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Structural Reform for Growth, Equity, and National Sovereignty

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Foreword

This paper has been prepared for the third annual Vietnam Executive Leadership Program (VELP), to be held at the Harvard Kennedy School from February 12 to 17, 2012. The goal of this paper is to provide participants in the VELP forum, including Vietnamese government officials, international scholars, and corporate executives, with an assessment of some of the key public policy challenges confronting Vietnam today. This paper is by no means comprehensive; by necessity, it has not been possible to undertake an exhaustive study of every policy area. In selecting which issues to address, the authors have been guided by the priorities of the Vietnamese government as they have been articulated in policy statements promulgated over the past year. In an effort to ensure the paper's relevance to the Vietnamese policy community, earlier drafts of this paper were shared with current and former policymakers and policy analysts inside and outside of government. It is hoped that this paper will serve as a catalyst for informed discussion and debate both among VELP participants and among the larger policy community in Vietnam.

Part I. **Introduction**

A. The new consensus

There now exists a broad consensus regarding the structural roots of Vietnam's macroeconomic instability and an understanding that fundamental, structural reforms are needed to enable the country to achieve high rates of economic growth with low inflation and a stable currency. This consensus is expressed in recent policy statements from the Politburo (02-KL/TW), the Central Committee (3rd Plenum of the 11th Central Committee), the National Assembly (Resolution 59/2011/QH12) and the government (October 20 report to National Assembly). These statements recognize that Vietnam's exceptionally high investment rates have not delivered rapid economic growth, world-class infrastructure, productivity growth, a skilled labor force or technologically advanced state owned enterprises. Quite to the contrary, high rates of investment have generated price inflation, a weakening currency, large trade deficits, dependence on foreign savings and dwindling foreign exchange reserves. The heart of the problem is the inefficiency of investment, which in turn is a product of poor selection of projects, cost overruns and delays in implementation, weak management of public sector firms and lack of transparency in public finances.

There has been less discussion of the effects of the present growth model on the distribution of income, but it is apparent that inefficient investment has made Vietnam a more economically unequal country. The craze for luxury sports cars, beach-front villas, and foreign shopping sprees is just the most visible manifestation of an increasingly polarized society. At the other end of the spectrum, the working poor struggle to survive on a minimum wage that only covers 65 percent of basic needs, and carry the heaviest burden in terms of out of pocket costs for health care in Asia.[1] Insufficient consideration—at least in the public realm—has also been given to the implications of economic inefficiency and stagnation for Vietnam's international profile and foreign relations. Vietnam has earned a reputation as a responsible, respected member of the international community, capable of charting an independent foreign policy and dealing from a position of strength with the world's great powers. However, continued economic instability will eventually undermine Vietnam's international standing, as a weakened currency, rising debt levels and trade deficits erode the country's economic and hence political autonomy. Both of these emerging challenges—rising inequality and the geopolitical consequences of economic instability—arise as a direct result of the inefficiency of the current growth model.

While a consensus has formed around the need for economic reform, there is less agreement on the precise form that reform should take. The policy documents cited correctly identify the banking system, state-owned enterprises and public investment as primary candidates for restructuring. However, the ultimate aims of restructuring, and the appropriate policies to achieve these aims, are still open to debate. Policy makers too often confuse the *means* and *ends* of restructuring. Reducing the number of state-owned enterprises (SOEs), the number of banks

[1] "Lương tối thiểu vẫn chưa đủ đáp ứng mức sống" (2011) *Tuổi Trẻ*, October 26, http://tuoitre.vn/Chinh-tri-Xa-hoi/462183/Luong-toi-thieu-van-chua-du-dap-ung-muc-song.html. On out of pocket health care spending, see Van Doorslaer, et al. (2006) "Effects for Payments for Health Care on Poverty Estimates in 11 Countries in Asia," *The Lancet*, 368:1357-1364.

or the investment to GDP ratio are not in themselves desirable goals: they are only instruments to achieve the real aims of restructuring, namely productivity growth, international competitiveness, job creation, and higher living standards for all Vietnamese people.

One of the main points of this paper is that in themselves, these instruments are not sufficient to achieve the deeper objectives of restructuring. Reducing the number of SOEs will not promote productivity growth and job creation if equitized firms are given unfair advantages in domestic markets, and if the remaining large SOEs still enjoy monopoly power and are not forced to conduct their business in a transparent and accountable manner. Reducing the number of joint stock banks will not improve financial intermediation if the behavior of remaining banks is distorted by connected ownership and connected lending. Reducing the rate of public investment will not put in place the essential infrastructure that Vietnam needs if local authorities still have an incentive to select the wrong projects, inflate costs and resist regional and national coordination.

Real restructuring requires more than just reaching numerical targets for the number of state firms and joint stock banks or trillions of dong invested in public sector projects. It will mean, first and foremost, imposing discipline on both public and private sector entities through greater transparency and accountability. Vietnam must move towards international standards of economic governance, including a clear separation between regulators and market participants, an unswerving commitment to a judicial system that is independent of politics, and public finance and fiscal policy reforms based on clearly enunciated rules and complete transparency.

B. Structure of this discussion paper

This policy discussion paper presents an analysis of the existing situation and proposes seven policies to translate calls for structural reform into concrete actions. The paper begins with a brief discussion of the global context. The main message of this section is that the recovery from the global economic crisis of 2009 has stalled, and that the risks of another major global downturn have risen substantially in recent months. Vietnam can expect fierce competition for export markets and inward investment for the foreseeable future. However, unlike 2008, this is not the time for a government-led stimulus, since inflation is already high, the fiscal deficit is large, Vietnamese firms are already deeply in debt and the banking system is weak. The following section presents a critique of the existing growth model, and shows why Vietnam has been unable to increase productivity and international competitiveness and create enough good jobs for its growing population. The essential problem is poor economic governance: existing institutions create incentives for public and private firms to direct their energies towards speculation and rent seeking rather than the development of technical and managerial capabilities. This generates large profits for some but at the price of declining international competitiveness and macroeconomic instability.

These problems will not be solved overnight. It takes time to develop sound institutions of economic governance. However, there are things that the government can do in the short period to launch a meaningful process of economic restructuring. The following section of the paper highlights seven policy recommendations designed to change the incentives facing public and private firms and government agencies. These recommendations are:

- Force commercial banks to divest cross-shareholdings and impose strict rules on bank lending to connected firms;
- Withdraw subsidies from state owned enterprises, dismantle all state monopolies and require them to operate transparently;
- Create independent regulating agencies that are not connected to ministries and other state organizations that control market participants;
- Adopt a simple fiscal rule, for example requiring the government to balance its budget over the business cycle (allowing for deficits in bad years and surpluses in good years);
- Restructure the public finance system to reduce the dependence of local authorities on central government transfers, and increase their reliance on locally generated revenues;
- Create regional bodies to coordinate public investment, independent oversight agencies to review public investment project implementation and greater use of international competitive bidding in public sector projects;
- Rotate provincial leaders regularly and institute a ban on top provincial leaders serving in their province of origin.

Restructuring is not limited to these policies, and numerous opportunities exist at the sectoral level to increase competition, accountability and transparency through other means. However, we believe that these policies are achievable and would have an immediate and positive impact on the efficiency of investment and macroeconomic stability. Indeed, we do not believe it will be possible for the government to realize its stated goals if it does not take these steps, which are the minimum required to recast incentive structures towards productivity growth and away from speculation and rent-seeking.

The final section of the paper situates policy reform in a geopolitical context, arguing that economic restructuring is necessary if Vietnam is to avoid becoming the subordinate partner in asymmetrical, dependent economic relationships with other countries. More than at any time in world history, a dynamic, innovative economy is a critical guarantor of national sovereignty and international credibility.

Part II. **The International Context and Domestic Implications**

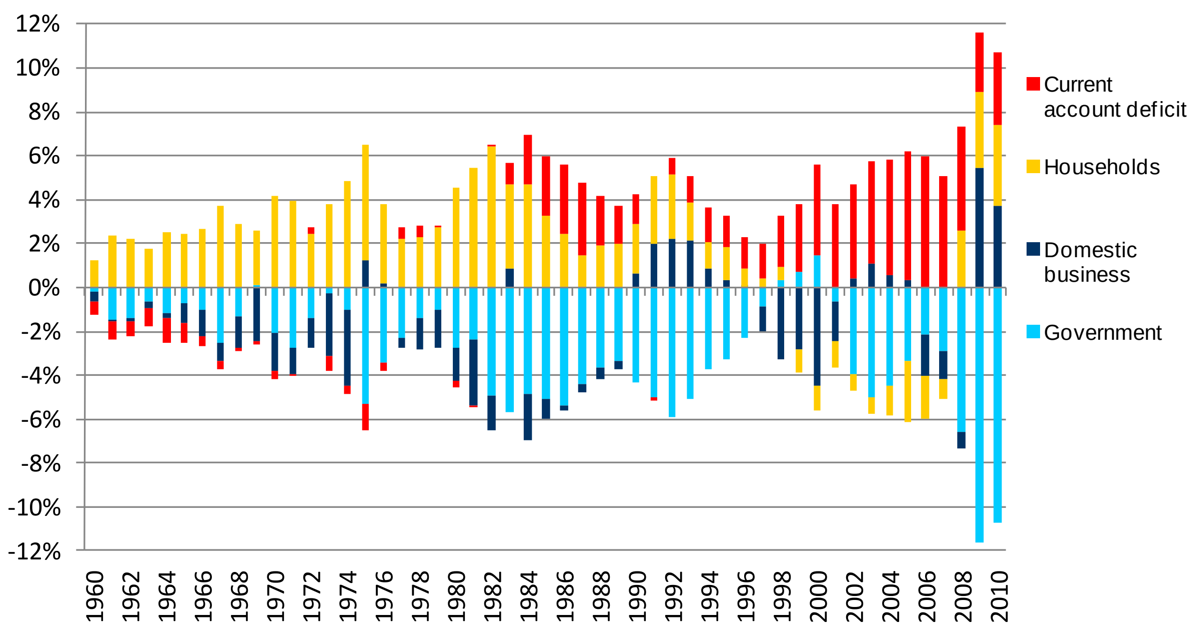
The global economy is now entering a phase that the *Financial Times* columnist Martin Wolf calls "The Great Contraction."[2] The US, EU and Japanese economies are extremely fragile. The corporate and household sectors are deleveraging (paying down debt) at historically high rates, trying to repair balance sheets that expanded too quickly during the long credit binge of the 2000s and the subsequent collapse in 2008. Global debt increased from $84 trillion in 2002 to $195 trillion in 2011. Returning to a more normal situation of global leverage will take time, and it will slow down global growth for years to come. The experience of Japan since the 1990s shows that repairing corporate and household balance sheets can take many years. As governments around the world ran large deficits to prevent the onset of depression, the private sector debt crisis has been transformed into a public sector crisis. Rising interest rates on

[2] Martin Wolf (2011) "Struggling with a Great Contraction," *The Financial Times*, August 30, http://www.ft.com/intl/cms/s/0/079ff1c6-d2f0-11e0-9aae-00144feab49a.html#axzz1cWFrd6b0.

sovereign debt combined with slow rates of economic growth have driven several European countries to the brink of insolvency, with serious implications for growth in the eurozone and the stability of the European banking system.

OECD countries outside the eurozone face less immediate threats but also have limited policy options. The United States has the great advantage that the US dollar is the world's reserve currency, and hence the US government borrows its own currency and does not need to worry about generating enough foreign exchange to service its debts. Moreover, with the euro under threat and China running massive trade surpluses, there are no ready alternatives to the dollar. Therefore, the US can continue to run deficits and print money. This has the advantage of preventing the dollar from rising relative to other currencies (the dollar tends to rise as a safe haven currency when financial markets are in trouble), and may even achieve some depreciation of the dollar relative to the Japanese yen, the euro and the Chinese RMB. A cheaper currency would increase exports, providing some additional demand for the American economy.

Figure 1. US Current account, deficit, net lending and fiscal balance



Source: US Bureau of Economic Analysis (www.bea.gov).

But the additional stimulus from export growth, even if it were to materialize, will not be sufficient to replace the effective demand that is leaking from the system as households and corporations pay down debt. This is apparent from Figure 1, which shows net lending (borrowing) by the corporate sector and the household sector, the current account deficit and the government's fiscal balance. According to the rules of national accounting, these four resource flows must sum to zero. The figure shows that households have traditionally been net savers, money that is typically recycled through the banking system to lend to business. But in the late 1990s, households became net borrowers for the first time. This was the main effect of the house price bubble and the excessive borrowing that fueled it. With the onset of the 2008 crisis, both households and corporations have sought to pay down debt to repair their balance sheets. Both are large net savers, leaving the government to pick up the slack.

The process of deleveraging has only just begun. Unemployment is nearly nine percent of the labor force, which means that households do not have sufficient income to pay down their debt or support domestic demand. Household liabilities as a percent of GDP are still at historically high levels. It is little wonder that the Economist magazine recently claimed that we are "Six Years Into a Lost Decade."[3] The question of whether the industrialized countries are in a "double dip" recession misses the point. As the figures in Table 1 show, growth slowed sharply in 2011 and the situation will continue to deteriorate in the first half of 2012. The recovery that began in 2010 has stalled, and even if the world avoids another financial crisis—this time centered on the euro—it is unlikely that the developed countries will return to pre-2008 growth rates until after 2015.

Table 1. Economic growth in the OECD countries

	2010	2011	2012 forecast			
			Q1	Q2	Q3	Q4
OECD total	3.1	1.9	1.2	1.7	2.2	2.1
Euro area	1.8	1.6	-0.4	0.5	1.1	1.3
Germany	3.6	3.0	-0.6	-0.3	0.8	1.6
Japan	4.1	-0.3	1.5	1.8	1.8	1.6
USA	3.0	1.7	2.5	1.7	1.9	2.2
UK	1.8	0.9	-0.1	-0.6	0.5	1.2

Source: OECD.

Japan faces a unique set of problems that are a legacy of the 1990s meltdown. Japan's sovereign debt is now 200 percent of GDP. Fortunately for Japan, nearly all of this borrowing is in the domestic currency because of exceptionally high domestic savings rates. But as the population ages, savings rates will inevitably decline, and Japan will eventually face a day of reckoning. Moreover, sovereign debt is now so large that even a small increase in interest rates would drive the fiscal deficit to unprecedented levels. If this happens, the government will need to force the economy into a deep recession, or print money. Either way, the Japanese economy faces some difficult years ahead.

The implications for Vietnam of slow growth in the OECD countries are profound. First, demand for exports from the industrialized countries will not grow much as these economies deleverage. Countries all over the world will allow their currencies to depreciate in an effort to try replace domestic with foreign demand. Competition for foreign markets is intense and will become even more so if the global slowdown persists for more than one or two years. Foreign corporations are responding to slow demand growth by paying down debt rather than investing in new projects. They are accumulating cash, which they are using to buy up other companies. In other words, they are increasing sales by cannibalizing each other rather than relying on economic growth. Vietnam will have to compete more aggressively for inward investment and may see demand for labor export (and hence foreign remittances) drop off.

[3] "Six Years Into a Lost Decade," (2011) *The Economist*, August 6, http://www.economist.com/node/21525440.

Unlike 2008, this is not the right time for fiscal or monetary stimulus. Price inflation in Vietnam is much more rapid than in neighboring countries, largely because of the delay in withdrawing the monetary stimulus in 2010. Vietnam's fiscal deficit is already large and financing it is becoming more expensive. Official public debt is now nearly sixty percent of GDP, but the actual figure is probably closer to 75 percent if we include the government's contingent liabilities, for example local government debt, SOE debt and undercapitalization of state owned commercial banks. The government's deteriorating debt position is reflected in the price of credit default swaps on Vietnam's sovereign bonds (Figure 2).[4] Vietnam's credit default swaps rose by one-third after Vinashin defaulted on a $600 million syndicated loan. Prices settled down by mid-2011, but established a new high in October.

