

## VIETNAM DEVELOPMENT REPORT 2012: MARKET ECONOMY FOR A MIDDLE-INCOME VIETNAM

WORLD BANK VIETNAM. **Vietnam Development Report 2012: Market Economy for a Middle – income Vietnam.** 2012.

The theme of this Vietnam Development Report 2012 (VDR 2012) is market economy for a middle-income Vietnam. The report focuses on weak institutions, distorted incentives and inadequate information - labeled as the three "T's" of the market economy - as the explanation for Vietnam's current tribulations.

In 1986, Vietnam launched *Đổi Mới* - a homegrown, political and economic renewal campaign - that marked the beginning of its transition from a centrally planned economy to a socialist-oriented market economy. Between 1990 and 2010, Vietnam's economy has grown at an annual average rate of 7.3 percent, and the per capita income almost quintupled. Vietnam's transition from a centrally planned economy to a market economy and from an extremely poor country to a lower-middle-income country in less than 20 years - is now a case study in many development textbooks.

But Vietnam's other transition - to becoming an industrialized and modern economy - has barely begun. According to its recently approved Socio-Economic

Development Strategy for 2011–2020, Vietnam aspires to achieve a per capita income level of US\$3,000 (in current U.S. dollars) by 2020. This translates into a nearly 10 percent annual growth in per capita income over the next decade - requiring the country to replicate and sustain the economic success it achieved in the last 10 years. The Socio-Economic Development Strategy goes on to identify the country's key priorities to meet this ambitious target: stabilize the economy, build world-class infrastructure, create a skilled labor force, and strengthen market-based institutions.

Meeting these aspirations will not be easy. The country has experienced bouts of macroeconomic turbulence in recent years - double - digit inflation, depreciating currency, capital flight, and loss of international reserves - eroding investor confidence. Rapid growth has revealed new structural problems. The quality and sustainability of growth remain a source of concern, given the resource-intensive pattern of growth, high levels of pollution, lack of

diversification and value addition in exports, and the declining contribution of productivity to growth. Vietnam's competitiveness is under threat because power generation has not kept pace with demand, logistical costs and real estate prices have climbed, and skill shortages are becoming more widespread. As the country celebrates the Silver Jubilee of Đổi Mới, this VDR 2012 looks ahead at some of the pressing issues Vietnam needs to tackle to build a strong foundation for its quest to become an industrialized country by 2020. According to the recently approved five-year plan, three areas that need urgent attention are restructuring of the state-owned enterprises (SOEs), improving the effectiveness of public expenditure and stabilizing the financial sector. The analysis undertaken in this report focuses on first two of these priorities.

A reading of the various resolutions of the Party Congress and the Party Central Committee suggests that its leaders did not necessarily see a contradiction between the existence of a large state economic sector and a market-oriented economy. But in recent years, as the country appears to have veered toward a model of state capitalism in which the SEGs have enjoyed privileged access to factor inputs and a high level of operational autonomy, more questions have been raised about their usefulness. As a result, the National Assembly in one of its resolutions indicated that restructuring the SOEs will be a top priority of the government in the next

Socio-Economic Development Plan, spanning 2011 to 2015.

### ***A level playing field: Reforming the stated-owned sector***

Vietnam's state sector has become smaller but is still relatively large and inefficient. The importance of the state sector in the economy has steadily declined as the domestic private and foreign sectors have rapidly grown over the last two decades. Between 2000 and 2009, there was a sevenfold increase in the number of nonstate enterprises and over a fourfold increase in foreign enterprises, while the number of SOEs declined by 40 percent during the same period.

The decline in the importance of SOEs can also be seen through their steadily diminishing share in factor inputs. In 2000, SOEs accounted for nearly 68 percent of capital, 55 percent of fixed assets (such as land), 45 percent of bank credit, and 59 percent of the jobs in the enterprise sector (see figure 2.2).

SOEs use several times more capital to produce one unit of output than the industry average. In 2000, the average ratio of turnover to capital (a proxy for the productivity of capital) in SOEs was 1.6 compared to 8.8 for the enterprise sector as a whole. This implies that an average SOE required nearly nine units of capital to produce one unit of output (turnover) compared to the industry average. By 2009 the average ratio of turnover to capital for the SOEs fell to 1.1 while it increased to 21.0 for the industry (see figure 2.10). SOEs are also

less efficient in their use of fixed assets such as land and machinery. Along with being operationally less efficient, SOEs are also found to be financially less prudent.

