budget or undertake participatory planning in line with the decree.

Also, according to the Decision, the People's Councils at the commune level are instrumental for effective implementation. However, those councils have a rather ceremonial nature. The upcoming amendment of the Law on the Organization of People's Councils and Committees will be a pertinent opportunity to revisit their roles and functions.

*Source:* Asian Development Bank staff.

## Accounting, auditing and procurement

Ensuring financial transparency and accountability is an important dimension of good governance. A recent diagnostic study of accounting and auditing practices in Vietnam highlights several problems with the current system. International accounting and auditing standards are yet to be introduced. There is also a need for more qualified accountants. The profession itself, and the Vietnam Accounting association, should be strengthened. And there is excessive interference and government control in accounting and financial reporting matters (Narayan, 2000; Fritzen 2001; Sau & Thong, 2001; Vietnam Radio, 5 March 2002).

As for procurement, the legal framework is sound, but shortcomings have been rooted in institutional and human resource capacity deficiencies. The introduction in 1996 of a procurement system with some competitive elements might have already led to significant savings. According to government estimates, in 1999 those savings reached 14 percent of the pre-bid estimates. However, even larger savings could be made and corruption curbed if further reforms were undertaken (box 14.5).

A comprehensive review of the oversight function should be undertaken, to streamline the roles and responsibilities of various agencies involved in audit and inspection. Ensuring that the State Audit of Vietnam has a formal and direct reporting relationship to the National Assembly, and makes audit reports publicly available, are important steps towards effective accounts oversight.

**Box 14.5 : Further procurement reform**

Measures to make procurement more efficient and transparent should include the following:

- Promulgate the proposed procurement ordinance to: ensure competitive bidding as the main method for procurement; introduce mandatory publication of procurement announcements in a national Procurement Bulleting, and mandatory use of standard bidding documents, standard bid evaluation and standard contracts; and to define types of violations of rules and corresponding corrective measures.
- Reduce monetary thresholds for automatic use without a justification for direct purchase of goods, appointment of contractors and selection of consultants without competition down to the values normally used in other countries.
- Establish an autonomous Public Procurement Office reporting directly to the top political level, and a clear and credible system of complaints, sanctions and appeals mechanism for procurement.
- Build a cadre of procurement professionals through training, link training and merit system to the public administration reform process and establish a procurement career path.
- Separate state-owned enterprises and institutes from direct management of ministries as part of the overall administrative reform. Make state-owned enterprises and institutes fully independent by separating the state management function and ownership management function. Accelerate the divestiture of state-owned enterprises to facilitate their participation in the open market in a fair and equitable manner with all others.

*Source*: World Bank (forthcoming b).

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# STATISTICAL APPENDIX

(see attached excel file)