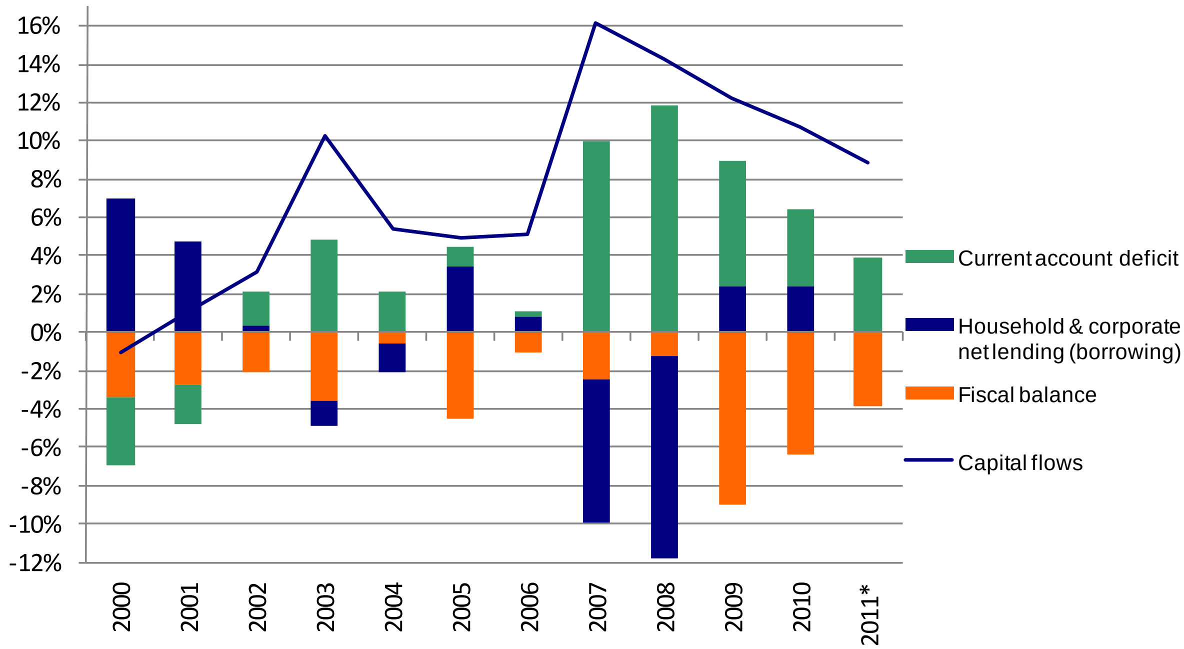
Figure 2. Vietnam 5 year bond credit default swap, basis points

Source: Reuters.

Most importantly, Vietnam's businesses are already highly leveraged. During the boom years of 2007 and 2008, corporations and households in Vietnam borrowed a huge amount of money. This was largely driven by capital inflows, which forced up domestic asset prices and fueled credit expansion (SBV failed to sterilize a sufficient portion of these inflows). Although the Vietnamese data do not allow us to separate households from corporations, it appears the households began to deleverage during the global crisis, saving in gold and foreign currency. Corporations, however, took advantage of subsidized lending rates to increase their leverage even further in 2009 and 2010 (Figure 3).

Figure 3. Current account, deficit, net lending and fiscal balance, Vietnam

[4] Investors purchase credit default swaps to hedge against the risk of default on debt that they hold. As the perceived risk of default grows, the cost of default swaps increases; they are therefore regarded as a reliable indicator of investor sentiment.



Source: Authors' estimate based on IMF's International Financial Statistics.

Vietnamese corporations are now attempting to repair their over-extended balance sheets. They need to pay down debt because interest rates are high and revenues are either growing slowly or falling. Most banks are not in a position to lend more because they are undercapitalized relative to the size of their loan portfolios and because of the need to write off non-performing loans.

Rather than stimulate the economy, the government needs to prepare the country to endure a period of slow growth in the world economy. It can do this best by redirecting resources away from wasteful activities and towards investments that increase productive capacity and consumption by middle income households and the poor. In short, the government does not have the resources to engage in a fiscal and monetary stimulus, and even if it did the corporate sector is not in a position to respond. This is an opportune time to strengthen the financial system, reduce waste and inefficiency and to introduce more competition into the domestic economy.

Part III. **The Need for a New Growth Model**

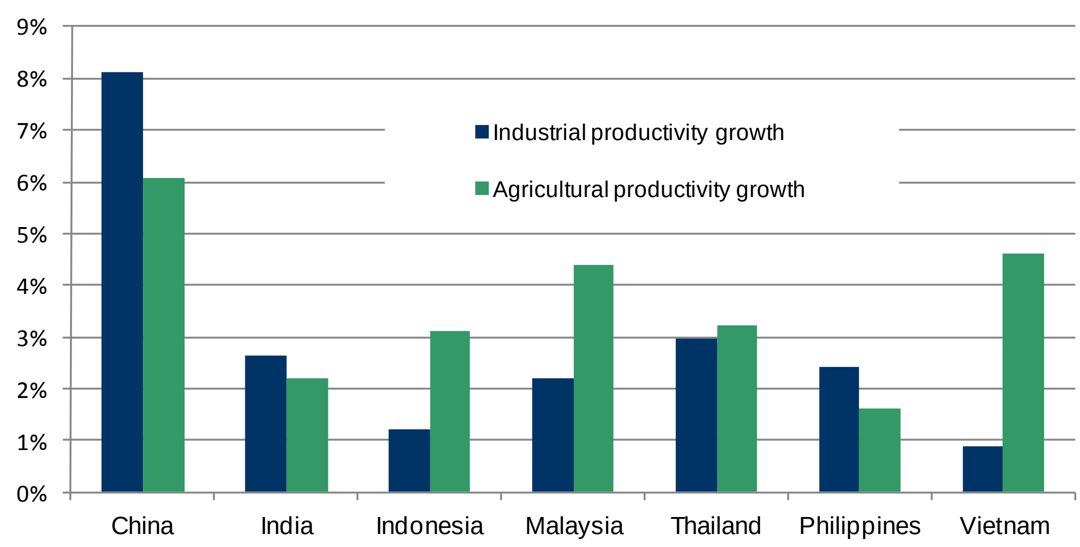
Economic development is the process of shifting factors of production from low to higher productivity activities. Higher productivity—meaning value added per person per labor-day—is ultimately the source of income growth, poverty reduction and economic competitiveness. If the economy is not becoming more productive, it cannot grow, and the average standard of living cannot rise.

Shifts in land, labor and capital from low to higher productivity activities can take place within sectors or between sectors. An example of within-sector productivity growth is the transition from labor intensive handicrafts to capital intensive factory production in the industrial sector. Between-sector productivity growth occurs when labor moves from agriculture to industry, for example when agricultural wage laborers migrate to the city to work in small workshops or large factories.

The imperative of shifting from low to higher productivity activities does not imply that government policy should aim to redeploy capital and labor from agriculture to the industrial or service sector. The market is much better at making these kinds of decisions than planners. If the market functions reasonably well, capital will flow to where profits are largest, and profits are a better guide to productivity growth than government's plans. Similarly, labor will flow to where wages are highest, and wages are a good guide to the level of labor productivity. However, if the market does not function well, capital will be deployed in activities in which labor productivity is not rising, and labor will be drawn into low productivity sectors. The result will be slow productivity growth in all sectors. Again, slow productivity growth means that incomes cannot grow and the economy will lose competitiveness over time.

Vietnam's current growth model consists of a highly competitive, export-oriented agricultural sector, an export-oriented labor-intensive sector dominated by foreign firms, and an inward-oriented capital-intensive sector dominated by state owned enterprises and other enterprises with close relationships with the government. The agricultural and labor-intensive manufacturing sectors account for most of Vietnam's exports. In 2011, for example, two-thirds of exports are produced by a combination of FDI firms and six agricultural commodities (rice, coffee, fish and shellfish, rubber, pepper and cassava).

Figure 4. Average labor productivity growth, 2001-2009



Source: Authors' estimate based on World Bank's World Development Indicators.

What are the sources of productivity growth in the current model? The answer is given in Figure 4, which presents labor productivity growth in industry and agriculture for Vietnam and other countries in the region. It is immediately apparent from the graph that Vietnam's farmers have achieved competitiveness on the basis of rapid productivity growth. Agricultural productivity growth in Vietnam is the fastest in the region outside of China. By way of contrast, Vietnam's industrial productivity growth is the slowest in the region, less on than one percent per annum over the past decade. Industrial productivity growth is slow for two reasons: i) labor productivity growth is slow in labor intensive export industries like garments and shoes because sewing shirts and shoes is difficult to mechanize; ii) state-dominated, inward-oriented industries are highly protected and inefficient.

Other countries in the region also have recorded rapid productivity growth in agriculture over the past decade. This in part reflects high commodity prices during this period, which has the effect of raising labor productivity measure (as in this case) in domestic currency adjusted for inflation. However, every country in the region has enjoyed more rapid growth in industrial labor productivity than Vietnam. The simple fact is that Vietnam will not be able to achieve rapid and sustainable income growth unless productivity grows more rapidly in the industrial sector.

The existing model has failed to deliver rapid productivity growth in the modern sector. A new growth model is needed that will force Vietnam's industrial firms to compete on world markets, just like Vietnamese farmers (and foreign invested garment firms) have been doing for two decades. Vietnam's industries must learn to compete and to rely less on government protection and artificially cheap land and capital. In setting out his three top priorities for the 2011-2015 term, the Prime Minister forcefully asserted the government's commitment to promoting a competitive business environment. At present, however, many important sectors of the economy are characterized by the absence of genuine competition.

A core problem facing Vietnamese industry is that non-state actors cannot achieve economies of scale. Non-state enterprises face higher costs and find it more difficult than state firms to access land, credit and markets. This is particularly true in relation to access to land and capital. Researchers have calculated that processing times for land use right certificates are *two hundred times greater* for private firms than for SOEs.[5] As a result, many private firms have to lease land unofficially from SOEs at inflated prices. Studies have found that access to credit is closely associated with connections to the party, government or state-owned enterprises.[6] Market access is also easier for state-connected firms. Government agencies and state-owned enterprises prefer to do business with SOEs, which forces private firms to sub-contract to SOEs rather than sell directly.[7] Public sector bidding is skewed by eligibility requirements, and private firms cannot afford kickbacks on the scale of their public sector competitors.[8] Private firms lack confidence in the courts, with the result that SOEs are more likely to seek legal redress since they can mobilize informal networks to ensure favorable decisions. Even if an objective verdict could be obtained from the courts, enforcement is the responsibility of the local authorities. This leaves outsiders at

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[5] Tenev, Stoyan, Amanda Carlier, Omar Chaudry, and Quynh Trang Nguyen. 2003. *Informality and the Playing Field in Vietnam's Business Sector*. Washington D.C.: International Finance Corporation, p. 67.
[6] Malesky, E. J., and M. Taussig. 2008. "Where Is Credit Due? Legal Institutions, Connections, and the Efficiency of Bank Lending in Vietnam." *Journal of Law, Economics, and Organization* 25 (June 20), p. 574.
[7] Van Thang, Nguyen, and Nick J. Freeman. 2009. "State-owned enterprises in Vietnam: are they 'crowding out' the private sector?" *Post-Communist Economies* 21 (June), p. 240.
[8] Hakkala, Katariina Nilsson, and Ari Kokko. 2007. The State and the Private Sector in Vietnam. EIJS Working Paper Series, June 1, 16.

a distinct disadvantage, as the local government may decide simply not to implement a court decision that goes against SOEs with strong local ties.[9]

Because of these forms of discrimination, private firms choose to remain small and informal rather than investing to achieve scale economies. This has a dampening effect on productivity growth, since small firms cannot invest in advanced technologies or achieve scale economies through more efficient organization and management.

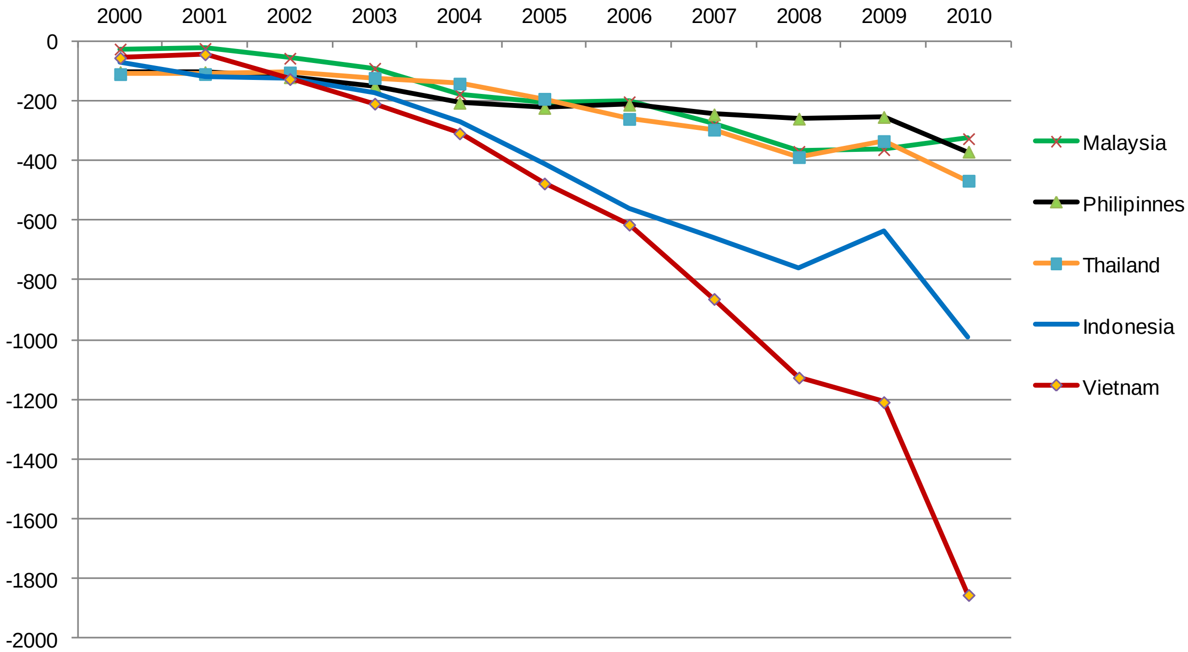
Vietnam's large domestic firms are in the state sector. But in fact the so-called state conglomerates (general corporations and economic groups) behave more like collections of many small firms rather than centrally managed large companies. Before its restructuring in 2010, Vinashin, the state-owned shipbuilder, controlled 445 subsidiaries in addition to twenty joint-venture companies. Why would a company with favored access to land and credit create so many small companies rather than centralize production to upgrade technological capabilities and reap scale economies? Vinashin's managers understood the incentive structure under which SOEs operate in Vietnam. They maximized their individual incomes by doing hundreds or even thousands of small deals. The fact that these small deals did not help the company operate more efficiently or compete better on international markets was not their concern, since the system did not discipline poor performance. Vinashin did not have to answer to an independent board of directors, it did not have to publish detailed balance sheets or cash flow and profit and loss statements.