***Ten reasons for reforming the SOEs:***

- SOEs are less efficient than nonstate and foreign firms;
- Equitization has been good for SOEs;
- Industrial policy can be carried out without the presence of a large SOE sector;
- SOEs have become too big to fail and too big to save;
- The role of the state in the economy has been changing and an inefficient and weak SOE sector gives bad name to the state;
- A large SOE sector is the source of an uneven playing field;
- SOEs have been slow to embrace modern corporate governance and transparency.
- The corporate framework for SOEs remain weak and incomplete;
- There is lack of vision and clarity regarding the role of SOEs in development;
- The SOE reforms can be leveraged to develop a healthier private sector.

***Remedies: The DREAM framework***

Since state ownership is not just an economic issue but also a political choice, major restructuring of SOEs is unlikely without strong political support. Any restructuring plan should be firmly based on a clear consensus on the role of

the state in the economy and the desirable institutional arrangement to achieve that goal. It would have to involve a number of measures including what we call a “DREAM” framework—Disclose, Regulate, Equitize, Account(able), and Monitor—a description of which follows.

- **Disclose.** A new information disclosure policy that requires SOEs, starting with the SEGs, to report their financial stakes in all their subsidiaries and affiliated members and to timely and accurately disclose their annual reports, audit reports, and earning statements through print and electronic media or the internet.
- **Regulate.** A modern corporate governance system that separates state ownership rights from regulatory functions and implements an objective and transparent mechanism for the selection of Chief Executive Officers (CEOs) and board members. There is also a need to put an end to SOEs’ privilege access to factor inputs and to value land at market price for all government and corporate transactions.
- **Equitize.** There is no more certain way to improve the internal functioning of SOEs than to subject them to the discipline of the market and oversight of the government. This would require accelerating the equitization of SOEs, including selling up to 49 percent of charter capital of the SEG parent company.
- **Accountable.** Holding the SOEs accountable for their actions,

including a reward for greater transparency and timely reporting of data and information and a penalty for noncompliance.

- Monitor. Overhauling the monitoring system with a provision for mandatory, independent annual audits and timely submission of financial data to the relevant ministries and agencies.

### ***Doing more for less: Improving the effectiveness of public investment***

Public investment is being viewed as unaffordable, inefficient and, therefore, unsustainable

Vietnam's successful growth story has been driven primarily by rapid factor accumulation—physical and human capital—with productivity growth playing a secondary role. Equally important has been Vietnam's ability to translate the high level of investment into basic infrastructure services, making the development process extraordinarily inclusive. But Vietnam's investment regime, especially its public investment component, is being increasingly viewed in the last few years as unaffordable, inefficient and, therefore, unsustainable.

There are three commonly cited concerns against the current investment regime:

- Affordability: Because the strategy has relied almost exclusively on raising the “level” of investment rather than improving its “efficiency,” the amount of financial resources required to meet Vietnam's future

infrastructure needs has reached an unaffordable level.

- Impact: Despite huge investment, Vietnam's infrastructure bottleneck remains a significant constraint to future growth. Along with macroeconomic stability, other factors cited by investors as some of the main constraints to operating in Vietnam are lack of adequate and reliable electricity, congestion on the roads and at seaports and airports, and poor quality of infrastructure in industrial areas.
- Link to growth: A strong positive correlation between investment rate and growth over a sustained period is one of the well-known stylized facts in the literature on growth. This relationship appears to have weakened in Vietnam in recent years.

Vietnam's existing public investment regime can be best described as one in which the parts do not add up to the whole. In Vietnam's highly decentralized administrative structure, developing infrastructure is the responsibility of local governments. This has been done without connecting the infrastructure to the strategic priorities of the country (such as improving competitiveness) or using the market as a means of allocating resources. Consequently, each province has worked in isolation to create fragmented, suboptimal infrastructure projects, many of which have become idle.

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If all the approved projects in Vietnam were built, the country would have one of the highest numbers of deep-sea ports, international airports and industrial parks in the world relative to the size of its economy.

The VDR 2012 uses three case studies - one on industrial parks and two from the port sector - to identify the problems that have contributed to an inefficient public investment regime and what can be done to address them.

These case studies were chosen because they illustrate the generic nature of the problem facing many infrastructure projects in Vietnam, namely (a) use of nonmarket means to allocate resources, especially land; (b) poorly specified and enforced property rights; (c) weak coordination among governments, line agencies, and state-owned enterprises (SOEs); (d) lack of impartial regulating agencies; and (e) weak implementation of existing laws. These case studies also reflect the problems associated at different stages of the public investment

cycle—strategic planning, screening, appraisal, selection, implementation, and evaluation—and discusses potential ways to address them.

The report proposes four ideas to strengthen the effectiveness of public investment:

- Clarifying and strengthening property rights to force competition for land into the market and out of the political arena: Land is the most important asset in Vietnam. Because land-use rights are administrative in nature, the solution to the problem is sought by the government through administrative means rather than through market mechanisms.
- Creating impartial agencies in key sectors to regulate infrastructure development: A second cause of institutional fragmentation is the absence of clear boundaries between regulators and market participants, central government ministries and local authorities, and even among units of one agency. Under these conditions, the rules of the game are unclear and unenforceable.
- Creating a mechanism to share revenues among local authorities to encourage development of regional and national infrastructure: Many local governments are keen to build infrastructure since it becomes a source of a future revenue stream.
- Strengthening the public investment management cycle: A more rigorous public investment management (PIM) cycle, synchronized with the budget process, will help Vietnam avoid

approving inefficient and cost-ineffective public investment projects. In Vietnam, the stages that need strengthening seem to be the initial stages of the PIM cycle, namely, strategic guidance and screening, formal project appraisal, appraisal review, and project selection and budgeting. Projects or programs that meet the first screening test should be subject to appraisal of their viability, which requires a feasibility analysis.

### ***Feeding a market economy: The role of information and transparency***

Vietnam has come a long way in the last 15 years in promoting the public availability of economic data and information. However, progress has been slower than expected due to the absence of a generalized law on access to information. The impact of weak transparency has been costly for Vietnam's development. A 2011 study of corruption in land management identified lack of transparency as one of the core drivers of corruption in Vietnam, a finding that is borne out by the data (see figure 4.2).

Given its current low level of transparency, the marginal benefit to the Vietnamese economy from increased transparency can be huge. The amount of fiscal, financial, and economic information that the Government of Vietnam currently collects and releases to the public is inadequate for the smooth functioning of a middle-income country. Even basic statistics such as sectoral composition of state spending,

off-budget expenditure, international reserves, and balance sheets of state-owned enterprises are either not collected, not disclosed, or disclosed only after a considerable lag. But market participants such as equity investors, exporters, importers, foreign exchange dealers, bondholders, banks, enterprises, and even farmers need information on almost a daily basis to operate in a market economy. And if such information is not available, market participants resort to speculation, rumors, and even unscrupulous means to obtain information. That is why it has been argued that one of the sources of the current economic turbulence in Vietnam can be traced to lack of credible and timely availability of economic data and poor communication of policy changes to the market.

### ***Information is the lifeblood of markets***

Public disclosure of information can mitigate market inefficiencies. Transparency reduces market uncertainty about policy makers' preferences, resulting in more predictable monetary policy and more efficient financial markets. Transparency and accountability can also play a big role in reducing macroeconomic instability. Cross-country evidence on the benefits of fiscal transparency is growing. More transparent countries also seem to be more competitive in the global market.

### ***Fiscal transparency in Vietnam***

Fiscal transparency plays a particularly critical role in Vietnam's economic transition, given the public sector's

relatively big role in the economy. Fiscal management in Vietnam has become more complex over time.

The government has made a good start in establishing the legal and institutional framework for fiscal transparency. Information available on the State Budget in the public domain has improved. Vietnam's State Budget has a detailed classification structure, but it has yet to systematically publish information using the Government Finance Statistics standards. The budget released to the public is presented at a relatively aggregate level by functional and administrative categories, not economic categories, although it is broken down by central and subnational governments. Budget execution reports provide detailed reports on spending across economic, functional, and program categories. The absence of a clear connection between budgeting and accounting data makes it difficult to assess the execution of budget policies in detail. However, with increased decentralization in recent years, the transparency of intergovernmental fiscal relations has gradually been strengthened.

Greater compliance with fiscal transparency principles could further improve fiscal management and analysis. Some important management

issues that could be better addressed by applying the principles of the fiscal transparency code:

- The separation of the capital and recurrent budgets makes it difficult to estimate medium term recurrent implications of capital spending and to establish a sound long-term balance between the creation of public assets and their operations and maintenance.
- A number of off-budget expenditures are not accounted for in the aggregate budget or deficit calculations.
- With regard to assessment of broader fiscal risks, although there are detailed provisions on financial reporting by state enterprises, the capacity to analyze this information and inform government responses is still limited.
- As one would expect with such high levels of decentralization, the quality of reporting is mixed.

The government is implementing public financial management reforms to address these challenges and to further improve the comprehensiveness, reliability, and timeliness of fiscal information. Another area that needs improvement is strengthening the capacity of the oversight institutions.