The absence of professionally managed, large-scale firms in the public and private sector has restricted Vietnam to the production of labor intensive, low value added products. Vietnam is proud of its export performance. Exports have increased five-fold in value since 2000, and manufactured good now account for sixty percent of merchandise exports, up from 43 percent ten years ago.[10] These remarkable statistics demonstrate the tremendous capacity of Vietnamese workers and managers to compete on global markets. The problem is that small, labor-intensive and largely foreign-owned firms continue to dominate manufacturing for export. It is extremely difficult to increase efficiency and value added in these companies, since they rely heavily on imported inputs from China. Figure 5 shows the rapid growth of Vietnamese net fabric imports from China. From nearly balanced trade in 2000, Vietnam now records net imports of nearly two billion dollars worth of cotton and synthetic fabric from China. The growth of net fabric imports from China to Vietnam was much faster than in other countries in the region. Only Indonesia comes close to Vietnam's heavy reliance on cloth imports from China.

With such a strong domestic garment industry, why doesn't Vietnam develop domestic textile firms? The state-owned conglomerate Vinatex is unable to compete with Chinese imports, and has instead focused on ancillary activities like garment production, industrial estates, vocational schools, fashion magazines and trade. The group has failed to take advantage of the large domestic market for export-quality fabric to achieve economies of scale in production.

Figure 5. Net imports of cloth from China, USD millions

[9] Tenev et al., op cit., p. 57.
[10] Data are taken from the World Bank's World Development Indicators.



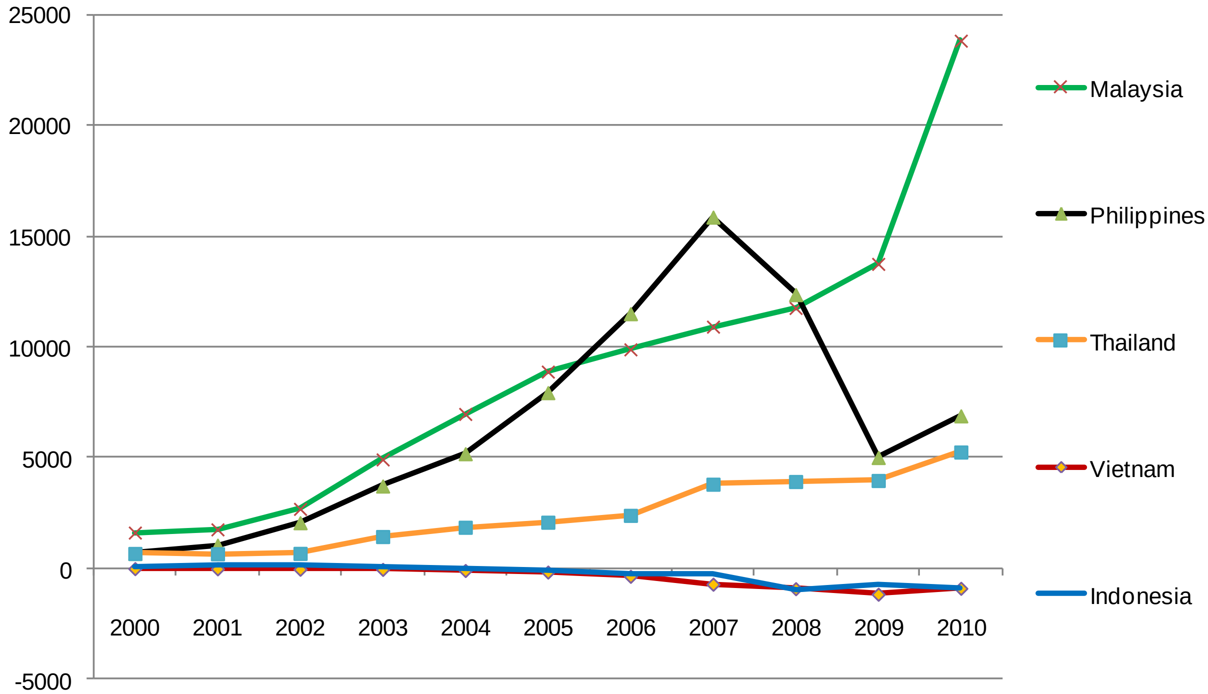
Source: Authors' calculations using data from UN Comtrade.

We find an analogous situation in examining the role of foreign direct investment (FDI) in Vietnamese industry. According to the Ministry of Planning and Investment, manufacturing accounted for about half of newly registered FDI projects by value in 2011. However, most of these investments are either directed towards the domestic market or consist of assembly operations that rely heavily on imported inputs. Domestic value added in these operations is limited.

Vietnam has not yet managed to use FDI to gain a foothold in global supply chains. A good example of this problem is the electronic components industry. In Southeast Asia, Malaysia, Thailand and the Philippines, foreign companies produce billions of dollars worth of electronic components for export to Chinese assemblers, most of which are also subsidiaries of or contract manufacturers for large multinational companies. Net exports of components generate large trade surpluses for these economies. Malaysia has done exceptionally well in this regard, recording net exports of components of nearly USD 25 billion in 2010. Both Thailand and the Philippines achieved net component exports in excess of USD 5 billion in the same year.

The two countries in the region that run narrow trade deficits in electronic components are Indonesia and Vietnam. The reasons for the failure of Indonesia and Vietnam to attract multinational component manufacturers are not the same in the two countries. Indonesia suffers from a chronically overvalued exchange rate and security issues. Vietnam has yet to overcome a shortage of skilled and educated workers: postsecondary school enrolments are the lowest in the region, and the quality of the universities is subpar. Both countries struggle with fragmented, decentralized political institutions that complicate and slow down foreign investment projects. Investors require numerous approvals at multiple levels within the system, and there is insufficient coordination between the various layers of government. Foreign investors also stress that Decree 46/2011/ND-CP, which regulates the recruitment and retention of foreign employees, has substantially raised the costs of doing business in Vietnam.[11] In both Indonesia and Vietnam, fragmentation and lack of transparency create opportunities for corruption and block efforts to streamline the approvals process.

Figure 6. Net exports of electronic components to China, USD millions

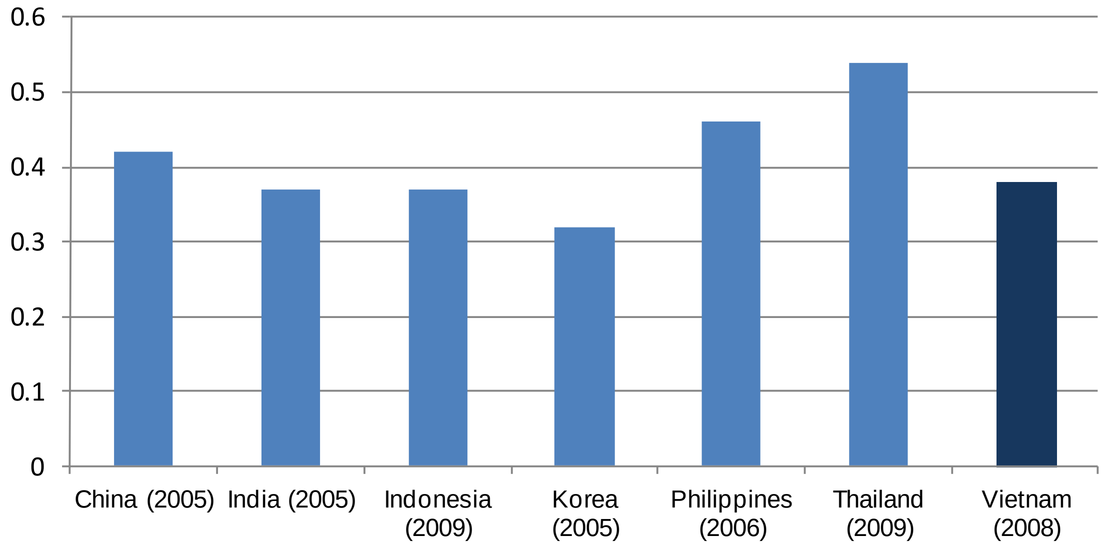


Source: Authors' calculations using data from UN Comtrade.

One of the consequences of slow productivity growth and the absence of large, competitive firms is rising economic inequality. Vietnam is not creating enough new jobs in the modern sector to employ its young population, forcing millions of job seekers into unstable, low wage jobs in the informal sector. According to the government's Vietnam Household Living Standards Survey (VHLSS), the gini coefficient—a simple measure of inter-household inequality—was 0.38 in 2008 (a gini coefficient of zero is perfect equality and unity is perfect inequality). As shown in Figure 7, income is distributed more equally in Vietnam than in China, the Philippines and Thailand, and a bit less equally than in Indonesia, India and South Korea.

Figure 7. Gini coefficients in selected Asian countries

[11] Decree 46 requires companies to hire Vietnamese personnel unless management can demonstrate that a person with the required skills cannot be identified in Vietnam. Companies claim that regulators do not have sufficient expertise to evaluate the relative knowledge and skill levels of specialized workers, and that the decree gives bureaucrats too much scope to interfere with internal operational decisions. In addition, the decree requires companies to pair foreign managers with domestic "apprentices" who can eventually replace them. In many cases this provision is regarded as unrealistic, and based on a poor understanding of the kinds of capabilities required in modern corporations. In fact, the higher cost of foreign workers compared with local hires already gives multinational firms a strong incentive to hire and promote Vietnamese workers.



Source: World Bank, World Development Indicators.

However, these data are cause for concern for two reasons. First, income inequality in Vietnam is underestimated since VHLSS excludes the richest and poorest households from the distribution. Rich households do not enter the survey (a problem that is common to these kinds of surveys), and many of the poor drop out because the survey explicitly excludes migrants.[12] Thus, the actual level of inequality is probably somewhat greater than the official statistics suggest. Second, Vietnam is already more unequal than countries in the region that are richer in terms of per capita income. As countries tend to become more unequal as incomes rise, Vietnam is likely to record levels of inequality similar to those in the Philippines or even Thailand.

Vietnam's international aid donors often brush aside concerns about rising inequality, pointing to the country's excellent track record in poverty reduction. But this misses the point. Thailand, which is now one of the most unequal countries in Asia, also records very low rates of absolute poverty.[13] This is made possible in part by an extremely low national poverty line, which has the effect of classifying all but the completely destitute as non-poor. Rapid poverty reduction—especially with an unambitious poverty line—is entirely consistent with rising inequality if all incomes are rising but the incomes of the rich are rising faster.

Economists are beginning to pay more attention to the social costs of rising inequality in developing countries. A recent OECD report, entitled *Social Cohesion in a Shifting World*, finds that rising inequality is a major cause of social discontent even in fast growing developing countries.[14] Globalization has created economic opportunities for many developing countries, particularly in Asia. But the benefits of globalization have not been distributed equally within these countries. Some people and regions have experienced sharply rising living standards, while

[1212] See Jonathan Pincus and John Sender (2008) "Quantifying Poverty in Vietnam: Who Counts?" *Journal of Vietnamese Studies*, 3:1.
[13] According to UNDP, less than one percent of the Thai population lives on less than $1.25 per day (in purchasing power parity terms), as compared to 13 percent in Vietnam.
[14] OECD (2011) *Perspectives on Global Development 2012: Social Cohesion in a Shifting World*, Paris.

others have seen little or no meaningful improvements. Globalization has favored people with capital, educational qualifications and other marketable skills, but has not reached millions of workers stuck in informal sector jobs, in low productivity agricultural production or completely out of work. The growing gap between the rich and poor breeds discontent, social conflict and alienation.

Political conflict in Thailand is directly related to the asymmetrical impact of globalization on the Thai economy, which is manifest in the country's exceptionally high rates of income inequality.[15] Although Thailand has invested heavily in education in recent years, the legacy of underperformance has left millions of Thai workers without the qualifications and skills they need to get stable employment. Thai farmers struggle to earn profits in competitive world commodity markets, but have not benefited from government policies which have favored the urban middle classes, many of whom work in the public sector or in state-linked firms.

Vietnam's current growth model bears striking similarities to the Thai experience. Vietnam's export success has been driven by competitive farmers earning small margins in global commodity markets. Meanwhile, state-owned and state-related firms in the industrial sector have received favored treatment and have been sheltered from global competition. While Vietnam has widened access to primary education at lower income levels than Thailand, school fees are a major burden on the poor and prevent many children from completing primary school and progressing to secondary school. According to the government, household spending on education now represents six percent of household income and has increased 28 percent in real terms from 2004 to 2008.[16] These young people, lacking qualifications and skills demanded in the labor market, find themselves trapped in unstable, low wage jobs in the informal sector, often moving from place to place in search of work. According to the government's 2009 Urban Poverty Survey, 29 percent of Ho Chi Minh City residents 18 to 36 years of age had no more than a primary school education, a number that rises to 33 percent among unregistered migrants in the city. The primary school completion rate in the Mekong Delta is just 82 percent.

Recent research conducted by the Fulbright School has shown that migrants in casual labor markets face a difficult dilemma. Because of the household registration system and high school fees in the city, migrants must choose between educating their children or living with them. Since there is very little work available in rural areas, remaining in the countryside is not a viable option. The result is that hundreds of thousands—perhaps millions—of families are split up by government policies that limit migrants' access to basic services. Many of these children are being raised in the countryside by elderly relatives who are not capable of looking after them. The study also corroborated research by national research institutes that shows that targeted anti-poverty programs are not reaching the poor, and are often directed to the non-poor.[17]

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[15] Pasuk Phongpaichit and Chris Baker (2008) "Thailand: Fighting Over Democracy," *Economic and Political Weekly*, December 13.
[16] Jonathan London (2011) "Education, Health and Institutional Responsibilities in Vietnam's Welfare Regime," http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1934531.
[17] Dinh Vu Trang Ngan, Jonathan Pincus and John Sender (2011) "Migration, Employment and Child Welfare in Ho Chi Minh City and Surrounding Provinces," November.

A new growth model is needed that will achieve rapid productivity growth in the modern sector, create millions of stable, well-paying jobs, and generate the resources needed to provide universal access to health care and education. The new model will use competition as a guide to the allocation of resources rather than politics; it will remove obstacles to the creation of large-scale private sector firms and encourage multinational corporations to relocate to Vietnam to produce higher value added products. It would restore discipline to the public finances to ensure efficient allocation of public investment, including investment by SOEs. Land, labor and capital must be allowed to flow to where returns are highest, thus stimulating productivity and export growth. In order to achieve this new model, the market must function well. Obstacles to market allocation must be removed. State-owned and state-connected firms can no longer be given privileged access to credit and land. Monopolies must be properly regulated and firms must be forced to compete on price and quality. The government must ensure that all children have access to free primary and secondary education, and that universities and vocational schools deliver a high quality education that generates the knowledge and skills required by competitive companies in industry, agriculture and services.

Part IV. **Seven Policies to Improve Economic Governance**

Previous sections have argued that real economic restructuring requires improvements to economic governance. Incentive structures that at present favor speculation and rent-seeking must be replaced with new institutions and rules that promote competition, transparency and accountability.

Institutional reform takes time. No one imagines that Vietnam can move overnight from a system based on the political allocation of land and capital to one based on modern economic governance. In this section we propose seven concrete policies to enable Vietnam to take its first important steps towards a new growth model. To keep the discussion brief, we will not present a detailed rationale for these proposals.[18]

1. Restructure banks through better governance, and eliminate firm-bank cross-shareholding and connected lending

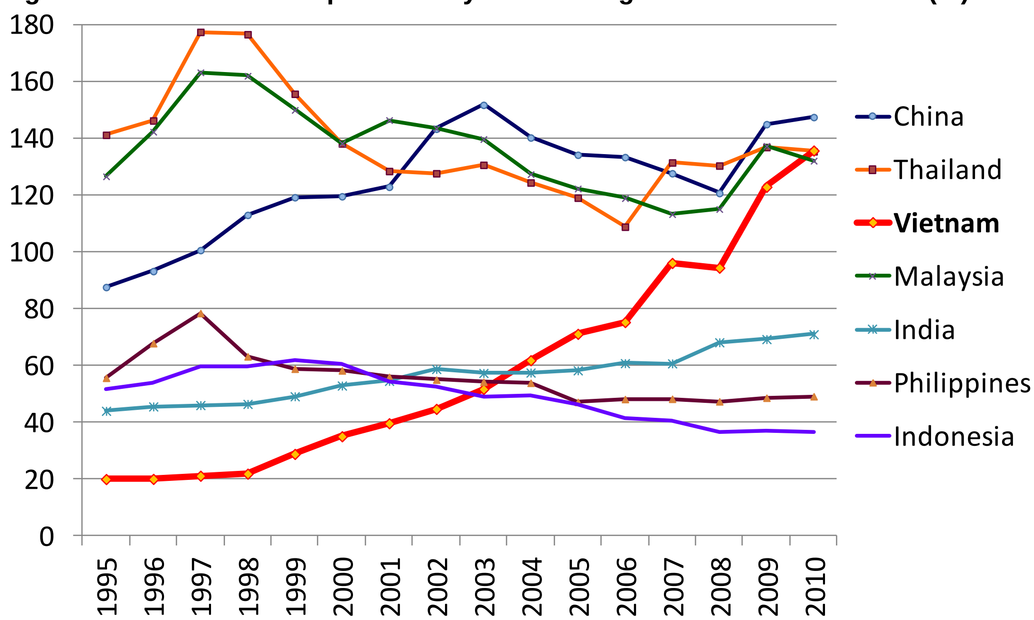
Banks are the heart of the economy. They recirculate capital from savers to investors and ensure that credit is available to facilitate domestic and international trade. One of the important functions that banks provide—when they work well—is to impose discipline on investors and traders. They limit the amount that investors can borrow to a fraction of the value of the investor’s assets. They do not lend money for extremely risky ventures. They protect their depositors’ money by restricting lending to a reasonable multiple of the bank’s capital, and by not lending too much to any one borrower.

The past 10 years have seen an extremely rapid expansion of the banking sector in Vietnam. As shown in Figure 8, bank credit relative to GDP increased from 20 percent in the late 1990s to

[18] More details will be provided in subsequent policy memos.

136 percent at the end of 2010, approaching the level in China and Thailand. While the credit expansion the early 2000s was associated with real financial deepening, in recent years it was the result of loose monetary policy. Even after a "mini break" in 2008 to fight inflation, credit exploded again in 2009 and 2010. International experience has shown over and over again that easy money coupled with weak governance over an extended period of time always results in banking system problems. And the banks in Vietnam are not well governed. Recent years have seen a spate of corruption scandals at Agribank, Vietinbank and BIDV, the three largest state-owned commercial banks. The Vietnam Development Bank (VDB) and Vietnam Bank for Social Policies operate almost entirely in the dark. VDB has not even released financial reports to the public since the middle of 2008. The state banks—including the commercial and policy banks—make up about half of the banking system, down from 70 percent in 2005. But even though their share of domestic lending is falling, their influence on the macroeconomy is still substantial. They remain the main source of financing for state owned enterprises, and they are subject to political pressure to make loans to favored SOEs by central and provincial government. Concern has risen that the state banks are under-capitalized and are in need of a major capital injection from the government. The impact of the Vinashin default on the banks' balance sheets, in particular BIDV, VDB and some joint-stock banks, has not been disclosed.

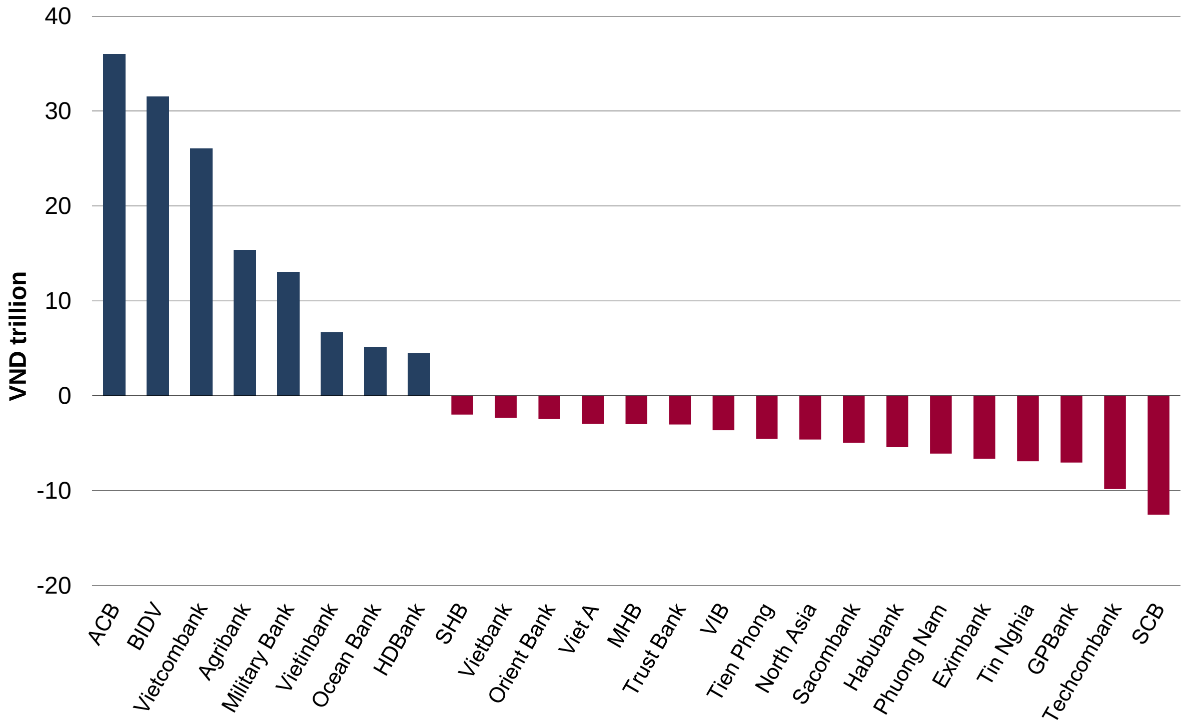
Figure 8. Domestic credit provided by the banking sector relative to GDP (%)



Source: World Bank, World Development Indicators.

Problems are not confined to the state owned commercial banks. Independent experts and credit rating agencies estimate that the share of non-performing loans (NPL) in the banking system is as high as 13-15 percent. According to reports of credit institutions to the State Bank of Vietnam (SBV), NPLs at the end of September 2011 were 3.3 percent of outstanding loans. But back in June, SBV's inspection and supervision section had found out that the NPL ratio was as high as 6.6 percent. Even that number surely does not reflect the real situation as Vietnamese accounting standards underestimate the share of bad loans, and Vietnamese banks rely on a number of accounting tricks to minimize their NPL ratios.[19] Bad debt on this scale means that a significant number of banks are technically insolvent. Loan loss provisions are the first line of defense against bad debt. According to the banks' 2011 Q3 financial statements, the total loan loss provisions of 42 Vietnamese banks stood at only VND46 trillion or 48% of NPLs. According to SBV's own assessment, this small level is not commensurate to the risks posed by bad debt and is far below the range of 70-100 percent observed in other emerging economies. As the second line of defense, banks can use their capital to cover loan losses. On the positive side, Vietnamese banks have been asked to raise their capital substantially in recent years. But on the negative side, a lot of the new capital contributions appear to have been an accounting illusion as existing shareholders tend to borrow money from one bank to buy newly-issued shares in another. This is a consequence of a cross-shareholding structure that will be discussed later in the section.

Figure 9. Net lending and borrowing in the interbank market



Source: Authors' estimate from Q3 2011 financial statements of Vietnamese commercial banks.

As a result of the problem of increasing NPLs coupled with low loan loss provisions and inadequate capital, small banks now rely heavily on the interbank market for liquidity: SBV estimates that the interbank market now accounts for about one third of funding. From Figure 9, it comes as no surprise that most of the banks widely considered to be "weak", including the recently-merged banks, are heavy borrowers in the interbank market. At first, the only signal of the liquidity problem was repeated episodes of interbank interest rate hikes. This was followed by major loan defaults in the black market involving commercial banks as they had to move outside of the formal system to solve the liquidity problem and avoid formal regulations. And

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[19] An economist representing a multilateral organization in Vietnam confided to the authors that a reasonable estimation of NPLs in Vietnam can be obtained by taking the official figure and multiplying it by five.

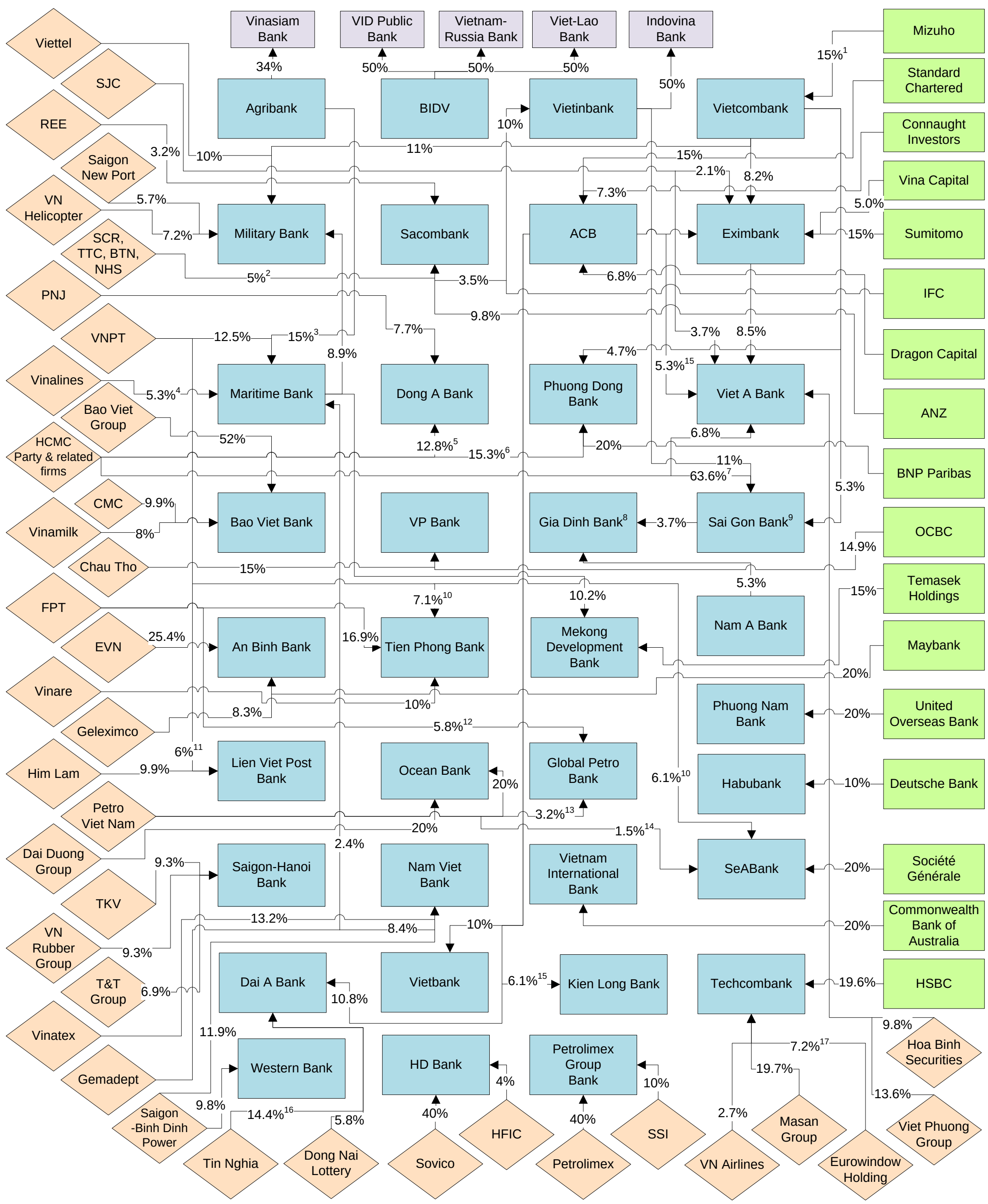
emerging in the past few months was news of banks unable to recall their loans extended to other banks.

It has been extensively documented that financial institutions on the verge of bankruptcy tend to engage in more risky ventures in the hopes of getting themselves out of trouble, a phenomenon often called "gambling for resurrection." For the moment, the concern of government officials is on the "circular flows of funds" in the inter-bank market and the resulting "cutoff" of access by firms to formal finance. However, unchecked liquidity provision either from the central bank or from the interbank market gives these financial institutions resources to engage in these activities, which raise the overall level of systemic risk and increase the costs of any eventual bailout. Therefore, the job of the financial regulating authority is to impose close supervision on illiquid banks, first preventing them from excessively increasing their assets/liabilities, and then sorting out institutions which only temporarily suffer from liquidity constraint from those already insolvent.

There is some indication of this phenomenon in Vietnam's banking sector. Total liabilities and capital of 42 Vietnamese banks increased by 12.7 percent from the end of 2010 to September 2011, but lending to the economy increased by only 7.2 percent during the same period. Other assets and its sub-category account receivables increased by 56.8 and 44.3 percent respectively. It is always a dangerous sign when banks stop lending, but increases to murky asset categories such as receivables and "other" investments suggest that banks are attempting to conceal risky behavior from the regulator. A clearer picture can be seen from the case of the two banks that were merged in the late 2011.[20] In the first nine months of 2011, the total assets (and liabilities) of Saigon Commercial Bank (SCB) increased from VND60 trillion to VND78 trillion, a 30 percent growth rate. To finance this increase on the liabilities side, SCB mobilized VND5.8 trillion more in deposits and borrowed VND8.2 trillion more from other credit institutions. On its asset side, however, only VND8.6 trillion more was lent out, while account receivables increased by VND10.2 trillion. At Tin Nghia Bank (TNB), deposits also went up by VND9.5 trillion, but lending actually fell by VND1.6 trillion while both receivables and other assets went up by VND14.5 trillion. Within the banking community, it is well known banks often transfer problem loans to their own asset management companies and other special vehicles to hide NPLs so that they can reclassify these loans as other assets.

[20] Ficombank was also merged with the two banks, but it is one of the smallest banks in the system.

Diagram 1. Shareholding structure in Vietnam's banking sector



Note: Shareholding information is as of 30 June 2011. Shareholdings by individuals are not depicted in the diagram. Shareholdings by institutions of less than 5 percent are not depicted except for those having representation in boards of directors or strategic partner status. Mekong Housing Bank and five joint-stock banks are not included in the diagram.

[1] Shareholding by Mizuho Bank at Vietcombank is not yet official.
[2] Shareholdings by a group of related companies including Sacomreal, Thanh Thanh Cong, Bourbon Tay Ninh, Ninh Hoa Sugar.
[3] Indirect shareholding through Agribank Securities Company (Agriseco).
[4] Includes shareholdings by Vinalines and its subsidiaries such as Hai Phong Port and Vosco.
[5] Includes shareholdings by HCMC Party Office, Ky Hoa Tourism and Trading, and Phu Nhuan Construction and Housing Trading.
[6] Includes shareholdings by HCMC Party Office, Sunimex and Savico.
[7] Includes shareholdings by HCMC Party Office, Ky Hoa Tourism & Trading, Saigon Petro, and Saigon Tourist Holding.
[8] Does not reflect the VND1000 billion capital increase announced in November 2011 and Viet Capital's acquisition of a controlling stake.
[9] Does not reflect the VND500 billion capital increase announced in November 2011 by Phu Nhuan Construction and Housing Trading Co. Ltd.
[10] Indirect shareholding through VMS (Mobifone).
[11] Indirect shareholding through Vietnam Post.
[12] Indirect shareholding through FPT Fund Management Company.
[13] Indirect shareholding through PVFI.
[14] Indirect shareholding through PV Gas.
[15] Indirect shareholding through ACB Securities.
[16] Including shareholding by Tin Nghia Petroleum.
[17] Including shareholding by Eurofinance.

Source: Compiled by Fulbright Economics Teaching Program (FETP) from banks' financial reports.

These very serious problems are compounded by pervasive cross-shareholding and connected lending. Since 2005, the rapid growth of the banking sector has been accompanied by the emergence of an extensive multilateral-shareholding structure. As illustrated in Diagram 1, many large non-financial companies, particularly state-owned economic groups and joint-stock conglomerates, now hold long-term shares in joint-stock commercial banks as founders or strategic investors. Banks also own shares of other banks. Cross-shareholding among banks is partly the legacy of earlier restructuring efforts but, more importantly, reflects strategic business decisions. The diagram only takes into account direct shareholdings between banks and economic organizations. The picture is more complicated when indirect ownership through investment vehicles and family/individual cross-holdings is included. For example, Techcombank is directly owned by Masan (19.7 percent), HSBC (19.6 percent), and Vietnam Airlines (2.8 percent). ACB Securities and Thang Long Securities own 3.4 percent and 2.6 percent of Techcombank respectively. Thus, ACB and Military Bank in effect are also owners of Techcombank.[21]

Cross shareholdings enable companies secure stable sources of funding from the banks that they partly own. Current regulations prevent banks from lending to their own shareholders. However, this rule is often sidestepped as banks choose to lend to subsidiaries instead of parent companies.[22] Japan, Korea, Thailand, and Indonesia all suffered severe economic difficulties resulting from cross-shareholding between banks and industrial companies. Because of connected lending, banks fail to appraise and monitor their loans properly when lending to their corporate shareholders, resulting in large non-performing loans. The relationship between state owned enterprises and some joint stock banks provides a valuable lesson. While state-owned banks were directed by the government to lend to SOEs, the joint-stock banks were under no such pressure. However, SOEs have acquired shares of many joint stock banks, which then bought bonds issued by the same SOEs or lent money to their subsidiaries. These loans are political rather than commercial in nature. If the companies cannot service their debts, the joint stock banks involved in these transactions are at risk of failure.

Compared to the business-bank ownership linkages, cross-shareholdings among banks pose an even greater, systemic, risk, since liquidity or solvency problems in one bank can lead to similar problems in many others. From the diagram, apart from the ownership stakes held by foreign banks, the shareholdings among domestic banks do not have any clear strategic rationale. However, a deeper look at the banks' corporate structure and financial statements reveals that these cross-shareholdings can facilitate more connected lending. Because Company X owns Bank A which in turn owns Bank B, X can borrow from B instead of A. A new phenomenon in recent years is the use of investment vehicles (ủy thác đầu tư) by banks facilitated by cross-shareholdings. In the inter-bank market, larger banks have been serving as a continuous source of funding for smaller banks, particularly those who are owned by them. The smaller banks use the mobilized funds to lend to investment vehicles such as investment funds, investment

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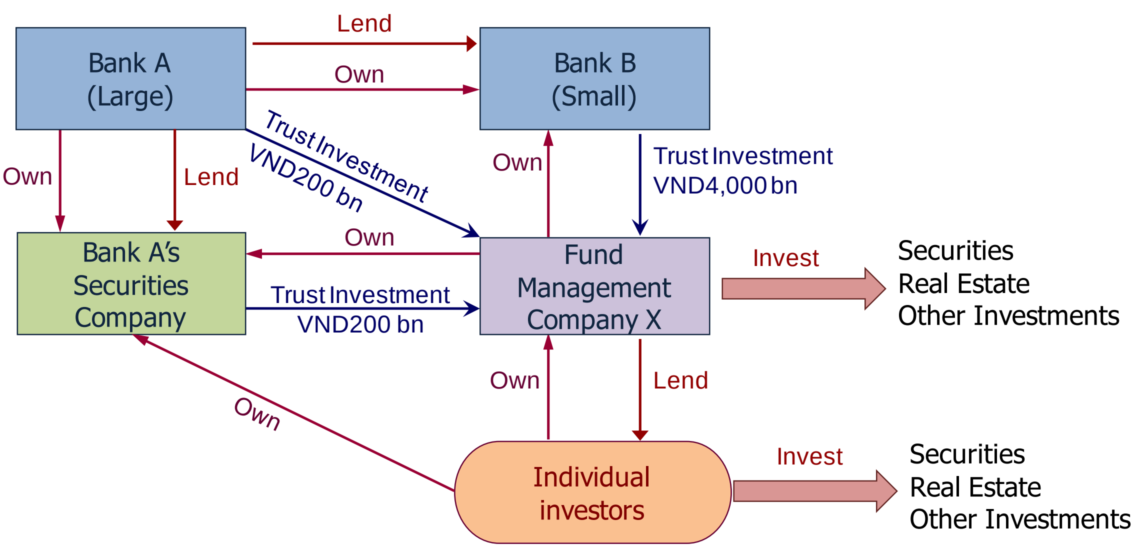
[21] ACB Securities is a 100% subsidiary of Asia Commercial Bank (ACB). Military Bank (MB) owns 62% of Thang Long Securities. Petro Vietnam Finance Company also owns 3% of Techcombank, meaning that Petro Vietnam (PVN) also has a stake in the bank.

[22] In fact, it is public information that An Binh Bank has mad loans or purchase bonds issued by EVN companies. Viettel is a major borrower of Military Bank.

management companies, and securities companies, many of which are owned by large banks' shareholders. A significant proportion of these funds eventually find their way into the real estate market and the stock market, including derivative-type transactions. Falling prices in these markets have been and are creating significant investment losses and non-performing loans for the banks, which can be extensive but difficult to quantify. Public evidence of the problem so far only centers on a limited number of small banks. However, the multilateral nature of both bank ownership and lending means that larger banks may also suffer significant capital losses if the smaller banks are not just illiquid but also insolvent. This problem is illustrated in Diagram 2, which describes the actual situation in one large bank (with the names of the financial institutions withheld to protect the identity of the institutions involved).

Diagram 2. Cross shareholdings, interbank lending and investment vehicles



Source: Fulbright Economics Teaching Program.

In short, any claimed advantage of building stable firm-bank relationships through cross-shareholdings has been demythologized by past experience of financial crises in the region and Vietnam's current macroeconomic and financial realities. A government-led restructuring program of Vietnam's banking sector must aim at substantially eliminating bank-firm cross-shareholding. Connected lending of all kinds must be outlawed and strictly monitored. Many recent announcements by SOEs to divest from commercial banks are encouraging but need to be followed through. The consolidation of banks under the principle of "merging banks under the same major shareholders" can also help lessen the extent of cross-shareholdings, but simply putting several weak banks under the same roof may not be effective.[23]

[23] SBV plans to rely on voluntary mergers and acquisitions to eliminate the eight most vulnerable joint stock banks. The first such action was completed on January 2, 2012, when SCB, Tin Nghia Bank and Ficombank were merged. A group of shareholders already have substantial ownership in these banks. At them same time, they own real estate companies that are involved in a number of high profile and expensive ventures such as the Times Square, Royal Garden and Saigon Peninsula property projects. These projects actually advertise intensively that they secure financing from the above banks.

The medium-term priority in bank restructuring should be to comprehensively revamp the banking sector away from cross-shareholdings. It will first require SBV to revise its definitions of and restrictions on major shareholders of banks so that it is illegal for individuals and organizations to control banks through layers of third-party entities. Next, existing groups including both state-owned and private groups which are deemed holding banking shares above the limits set by the revised regulations will have to submit their detailed divestiture plans to SBV, who in turn put a close supervision and enforcement mechanism on their implementation.

We believe that the banking sector in Vietnam can be restructured successfully, but it will require decisive actions and significant fiscal resources. At the moment, it is still very urgent to get the banking sector out the current conundrum in which the bank assets are still increasing rapidly, but healthy firms cannot borrow either because of high interest rates or lack of access altogether. Here, resolving NPLs is crucial. Past and present international experience provides good examples of NPL resolution through mergers and acquisitions, asset management companies, debt-equity swaps, and government bail-outs, which are all included in the government's bank restructure plan. SBV is already going through the books of the banks to separate "weak banks" from "strong" banks. Moreover, within the weak banks, SBV also needs to separate temporarily illiquid banks from insolvent banks which already have negative capital. Temporarily illiquid banks can be supported by SBV through its refinancing window. It is quite straightforward for insolvent banks to be put under special supervision and subject to restrictions on operations, dividend payment, and transfer of assets and shares. But more importantly, insolvent banks must be prevented from further rapidly increasing their assets and liabilities through the imposition of severe restrictions on deposits or borrowings from other financial institutions. Providing liquidity to insolvent banks mean that they will have more resources to gamble.

Since it has been decided by the government not to let any bank go bankrupt in Vietnam, injection of new capital using fiscal resources to restructure insolvent banks is the only realistic alternative. Simply asking state-owned banks to take over insolvent private banks as was done in the late 1990s would significantly weaken state-owned banks because the size of assets of even the smallest private banks is very substantial now. Domestic private banks and foreign banks will not want to buy insolvent private banks unless the government provides a guarantee to cover some of the loan losses. The guarantee would have to be explicit in light of the experience of the Vinashin default. Because of the recent experience with existing shareholders using accounting tricks and regulatory loopholes to inflate their banks' capital, allowing insolvent banks to issue convertible and long-term bonds to bolster their second-tier capital may not be an effective solution, but just another way of allowing them to survive longer. In other words, a public-sector solution is needed to restructure insolvent banks before reverting to any private-sector solution.

Finally, when injecting fresh money into an insolvent bank, SBV needs to have clear legal authority to take over the bank while existing shareholders lose a substantial part or all of their stake: financial assistance from the government can be used to guarantee deposits but not to bail-out bank owners. The financial resources required to restructure the banks has to come from the state budget. It is always tempting to resort to printing money to cover the costs of bank restructuring. However, this would be highly inflationary and put immediate pressure on the exchange rate. Since the promulgation of Resolution 11, the government has been steadfast in tightening the money supply, resulting in falling inflation and stabilizing the exchange rate. This solution, if implemented, will destroy the painful and effective efforts achieved in the past seven months. Instead, resources have to be secured from reserves, tax revenue, and even sale of public-sector assets.

2. Withdraw subsidies from state-owned enterprises, dismantle state monopolies and require SOEs to operate transparently

SOEs in Vietnam enjoy favorable treatment in terms of market access, cheap land and credit and other subsidies. In many cases these advantages have enabled SOEs to crowd out more dynamic and efficient firms. Yet as SOEs have increased scale and scope they have failed to create jobs, net exports, tax revenues or output commensurate with the size of the government's investment. Indeed, in some cases—for example, the collapse of the shipbuilder Vinashin—poor performance has imposed large costs on the public treasury.

The government implicitly recognizes the poor performance of SOEs when it promises to reduce the number of state-owned companies as part of economic restructuring (if they were earning their subsidies one would expect the government to promise to create more of them rather than reduce their number!). Yet real restructuring has less to do with the *number* of state companies than the governance of both state and non-state companies. All firms, regardless of ownership, must be required to operate transparently and must be held accountable to independent boards of directors that assume full legal responsibility for the performance and actions of the company. Monopolies should be eliminated except for the rare cases in which they operate in the public interest: for example, in cases of natural monopoly (for example, provision of piped water or the operation of the electricity grid or a national railroad).[24] Monopolies, if they are allowed to exist, should be regulated by independent agencies that are accountable to the public and have no political or financial interest in the success or failure of the company.

The question of the appropriate use of subsidization and trade protection is central to the restructuring of Vietnam's SOEs. State-owned firms receive privileged access to credit, land and markets. They are protected from international competition by rules that restrict foreign companies operations in domestic markets. All of Vietnam's "economic groups" are protected from competition from foreign firms, including sectors are diverse as natural resource exploitation, transportation, distribution, manufacturing and agribusiness.[25]

The problem is not necessarily protection and subsidization, but rather the overuse of these policy instruments, and, most importantly, the failure to tie the continuation of state support to clear and monitored performance criteria. The absence of performance criteria has allowed these firms to benefit from state favors without contributing to the achievement of the government's

[24] The production of electricity itself, however, is not a natural monopoly.

[25] Another recent example of protection is the decision of the government to block foreign airlines from using international brands on domestic routes in Vietnam. As a result of this rule, Air Asia withdrew from its planned joint venture with the domestic carrier VietJet. These is no economic justification for this rule: its transparent intent is to protect Vietnam Airlines from competition on its most lucrative domestic routes. This refusal to permit competition represents a transfer of resources from Vietnamese consumers to a monopoly state-owned company.

policy goals. Instead, they have enriched themselves and used their financial resources to influence the very institutions of government that should be regulating them.

There are cases when subsidization and protection can be justified on economic grounds. The government may decide to protect industries that are essential for national security and defense, and it may prefer to hold some of these firms in the state sector. Companies that provide essential public goods and services such as utilities may require subsidization. An argument can also be made for protecting or subsidizing firms that need time to acquire skills and technological capabilities, or which cannot compete internationally until they achieve a minimum scale. This form of "infant industry protection" was used in the present-day developed countries when they embarked on the process of industrialization.

However, an important lesson from the now developed countries is that subsidization and protection must be accompanied by clear and enforceable performance standards to ensure that industry support is being used for the purposes in which it was intended rather than for rent-seeking and speculation. Korea, for example, used subsidies and protection to help its large private and state companies achieve economies of scale and develop technological capabilities. Yet this support was closely tied to export performance targets, and failure to achieve these goals resulted in the loss of state support.

The problem in Vietnam is that the government has directed massive subsidies to state companies and erected high protective barriers to reduce competition, but it has failed to demand the achievement of measurable performance targets in return. This policy is sometimes justified by reference to the social contribution of SOES, for example the provision of cheap electricity to the public, or of cheap inputs to other state industries. However, as no attempt is made to compare the costs of subsidies and protection to the benefits to society of these contributions, one suspects that this is an attempt at political rationalization rather than a serious argument in favor of state favors for SOEs.

Indeed, the evidence that we do have strongly suggests that SOEs are performing poorly. According to the government's own estimates, SOEs control 70 percent of fixed assets in Vietnam and account for 45 percent of new investment. Yet they are responsible for only about one-fourth of employment, and in fact the number of jobs in SOEs shrank by 22 percent from 2006 to 2010. They accounted for only 19 percent of GDP growth and eight percent of growth in the industrial sector. They do not export and have failed to develop technological capabilities in new industries. As noted above, Vietnam remains dependent on fabric imports from China despite the fact that one of the country's largest state conglomerates has been assigned the essential task of developing the textile industry.

The experience of the newly industrialized East Asian countries has shown that growth of exports is the most effective criterion for evaluating the performance of domestic firms. There are several reasons of this. First, success on international markets is a reasonably objective indicator. While it may be possible to increase exports to a limited extent on the basis of subsidies, if the firms in question cannot produce goods that achieve international quality standards they will not survive long on international markets. Second, export growth is essential for economic development since it relaxes the foreign exchange constraint that emerges during the growth process. Third, since global markets are larger than domestic markets, exporters can achieve economies of scale and scope that are not available to producers oriented towards the domestic market. Finally, and perhaps most importantly, exporters use their political influence to reduce corruption and other unnecessary costs because they face tough price competition in foreign markets. Protected firms that rely solely on the domestic market are happy to pay these costs as long as they are shielded from foreign competition.[26]

Table 2. Share of resources and contribution to the economy of the three sectors (%)[27]

	SOEs		Non-state		FDI	
	2001-05	2006-10	2001-05	2006-10	2001-05	2006-10
Use of resources						
Investment capital	56,6	44,6	26,4	27,7	17,0	27,8
Credit	36,6	30,9	-	-	-	-
Contribution to the economy						
Budget (non-oil)	19,6	17,0	6,7	9,8	6,6	10,3
Employment	43,5	24,1	40,1	53,7	16,3	22,3
New job creation	-4,1	-22,0	74,1	88,1	30	33,9
GDP	30,0	27,8	46,7	46,1	14,6	17,9
GDP growth	32,9	19,0	44,6	54,2	14,5	17,4
Industrial value	28,9	20,1	28,3	35,4	42,7	44,5
Industrial value growth	28,5	7,9	34,0	45,8	37,4	46,3

Notes: Data of 2009 are estimates. Employment data are of 2001-2005 and 2006-2008 periods.
According to the GSO's classification, *state-owned enterprises* (SOEs) consist of (i) enterprises wholly owned by the state (these enterprises were established before July 1, 2010 under the Law on State Enterprise or after July 1, 2010 under the unified Law on Enterprise); (ii) joint-stock companies in which state accounts for more than 50% of the chartered capital. *Non-state enterprises* (NSEs) include (i) domestic private enterprises; (ii) domestic limited liability private companies; (iii) domestic joint-stock companies in which state accounts for less than 50% of the chartered capital; (iv) partnerships; and (v) collectives. *Foreign direct investment* (FDI) comprise all enterprises with foreign direct investors' participation, regardless their proportion of ownership.
Source: GSO, MOF and IMF.

Vietnam's SOEs are not engaged in production of manufactured goods for exports. In fact, the only economic group that was set up explicitly to export manufactures was Vinashin, a company that failed in 2010. The remaining economic groups either enjoy domestic monopolies or are in the business of exploiting natural resources. Vietnam is not a wealthy enough country to lavish

[26] See Vivek Chibber (2006) *Locked in Place: State Building and Late Industrialization in India*, Princeton: Princeton University Press.
[27] It should be noted that official statistics regarding investment and credit ratios do not fully and accurately record the actual level of resources allocated to SOEs. Many government transfers to SOEs are off-budget. A significant percentage of investment by conglomerates and general corporations are made through subsidiaries. Moreover, many SOEs, especially in sectors like transportation, aviation, and telecommunications benefit from infrastructure developed with public funds. SOEs also received significant amounts of credit from the Development Assistance Fund and continue to receive credit from its successor, the Development Bank of Vietnam, but these loans are not captured by commercial banking statistics. The actual amount of credit directed to subsidiaries, "backyard" companies, and equitized enterprises controlled by conglomerates and general corporations is also not known.

favors on this special class of overprotected and subsidized companies. This policy represents a net loss of income to Vietnamese consumers and the government, and makes it more difficult for non-state companies to compete on international markets because of the high cost of domestic goods and services. The wasteful behavior of SOEs also generates inflation, undermines the value of the Vietnam dong and widens the trade deficit.

Enhancing the efficiency of SOEs requires political as well as market discipline. In terms of political discipline, the government must bring a halt to the diversion of SOE investment away from their core businesses. The government must also demand full transparency in the form of regular independent audits and the release of corporate results to the public. The people, as the ultimate owners of the SOEs, are at least entitled to know the current status of these enterprises.[28] The government also needs to assess the pilot program of developing state conglomerates objectively and comprehensively, thereby avoiding the current situation of "too many and too big to fail" SOEs.

Also in terms of market discipline, forcing SOEs to achieve greater competitiveness and transparency in corporate governance requires the government to issue and ensure the implementation of an effective legal framework. This framework includes the law on competition, the law to enhance transparency and accountability in governance of SOEs, and the bankruptcy law to protect the interests of creditors and other stakeholders when companies become insolvent.

These important laws, including the Law on Competition 2004 and the Law on Bankruptcy 2004, were adopted at time when Vietnam was seeking to join WTO. Without a doubt, great efforts have been made in Vietnam to pass a set of basic laws needed to transform the existing SOEs into commercial legal entities operating in a market environment. However, since coming into effect, the implementation of these laws remains extremely problematic. Lack of political and ideological support in the government and absence of capable institutions led to a situation in which most of the transplanted laws on the books cannot be properly implemented in action.

For example, because of the absence of political will to constrain state monopolies, the Law on Competition 2004 has had no impact in regulating abuses of market power by large SOEs. Over the past five years, the Vietnam Competition Authority has handled only one case. This case involved Vinapco, a subsidiary of Vietnam Airlines Corporation, which had abused its monopoly position in providing jet fuel to civil aviation airlines. While the legal relief provided by the law can be very tough, reaching ten percent of the total turnover of the infringing company, the Competition Authority finally ordered only a nominal fine equal to only for 0.05% of the turnover of Vinapco. In order to impose market discipline on SOEs, it will be necessary to implement the Law on Competition 2004 by means of strengthening the capacity and independence of the Vietnam Competition Authority.

The failure to implement the Law on Bankruptcy of 2004 also demonstrates that without political commitment to enforce market discipline on SOEs, creditors and insolvent firms will both avoid

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[28] To ensure transparency and accountability, the government should not force the SOEs to shoulder more political and social duties. Instead, the government should carry out this mission through explicit and transparent fiscal and social policies.

bankruptcy proceedings provided by the law and seek to protect their interests through ad hoc administrative means. Looking back to the implementation of Bankruptcy Law in Vietnam over the last two decades, insolvent SOEs have been resolved through administrative intervention without reference to the legal bankruptcy procedures. This includes notable cases such as the Nam Dinh Garment Corporation, the Long An Garment Corporation and Vinashin. The line ministries and local authorities understandably have no interest in blaming themselves for the weaknesses and wrongdoings of these firms in open court proceedings. From another perspective, as a consequence of the cross-shareholding situation, creditors of insolvent firms are, in the most cases, state owned commercial banks or other state companies. The bad debts of one SOE are still assets on the other company's balance sheet; postponing the use of bankruptcy law gives them a chance to conceal their losses.

Therefore, the Bankruptcy Law needs to be revised to enable all creditors, with or without collateral in the insolvent company, to enjoy the right to bring the insolvency case to court, to participate in creditors' negotiations and restructuring programs for the insolvent company. With regard to institutional building, implementing the Bankruptcy Law requires further judicial reform to strengthen the independence and capacity of the court system. Without professional, capable and reliable judges, large business restructuring programs of insolvent SOEs cannot be monitored by the judiciary in bankruptcy procedures.

Policies dismantling state monopolies and imposing market discipline on SOEs as recommended by this policy paper need to be considered as an integral part of broader reforms to public governance in Vietnam.

3. Eliminate conflicts of interest in economic regulatory structures

A defining feature of competitive economies is a transparent, independent regulatory apparatus. Regulatory agencies perform a number of essential functions. They guard against collusive and monopolistic behavior by firms and promote a level playing field for enterprises. They protect the public welfare by ensuring that firms do not engage in behavior that is harmful to the health and well-being of the public. They also enforce compliance with national laws and international commitments. To execute their mandates effectively, regulatory agencies must be fully independent from the industries over which they exercise oversight. Why this is the case is obvious: when the regulator and the regulated share a common roof, the likelihood that the former will favor the latter is high, especially given the immense financial and political resources that corporate interests control.

In many important sectors, Vietnamese regulatory agencies are both "players and referees." They are embedded within line ministries that also control companies that are active—and in many cases dominant—participants in the sectors they are tasked with regulating. The likelihood that regulators will be pressured to favor firms that are linked to its parent ministry is increased when senior executives of state-owned enterprises are promoted to leadership positions in line ministries, as often occurs in Vietnam. The table below presents some of the most significant conflicts of interest. The government must recognize that it will encounter great difficult in imposing competitive discipline on state-owned firms until it severs the cozy ties that firms enjoy with their ostensible regulators.

Table 3. Conflicts of interest in economic regulatory structures

Ministry	Conflict	Solution
Planning and Investment	Responsible for setting investment priorities and allocating investment funds	Create separate research and planning institute to assess investment proposals
Health	Responsible for regulating pharmaceutical industry but also controls many drug companies and controls importation of drugs and medical equipment	Create a regulatory agency that is full independent of the ministry
Transport	Responsible for development of transport infrastructure but also operates construction companies Responsible for regulating the civil aviation industry but also operates the largest domestic airline	Privatize construction companies Create independent civil aviation agency; list portion of Vietnam Airlines on a foreign stock exchange
Agriculture and Rural Development	Responsible for promoting well-being of farmers but is also a dominant market participant in the rice, pesticide and fertilizer trades.	Sever ties between the ministry and its constituent enterprises, including Vinafood
Industry and Trade	Responsible for creating a level playing field for enterprises but also controls companies with monopoly positions in electricity and gasoline.	Break monopoly position of EVN and Petrolimex
State Bank of Vietnam	Responsible for regulating financial institutions but also grants licenses to new banks	Create a separate agency responsible for licensing banks

Source: Fulbright Economics Teaching Program.

4. Adopt a simple and credible fiscal rule

Macroeconomic instability reduces the rate of economic growth largely through its impact on investment. When countries enter into a pronounced boom-bust cycle, investors cannot form expectations about future profits, and therefore favor short-term, speculative investments over long term investments that are more closely linked to productivity growth.[29] Pro-cyclical fiscal policy is a major contributing factor to macroeconomic instability in developing countries.[30] Governments spend too much when capital and tax revenues are plentiful during the boom, and

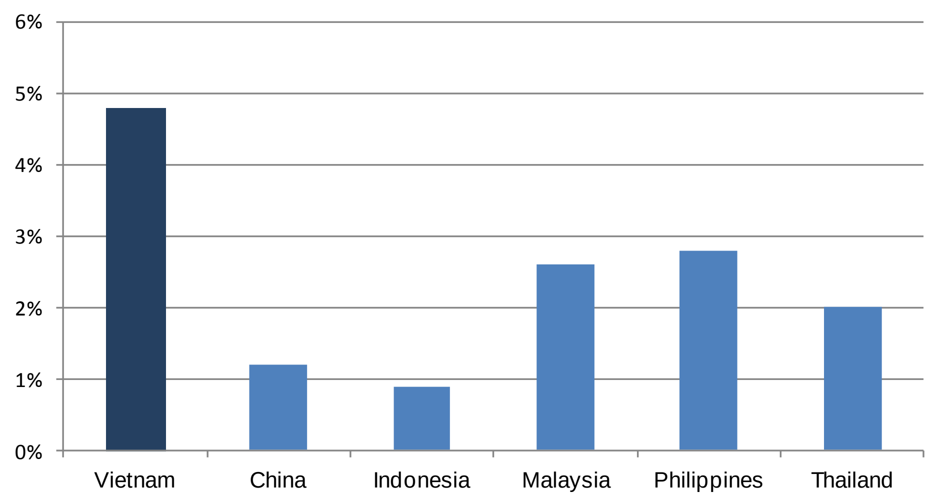
[29] See, among others, Luis Serven (1998) "Macroeconomic Uncertainty and Private Investment in Developing Countries: An Empirical Investigation," World Bank Policy Research Working Paper No. 2035, September.
[30] Graciela L. Kaminsky, Carmen M. Reinhart, Carlos A. Végh (2005) "When it Rains it Pours: Procyclical Capital Flows and Macroeconomic Policies," in Mark Gertler and Kenneth Rogoff, eds., *NBER Macroeconomics Annual 2004*, Cambridge: MIT Press, 11-53.

then have to cut back when capital and revenues are scarce during the bust. This generates inflation in good times and deep recessions in bad times.

Vietnam's fiscal policy has been extremely pro-cyclical over the past decade. The government has consistently run large fiscal deficits in years when capital inflows have peaked, as in 2003 and 2007 (see Figure 3). This has made inflation and trade deficits much worse than they would have been if fiscal policy had been counter-cyclical, that is, if the government had run a modest surplus in years when capital inflows were surging into Vietnam.

Like the other countries in the region, Vietnam introduced a fiscal stimulus in 2009 to counteract the effects of the global crisis. This is an example of counter-cyclical fiscal policy. However, unlike other countries in the region, Vietnam was already running large fiscal deficits before the crisis, and failed to remove the stimulus early enough. As shown in Figure 10, Vietnam's fiscal deficit over this period was much larger than in other countries in the region. This is part of the explanation of Vietnam's large trade deficits and struggle to contain inflation.

Figure 10. Average fiscal deficit as percent of GDP, 2007-2011



Source: World Bank, World Development Indicators.

Moving from pro-cyclical to counter-cyclical fiscal policy is difficult because when the boom is on there is plenty of money around to invest in new projects. Running a small surplus during the boom requires more self-control than most governments possess. It is difficult for government leaders to tell public sector workers that there is no money for wage increases when the economy is growing rapidly. During the boom, local authorities and SOEs find it easy to lobby for more transfers from the central government to increase investment in infrastructure. The central government feels constrained in its ability to limit the increase in public investment when times are good.

One way to introduce discipline into the fiscal system is to impose a simple rule on fiscal policy. Rules can constrain spending, the budget balance, public debt levels or some combination of these variables. A credible fiscal rule—that is, if it is legally binding on the government and if compliance is independently verified—can help shelter fiscal policy from political pressure and set limits on the size of government borrowing. According to the IMF, in 1990 only seven countries had adopted national fiscal rules. By 2009, however, the number had risen to 80 member countries, 53 of which were middle or lower income.[31] The growing popularity of fiscal rules reflects the generally held view that rules have helped to improve fiscal policy under a wide range of economic conditions.

The main criticism of fiscal rules is that they do not leave enough room for the government to adjust policy during bad times. Exporters of oil and other commodities may be subject to large revenue shortfalls when prices drop, and during these periods expansive fiscal policy may be needed to prevent the onset of recession. The best way to deal with this issue is to adopt a structural fiscal rule that takes output gaps into consideration. When the rate of economic growth is below trend, the government is permitted to increase the fiscal deficit proportionate to the size of the output gap. Conversely, if growth is above trend, the government must run a budget surplus. The goal is to achieve a balanced budget (or small surplus or deficit depending on the rule adopted) over the life of the economic cycle.

For example, Chile introduced a rule requiring the government to run a *structural* budget surplus equal to one percent of GDP every year.[32] The structural surplus is the surplus that the government *would have had* in a year of normal growth given copper prices (Chile's top export) at their long term trend levels. In other words, the government may run a fiscal deficit when growth and copper prices are below their long-term trends. An independent group of economists is assigned the task of calculating the structural surplus or deficit every year. Politicians are not allowed to estimate the structural surplus, since they would no doubt conclude that it is too large and the government has plenty of money to spend.

Chile's policy has worked well. The government paid down debt, its credit rating improved and growth fluctuated less than in the past.[33] Although the rule was originally a guideline voluntarily followed by the government, it was passed into law in 2006.

Indonesia adopted a simple fiscal rule in 2003 that forbids the government from running a deficit that is larger than three percent of GDP, and caps public debt at 60 percent of GDP. Since local authorities are required to balance their budgets, the fiscal rule reflects total government borrowing, not just borrowing by the central government. Since this law was enacted, the government has paid down public debt to the equivalent of 35 percent of GDP.

Vietnam needs a strong fiscal policy rule to reduce pro-cyclicality, smooth out the boom-bust cycle, reduce the public sector debt burden and improve the country's credit rating. A structural balanced budget rule would be a good start, provided that an independent (non-political) panel was given authority to calculate the size of the output gap and to estimate the appropriate fiscal surplus or deficit given deviations from the trend rate of growth.

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[31] International Monetary Fund (2009) "Fiscal Rules: Anchoring Expectations for Sustainable Public Finances," Washington, D.C., November 11.
[32] The required structural surplus was subsequently reduced to zero percent.
[33] Jeffrey Frankel (2011) "A Solution to Fiscal Procyclicality: The Structural Budget Institutions Pioneered by Chile," Central Bank of Chile Working Papers No. 602, January, http://www.hks.harvard.edu/fs/jfrankel/ChileCB-WP-Frankel2011-01-07DTBC.pdf.

One of the obstacles to adopting a strong fiscal rule in Vietnam is that no one is quite sure how big the fiscal deficit is. Vietnam continues to use non-standard revenue and expenditure categories, and to exclude sub-national budgets and substantial amounts of off-budget spending. Even this information is not shared with the tax-paying public. Fiscal policy in Vietnam is less transparent than in any other emerging economies in Southeast Asia, and indeed most countries of the world. Vietnam ranked 14th out of 104 countries in the Open Budget Index rankings compiled by the International Budget Partnership, a policy think-tank.[34] Surely Vietnamese citizens have a right to know how the government is spending money raised mostly from domestic taxes and to serve the interests of all Vietnamese people.

5. Restructure public investment through institutional coordination, independent oversight and international competition in procurement

Over the last fifteen years, the Vietnamese economy has sustained a very high level of investment, in particular infrastructure investment. Investment spending on electricity, water supply, waste treatment, transport and communications in Vietnam steadily increased from 9.4 percent of GDP from the period 1996 to 2000 to 10.1 percent from 2001 to 2005 and 11.9 percent from 2006 to 2010. Successful countries build the infrastructure needed to maintain growth. However, the past and current relative investment level is way above international norms. Taiwan and South Korea invested around nine percent of GDP in infrastructure from 1960 to 1990.[35] China on average invested 8.7 percent of its GDP in infrastructure over the period 2003 to 2008.[36]

Despite a very high level of investment, Vietnam's infrastructure is still a binding development constraint. Survey-based international rankings such as the World Bank's infrastructure performance index and WEF's Global Competitiveness Reports all reveal that Vietnam is still far behind other Asian emerging economies in terms of infrastructure development. It is possible that Vietnam started with much poorer infrastructure and therefore has to invest heavily to catch up. But the large mismatch between spending and performance points to major inefficiencies.

It must be recognized that as long as money can be made easily available to sustain a high investment rate, government agencies and businesses will continue to invent projects for inclusion in master plans, seek implementation approval, and increase the scale and cost of projects during implementation. Furthermore, the past four years of macroeconomic instability has made plainly clear that expansionary monetary and fiscal policies to support high levels of investment cannot be sustained. Thus, the first action to restructure investment should be a significant tightening in its development budget. The government has already decided to reduce total investment from more than 40 percent of GDP in the past to 34 percent in 2012. Correspondingly, infrastructure investment should be reduced to 8-9 percent of GDP, which is in

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[34] See http://internationalbudget.org/what-we-do/open-budget-survey/.
[35] World Bank, Infrastructure Strategies in East Asia: The Untold Story, 1997 and Danny Leipziger, "Lessons from East Asia", University of Michigan Press, 1994.
[36] Only in 2009, propelled by a massive fiscal stimulus package, the infrastructure investment to GDP ratio jumped up to 11.3 percent. (Source: China's Statistical Yearbook 2010.)

line with the successful international experiences mentioned above. Setting a limit on infrastructure spending is a first necessary step towards imposing discipline on the public investment process. However, in itself it is not sufficient, since there is no guarantee that scarce resources would reallocated to the highest priority projects. Lower rates of investment could perversely eliminate good projects while bad projects retain political support.

(i) Strengthening institutions to overcome diffuse and fragmented investment.

The most important reason for inefficient investment is the scattered and fragmented nature of planning for infrastructure development. A common pattern is that once the central government confirms an investment program such as sugar mills, open economic zones, sea ports, airports or universities, state-owned enterprises and local governments all try to include these projects in a master plan. And soon similar projects are approved and implemented at the same time and throughout the country. The consequence is that a lot of money is spent but not many good facilities are built and put into use. The box below provides examples of this problem in several subsectors of the transport infrastructure.

Box 1. A Comparison Among Transport Projects

North-South Expressway vs. Ho Chi Minh Highway

- Vietnam's rapidly growing economy demands a modern network of limited-access expressways that can provide for free flow of traffic with high-speed and safety. The geography of Vietnam is such that a single north-south corridor can connect almost all major important economic centers of the country with an appraised average economic rate of return of 20 percent. So far, only the 40km HCMC-Trung Luong Expressway has been completed and three more sections are being constructed. The remaining sections have been put on hold due to lack of funding.
- The Ho Chi Minh Highway project was started in 2000 to form a western corridor ahead of the eastern expressway project. Connecting mostly poor and remote regions with one another instead of poor regions with richer ones, the Highway has a very low level of traffic and high maintenance costs. Had the funding for the Ho Chi Minh Highway been used for the expressway network, many critical sections would have been under operation. They are now facing steeply rising costs of land compensation and civil works.

International Gateway Ports vs. Van Phong Transshipment and Provincial Sea Ports

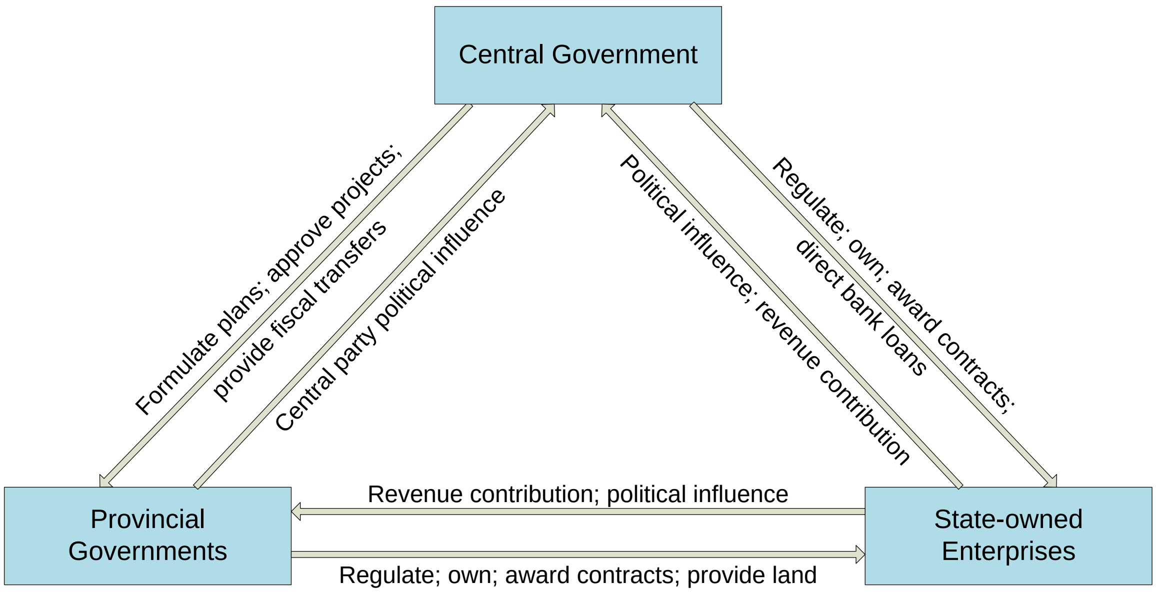
- Hai Phong in the north and Ba Ria – Vung Tau (BR-VT) in the south are Vietnam's international gateway ports. Due to its high financial viability, the Cai Mep – Thi Vai Port Complex in BR-VT already attracted US$1.2 billion of private investment and four world-class container terminals are already under operation. However, lack of funding and weak coordination delayed the development of supporting and connecting infrastructure facilities. The critical Lach Huyen Container Port in Hai Phong only secured its ODA financing from Japan in late 2011.
- Construction of Van Phong Transshipment Port started in 2009 although there is little prospect for any significant volume of transshipping containers, particularly in the current global economic environment. All coastal provinces have planned for or have already commenced construction of major sea ports. But besides Ha Noi and HCMC, only Quang Ninh, Da Nang and Quy Nhon currently have some container shipping, together accounting for 5.7 percent of the total volume in 2010. Ports in all remaining provinces account for only 1.2 percent of the total container volume.

Regional Airports vs. Local Airports

- More and more Vietnamese people are using air travel as their purchasing power increases and budget airlines emerge. Domestic air traffic in Vietnam grew by 20.8 percent a year on average during 2005-2009 (while passengers on international routes increased by only 2.6 percent annually because of the global financial crisis). It will not be costly to upgrade some of the military airports with good runways and build affordable terminals. The government should focus on developing key domestic airports serving an entire region, rather than just a single province. This option is viable as the expressway network will permit each airport to have a market service area within a 200-km radius.
- Air passenger volumes in Haiphong, Vinh, Da Nang, Cam Ranh and Phu Quoc are growing strongly. But other local airports are suffering significant financial losses. However, many airports near one another are still being proposed. Thanh Hoa Airport, which was not included in the 2007 Air Transport Master Plan, was added in 2010. It is just 142km from Vinh. Chu Lai, which will be designated as an international airport, is 125km from Da Nang. When these projects are complete, the central region alone will have four international airports. An Giang airport, which was also not in the original master plan, was approval in 2010. It is only 60km from Can Tho and Rach Gia airports.

The diagram below illustrates how institutional fragmentation leads to scattered and inefficient public investment. In the first dimension, the central government has to acquiesce to provinces' project proposals, and approve fiscal transfers for their implementation as the top leadership depends on provinces for political support. In the second dimension, state-owned enterprises are typically investors and/or contractors of infrastructure projects. They are awarded concessions and contracts on a non-competitive basis, and receive government-directed bank loans. In the third dimension, SOEs are dependent on local governments for access to land and other land-based resources. Local government, in turn, wants the projects in its area in order to keep the value-added tax revenue generated by the SOEs' investments. Thus in many instances, SOEs and provinces often team up to gain a maximum political leverage in securing projects and other favorable mechanisms from the central government.

Diagram 3. Relationship triangle



Source: Fulbright Economics Teaching Program.

Absent from the above diagram are a number of key mechanisms and institution such as market discipline based on competition, independent oversight agencies and regulatory authorities, and accountability to end-users and beneficiaries of infrastructure projects. It is impossible for any country to totally eliminate political influence in public investment. But the efficiency of public investment can certainly be improved significantly by giving broad power to a real independent oversight body at the central level, making local governments more accountable toward their people, setting up a regional mechanism for revenue sharing, and impose market discipline on investors.

(ii) Managing and controlling investment costs

Among the most economically and socially viable public investment projects that are being undertaken, the most important factor that gives rise to high levels of investment with low efficiency is inflated costs of investment. In 2007, international consultants estimated that the typical construction costs to build a four-lane expressway in Vietnam, taking into account bridge sections, terrain types, soft-soil conditions, and land compensation, were US$4.1-4.8 million per km.[37] This estimate is in line with international experience. The average expressway construction cost in 25 states in the US was US$1.45 million per lane per km in 2002 (or US$5.8 million per 4-lane km).[38] Chinese expressways completed in 2003-06 had an average cost of US$3.7 million

[37] The ADB's technical assistance project to prepare Vietnam's Expressway Development Plan.
[38] Washington State Department of Transportation, Highway Construction Cost Comparison Survey, April 2002.

per one 4-lane km.[39] Indonesia's Trans-Java Expressway was also planned in 2007 with a total cost of US$5.5 billion for 1,000km.[40] But when the expressway network was included in the government list of most important transport projects in the same year, the average cost was adjusted to US$7.6 million per kilometer.[41] The HCMC-Trung Luong Expressway was completed in 2010 costing US$9.9 million per kilometer. The Cau Gie - Ninh Binh is expected to cost US$9.8 million per kilometer upon completion in 2012. Using international cost benchmarks and adjusting for cost escalation during 2002-2010, the average cost of 4-lane expressway construction without land compensation and bridges is around US$6-8 million per km.

Table 4. Expressway Investment Costs

Project/Location	Distance (km)	Total cost (US$ mn)	Years of construction	Unit cost (US$ mn/4-lane km)
Vietnam's Expressways				
Phap Van - Cau Gie(*)	32.3	53	1998-2002	1.86
Cau Gie - Ninh Binh	56.0	548	2006-2012	9.78
HCMC - Trung Luong	61.9	613	2004-2010	9.90
Da Nang - Quang Ngai	131.5	1,404	2012-2016	10.67
HCMC - Long Thanh - Dau Giay	51.0	932	2009-2013	18.28
Trung Luong - My Thuan	54.0	1,000	2009-	18.52
Ben Luc - Long Thanh	57.1	1,608	2012-2015	28.16
International Comparisons				
China				
Jiangxi	134.0	320	1996-2004	2.39
Liaoning	109.0	288	1996-1998	2.64
Shenyang-Jinzhou (6-lane)	192.0	729	1996-2001	2.53
Shanxi	176.0	618	1999-2006	3.51
Chengdu-Nanchong	208.0	772	1998-2004	3.71
Changchun-Harbin	101.9	404	1998-2003	3.96
Chongqing (4 & 6-lane)	89.0	461	1996-2004	4.37
US (average of 25 states)			2002	5.80

(*) The Phap Van – Cau Gie is not strictly of expressway standard.
Source: Project completion and appraisal reports for Vietnamese and Chinese projects, and Washington State Department of Transportation for US projects.

Weak soils and land compensation are often cited as factors contributing to the high investment costs of transport projects in Vietnam. The HCMC – Long Thanh – Dau Giay project is appraised at US$18.3 million per kilometer. After deducting the costs of bridges and land acquisition (US$286 million), the unit cost is still US$13.5 million per kilometer. The Ben Luc – Long Thanh project appears to be the most expensive one, costing US$28.2 million per kilometer. Without the costs of US$1.1 billion to build three long bridges and land compensation, its unit cost is still US$16.8 million per kilometer.

[39] The estimate is made based on completion reports of Jiangxi, Chongqing, Chengdu-Nanchong, Changchun-Harbin, and Shanxi Expressways.
[40] Jamie S. Davidson, "Driving growth: Regulatory reform and expressways in Indonesia", Regulation and Governance, Volume 4, Issue 4, pages 465–484, December 2010.
[41] The Prime Minister of Vietnam, Decision 412/QĐ-Ttg, 11 April 2007.

The government plans to mobilize private sector capital to finance a substantial part of the expressway network. But its high cost structure will very likely defeat this purpose since all projects will have very low financial rates of return. As a result, the implementation of any public-private-partnership (PPP) scheme will have to involve significant government subsidies or soft ODA loans or both. The HCMC – Long Thanh – Dau Giay will have the highest level of traffic among all expressways in Vietnam upon completion since it will be the gateway of HCMC to the north and the east, connecting the city to the industrial zones in Dong Nai, the new Long Thanh airport, and the deep sea ports in BR-VT. Based on this high potential of toll revenue, the project should have been the strongest candidate for private sector participation.[42] But because its current cost is more than doubled the original estimate, 99.5% of its investment cost has to be financed by ODA loans from ADB and JICA.

The absence of oversight leads to this high cost problem right at the formulation phase. The vested interests that form the relationship triangle described above means that no one is interested in finding out the true costs of an investment and holding those who invest accountable. Furthermore, there is a real reluctance to truly embrace competition in government procurement. Both regulators and investors often cite the need to speed up the process, particularly for large-scale projects, to avoid competitive bidding. Bidding rules and regulations based on international best practices are already in place. The question remains is whether there is enough political determination to enforce them.

In terms of project implementation, much of the increases in investment costs occurs because of lengthy construction delays. Due to the diffused investment structure, every agency seeks to jumpstart the construction of their projects. The incentive is to start a project with whatever funds can be allocated before all financial sources are secured. The result is that many projects have to be stopped midway due to lack of funding. The government has issued a regulation requiring public investment projects to secure full financial commitments before implementation. This is a step in the right direction, but again this rule needs to be implemented and enforced. Construction delays and cost increases also occur due to poor management and supervision of contractors. Ex post, several government agencies have moved aggressively recently to cancel contracts with under-performing contractors. However, ex ante, the award of contracts should also be based on contractors' past performance.

6. Redesign the incentives for local governments

Currently, local and central governments each account for about 50 percent of total investment from the national budget. Local governments are thus also responsible for the inefficiency of public investment as shown in their race to build airports, deep seaports, coastal economic zones, industrial zones among other things, despite the inefficiency of these projects.

[42] Traffic in the HCMC-Long Thanh sections is projected at 51.000 passenger car units a day which is three times the projected figure for the Da Nang – Quang Ngai section. (Source: World Bank's and ADB's appraisal documents of the two projects.)

The cause of this situation is deeply rooted in public finance incentive structures. The first is the over-reliance on the GDP growth rate as a measure of economic performance. When the speed (not quality) of GDP growth is used as the most important measure of economic success, it follows that each province will seek out ways to accelerate GDP growth. For more than 50 provinces that cannot finance their investment, the simplest way to generate GDP growth is to secure a larger share of the central budget. Moreover, because no effective coordination mechanisms exist, provinces invest recklessly regardless of the aggregate effect on the region or the country. As a result, the administrative boundaries between provinces become their economic borders, dividing the national economy into 63 small and inefficient units. Additionally, the "term thinking" (*tư duy nhiệm kỳ*) makes the race for GDP growth even more pressing, and normally the quicker decisions are made, the larger the scope for error, especially if the decision maker will not be present in the next term to take responsibility for his or her decisions. The result is that, in the current institutional setting, the mind and eyes of local leaders are constrained spatially (provincial boundary) and temporally (5-year term).

Second, every province faces the pressure to achieve the national goal of industrialization. Leaders of many provinces, even in the two largest agricultural regions, take for granted the goal of "basically becoming a modern-oriented industrial economy by 2020." As a result, there has been a nation-wide and massive conversion of agricultural land to industrial, commercial, and residential land, despite the differences in provincial comparative advantage. The formula for "the ideal economic structure" of industry - services - agriculture may be appropriate for the country as a whole, but certainly is not suitable for many provinces in the Red River and Mekong River deltas, which have an absolute advantage in agricultural and fishery products.

Third, many commentators believe that inefficient investment in Vietnam is a consequence of excessive decentralization. Acceleration of decentralization has opened up much wider policy space for local governments, but this larger space is usually not accompanied by increased human and financial resources as well as supervision from the central government. As a result, decentralization has in reality become fragmentation, especially under the pressure of the GDP growth race and the industrialization imperative. It is worth emphasizing that although many provinces have taken advantage of decentralization, the lack of central government supervision and discipline together with the low quality of planning are important causes of redundant and inefficient investment.[43]

7. Reform personnel policies and ban senior officials from serving in their native provinces

Vietnamese policymakers and analysts express growing concern about the increasingly fragmented nature of the state's political, administrative, and economic structures. There is a lack of coordination, vertically, between the center and the provinces and, horizontally, among line

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[43] An example for the lack of central government's discipline can be found in the development of seaports, exemplified by the Mekong Delta seaports. From the decision of the Prime Minister in December 2009 to the detailed plan of the Ministry of Transportation in August 2011, the number of port complexes increased from 21 to 27, that is an increase of 30% in less than two years.

ministries and provinces in the same region. The waste and redundancy in public investment, analyzed elsewhere in this memo, is widely understood to be a consequence of this institutional fragmentation. Institutional fragmentation is the product of many factors. Former deputy prime minister Vu Khoan has criticized what he describes as the confusion between provinces as administrative entities and as socioeconomic units. Explaining inefficiency in public investment, he writes, "[t]here are many causes of the current situation: a psychology that desires rapid growth, a desire to 'industrialize' at any cost, an investment allocation system that operates in the "asking and giving" style, a term-limit driven [e.g. short-term] psychology, [and] considerations driven by sectoral, local, or personal interests."[44] Mr. Khoan likens the provinces to "63 fortresses" each intent on maximizing transfers from the central government in pursuit of rapid economic growth. While it is clear that provinces in Vietnam are too small to serve as autonomous socioeconomic units, provinces are at present the only meaningful sub-national policy planning unit. The comprehensive annual and quinquennial planning processes and sector master plans that provinces produce reinforce the misleading, autarkic conception of provinces as independent economic entities.

The experience of Southeast Asian countries such as Thailand, the Philippines, and Indonesia offer cautionary tales about the dangers of excessive localism. To varying degrees—with the Philippines as arguably the most extreme case—the political economy of these countries is characterized by entrenched local-level political and economic elites. This fusion of economic and political power has frustrated efforts to implement much-needed political and institutional reforms.[45] Much can also be gained by a careful study of the policies that the Chinese government has adopted since the mid -1990s to ensure that the central government did not lose control over the regions. It may be difficult to imagine now but there was a time when many inside and outside of China feared that the rapid decentralization that accompanied China's economic liberalization in the 1980s might weaken central control to the point of national dissolution. In response, the Chinese Communist Party and the central state revised the policies and procedures employed for managing senior officials. One of the most visible reforms was the reinstatement of the feudal-era "law of avoidance" that barred officials from serving in their native region.[46] Talented officials from central government agencies are increasingly expected to prove themselves in demanding leadership positions in the provinces. One goal of these policies is to ensure that provincial leaders act in the national interest and are incentivized to comply with directives and policies emanating from the center. Another objective is to restrict opportunities for provincial leaders to engage in self-serving behavior.

Decentralization has of course been a defining feature of the Doi moi period. There is a consensus that increasing the ability of local government to govern in accordance with local needs and conditions has been very beneficial. In our opinion, calls for a "recentralization" of political power are both unnecessary, and, in the final analysis, almost certainly unrealistic.

[44] Vu Khoan, "Lại bàn về đầu tư công," http://www.thesaigontimes.vn/Home/diendan/ykien/59005/Lai-ban-ve-dau-tu-cong.html

[45] There are 76 provinces in Thailand and 80 in the Philippines. By contrast, there are only 33 provinces in China, excluding Taiwan.

[46] Known as "hồi tị" in Sino-Vietnamese, this practice was followed in premodern Vietnam. See: http://phaply.net.vn/dien-dan-phap-luat/luat-hoi-ty-trong-cai-cach-cua-minh-mang-va-bai-hoc-cho-cong-tac-to-chuc-can-bo-hien-nay.html

Localism is a defining feature of almost all political systems. Vietnamese people identify deeply with their native place. The challenge for Vietnamese policymakers will be to strike the appropriate balance between local autonomy on the one hand while ensuring that national policy objectives are implemented in a coherent and authoritative manner and that provincial leaders advance national priorities and interests. Many of the policy challenges the government faces today can only be addressed through coordinated interventions on regional and national levels.

A central theme of this discussion paper is that the Vietnamese government will need to "get tough" with many powerful interest groups if it is to successfully make the transition to a new growth model. Real estate holdings must be taxed. Market competition must be imposed on firms. Infrastructure investment must become more efficient. This section recommends several concrete reforms to the policies by which the state and party manage senior officials and executives; we believe that these reforms can foster a political environment that is more conducive to the determined actions that are urgently needed.

(i) *Diversify the ranks of provincial leadership.* At present an overwhelming percentage of senior provincial leaders (understood here to include party secretaries and chairmen of provincial people's committees) are either natives of the province in which they serve or have spent a significant portion of their careers in that province. Based on an analysis of official biographies and press reports, as of November 2011, only eight provincial party secretaries could be classified as outsiders in the sense that they do not appear to possess strong pre-existing ties to the locality in which they are serving. Among people's committee chairmen, only two individuals appear to qualify as outsiders. This pattern stands in stark contrast to China where the revival of the "law of avoidance" has resulted in a sharp decline in the frequency with which officials hold leadership positions in the province of their birth. In 2010, only 18 percent of provincial leaders served in their native province.[47] By contrast, we calculate that nearly 70 percent of senior provincial officials in Vietnam serve in their native province. The percentage increases to almost 90 percent when officials who served the bulk of their careers in the province, but who were born elsewhere, are categorized as locals.

While it would be unfair to suggest that provincial leaders who serve in their home province are incapable of acting in the national interest, the likelihood that leaders will engage in nepotism or other forms of self-serving, collusive behavior is considerably higher when they serve in provinces where they possess extended political and kinship networks. Vietnam has operated a "cadre rotation" (luân chuyển cán bộ) policy for some time. However, we observe that in most cases officials who rotate to the provinces from the center are assigned second-tier posts such as deputy provincial party secretary; while some of these individuals are subsequently promoted to the post of party secretary, this pattern suggests a reluctance to impose outside leadership on provinces. One of the stated goals of the cadre rotation system is to provide promising young officials with opportunities to prove themselves in challenging conditions. Given the emphasis placed on consensus based decision-making in Vietnam, it would be easier to accurately assess an official's ability if he or she is given the opportunity to serve as a leader, rather than a deputy.

[47] Cheng Li, "China's Mid-term Jockeying: Gearing up for 2012 (Part 1: Provincial Chiefs)," *China Leadership Monitor,* 31. p. 11. Available at: http://media.hoover.org/sites/default/files/documents/CLM31CL.pdf.

Revising elite management policies is not only important for improving the quality of provincial governance. There is a need for greater regional diversity in central level agencies. In most line ministries, it is uncommon to encounter an official below the rank of vice minister who was born and raised in the center or the south. The regional character of Vietnam's central government distinguishes it from other governments in the region which tend to exhibit a higher level of diversity in the composition of their bureaucracies. A nationwide recruitment strategy for central government officials would help elevate the quality and effectiveness of the civil service by expanding the pool of potential applicants and by limiting the power of patronage networks in government agencies.

An analysis of the composition of the leadership of Vietnam's large state-owned firms reflects a similar lack of diversity, albeit with respect to professional, rather than regional backgrounds. The boards of directors of conglomerates and general corporations are composed almost exclusively of individuals who can best be characterized as "insiders" either because they were previously executives in the firm or because they are officials in the ministry to which the enterprise is administratively responsible. If the government is to succeed in forcing state owned firms to modernize and professionalize it will be necessary to inject new blood at the leadership level by allowing independent, non-executive directors to participate in corporate governance.

(ii) Recalibrate personnel incentives and cadre evaluation criteria. It has often been observed that provincial leaders feel pressure to deliver GDP growth at all costs during their term. If provincial leaders believe that their prospects for promotion are dependent on generating a high level of GDP growth, they will naturally give priority to economic activity, such as large scale infrastructure investments, that will produce such an outcome. Similarly, they will be less likely to devote energy and resources to the pursuit of policies that they do not believe will influence their future career trajectory. As inequality increases in Vietnam, the government should ensure that its personnel policies accord sufficient weight to human development indicators. Metrics that capture social welfare improvements should be given as much emphasis as economic performance in assessing provincial officials. Of course, the adoption of new metrics and targets is not a complete solution. Human nature being as it is, officials are likely to find ways to artificially inflate performance indicators. This is why increased democracy within the party is essential.

Part V. **Conclusion: Restructuring for a Dynamic Economy and Strong Nation**

Real economic restructuring must move beyond cosmetic changes such as reducing the number of banks and SOEs to address the deeper causes of macroeconomic instability. Economic institutions and economic governance in Vietnam do not promote competition, efficiency and innovation. Easier money can be made speculating on fixed assets like properties or currencies and gold prices or extracting rents from privileged access to land, capital, information and political power. As long as this is the case, resources will not be directed towards the most productive uses, and firms and individuals will think in terms of short term endeavors rather than long term investments in productive capacity and new markets, skills and technologies.

In this policy discussion paper we have recommended a set of concrete policy actions intended to reestablish macroeconomic balance and promote productivity growth. We began this paper by observing that the state's supreme decision-making bodies have displayed a high degree of consensus regarding the urgent need for structural reform. We have not witnessed such consensus in some time. Unfortunately, this consensus does not yet extend to the need for comprehensive institutional reforms to strengthen economic governance. The government is still expects superficial changes such as a few bank mergers and equitizations to restore the economy to balance. This is unlikely to be enough.

We recognize that institutional change takes time. To get the process started, we have proposed a number of policy initiatives to reshape the incentives facing firms, central government and local government in Vietnam. There is a common denominator to the actions we recommend: their implementation would require that the government to deal authoritatively with entrenched interest groups whose support it regards as essential to regime survival. Throughout its history, the Vietnamese Communist Party has successfully repulsed external threats to Vietnam's independence and sovereignty. Its track-record in disciplining insiders who divert public resources for personal gain or abuse authority in other ways is decidedly mixed.

The situation Vietnam finds itself in is not unique. Generally speaking, those countries that have achieved a level of economic development similar to Vietnam's today have followed one of two trajectories. Most have been unable to overcome political opposition to reforms needed to transition to a new growth model. In these countries the forces that benefit from the status quo have proven sufficiently powerful to subvert reforms they perceive as threatening to their economic self-interest. As a result of their failure to overcome opposition from domestic economic and political elites, these countries have suffered from economic and social stagnation marked by social tension, polarization, and, in many cases, violence. Vietnam need look no further than Indonesia, Thailand, or the Philippines for examples of this phenomenon. Latin America offers many more case studies in economic stagnation.

Another—regrettably much smaller—group of countries succeeded in implementing reforms that disciplined entrenched interest groups. Two of the most recent examples of this success are the reforms undertaken in China in the late 1990s and in Brazil in the early years of this century. Under the leadership of Zhu Rongji, China imposed market discipline on its state-owned firms and forced sweeping reforms on the state-owned banking sector. China brought about these reforms despite the fact that, then as now, the state-economy was viewed by the Chinese leadership as a critical bulwark of their regime. Brazilian President Luiz Inacio Lula da Silva faced a different, but no less daunting political challenge. Elected thanks to overwhelming support by poor Brazilians who demanded sweeping social reforms, Lula nevertheless recognized that abandoning the austerity measures adopted by his predecessor to regain macroeconomic stability would have severe consequences for the Brazilian economy, and for the welfare of poor Brazilians in particular. The political courage and vision he displayed in resisting pressure from within his owned base of supporters was rewarded by the social progress he was able to deliver.

China and Brazil are of course very different from each other and both are very different from Vietnam, historically, culturally, and politically. Nevertheless, the economic achievements both countries have realized over the past decade, and the enhanced international influence and prestige they have earned as a result, were made possible by an ability to reorder deeply entrenched economic relationships.

Since late 2008, the government has assigned the MPI to prepare the plan for economic restructuring. But three years later, this plan is still on paper while the economy continues to decline and inflation continues to rise. This shows the inertia of the bureaucratic system, and equally important, reveals the power of the entrenched interest groups who benefit from maintaining the status quo. In addition, the fact that the cost of non-action is increasing, as evidenced by the ballooning of non-performing loans, increasing losses of state conglomerates, and eroding national prestige because of Vinashin's default.

Economic instability and slowdown, together with increasing disparity between rich and poor, will inevitably lead to negative social consequences. As a result, two foundations for security and strength of the nation - strong economy and stable society - have been undermined. Therefore, implementing structural reforms and changing the growth model to restore economic strength, and thereby regaining the confidence of citizens and businesses, are urgent tasks. There is very little disagreement, inside or outside of government, about what needs to be done to transition to a new model, just as there is very little original in the actions we propose here. The only unknown variable is: will the state act in time to discipline those who claim to act on its behalf?