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TAKING STOCK

AN UPDATE ON VIETNAM'S RECENT ECONOMIC DEVELOPMENTS

Special Focus:
Improving Efficiency and Equity of Public Spending

December 2017

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This report was prepared by a team comprised of Dinh Tuan Viet, Sebastian Eckardt, Vu Hoang Quyen and Obert Pimhidzai under the general guidance of Ousmane Dionne (Country Director) and Deepak Mishra (MFM Practice Manager). Valuable comments are provided by Alwaleed Fareed Alatabani, Keiko Inoue, Annette I. De Kleine Feige, Ekaterine T. Vashakmadze and Congyan Tan. Administrative assistance was provided by Le Khanh Linh.

ACRONYMS AND ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
CDS	Credit Default Swap
CIT	Corporate Income Tax
CPI	Consumer Price Index
EAP	East Asia and Pacific
FDI	Foreign Direct Investment
FPT	Corporation for Financing and Promoting Technology
FTA	Free Trade Agreement
GDC	General Department of Customs
GDP	Gross Domestic Product
GSO	General Statistics Office
ILO	International Labor Organization
IMF	International Monetary Fund
MOF	Ministry of Finance
MOIT	Ministry of Industry and Trade
MPI	Ministry of Planning and Investment
NPL	Non-Performing Loans
NTM	Non-Tariff Measure
ODA	Official Development Assistance
OOG	Office of Government
PIM	Public Investment Management
PIT	Personal Income Tax
PMI	Purchasing Manager Index
PPP	Purchasing Power Parity
SBV	State Bank of Vietnam
SOCBs	State-Owned Commercial Banks
SOEs	State-Owned Enterprises
TPP	Trans Pacific Partnership Agreement
VAMC	Vietnam Asset Management Company
VAT	Value Added Tax
WB	World Bank
WTO	World Trade Organization

Vietnam's Fiscal Year: January 1 to December 31
Official Exchange Rate: US$ = VND 22,439

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OVERVIEW

Recent Economic Developments

As anticipated in the July Taking Stock Report, the global economy continued to strengthen in 2017. Economic activity has picked up in major advanced and emerging economies, trade is rebounding, financing conditions remain favorable, and commodity prices have strengthened, albeit at a gradual pace. Global GDP growth is expected to accelerate to about 3 percent in 2017. Amidst a generally favorable global context, developing East Asia and the Pacific continued to perform well in 2017, with GDP growth in the region projected to pick up to 6.4 percent this year, bolstered by resilient domestic demand and accelerating exports, which benefited from improved global demand.

Vietnam's economy also gathered momentum in 2017, reflecting strong domestic demand, robust export-oriented manufacturing, and a gradual rebound of agriculture. Real GDP expanded by 6.4 percent (y/y) during the first nine months of the year. Domestic demand and especially private consumption remained buoyant, fueled by low inflation and rising real wages. At the same time, the recovery in external demand helped Vietnam's export-oriented manufacturing and agricultural sectors. On the production side, manufacturing growth reached 12.8 percent during the first nine months of the year, offsetting a further contraction of oil production. Agriculture also continued to recover from last year's drought, expanding by 2.8 percent during first three quarters. Reflecting robust domestic consumption as well as strong performance of the tourism sector, the services sector expanded 7.3 percent.

Amidst muted price pressures, monetary and credit policies continued to balance stability and growth objectives. Headline CPI remains moderate at 3.0 percent (y/y) with stable underlying core inflation of 1.3 percent (y/y) in October. Taking advantage of subdued inflation, the State Bank of Vietnam in July cut its rediscount rate and refinancing rate by 25 basis points to 4.25 and 6.25 percent respectively. Credit growth remained elevated at around 18.5 percent (y/y) in October 2017. Such rapid credit expansion, especially if driven by administrative targets as opposed to economic fundamentals, may induce excessive risk taking and poor credit allocation and lead to associated deterioration in asset quality. Meanwhile, important steps have been taken to advance nonperforming loan (NPL) resolution, including adoption of Resolution 42 in June 2017. However, despite progress, the stock of unresolved NPLs remains sizable and capital buffers continue to be relatively thin in some banks compared to international standard, especially against the backdrop of sustained rapid credit growth.

Vietnam's balance of payments remains in surplus, underpinned by a trade surplus, resilient remittances, and large FDI inflows. Improved external demand helped lift Vietnam's already strong export performance. Underpinned by broad-based increases in both primary agricultural and manufacturing exports, export turnover reached US$174.5 billion (about 86 percent of GDP) in the first 10 months of 2017, up 21.3 percent from the same period last year. Import growth also rebounded in 2017, driven by a surge in imports of capital and intermediate goods, which in turn reflect buoyant investment and high import content, especially of Vietnam's manufacturing exports. The current account posted a surplus of about 1.5 percent of GDP (annualized) during the first half of the year, slightly shallower than last year. The capital account also remained in surplus, owing in large part to significant FDI inflows as well as inflows of official financing.

Bolstered by a robust foreign exchange inflows, the exchange rate has been stable and foreign reserves continue to accumulate. The SBV has kept the nominal U.S. dollar-dong exchange rate within a narrow trading band, with devaluation of the reference rate of 1.4 percent during the first 10 or 11 months of the year. This helped contain real effective exchange rate appreciation of the dong and allowed the SBV to continue to shore up foreign reserves of about US$5 billion during the first three quarters, bringing gross international reserves to around US$42 billion at the end of September, equal to just below three months of imports.

Fiscal consolidation is underway, but the quality and sustainability of the adjustment could be improved. The budget deficit narrowed significantly to less than 2 percent of GDP (annualized) during the first three quarters of the year, containing public debt accumulation and ensuring compliance with 65 percent of the GDP statutory debt limit. On the revenue side, deficit reduction was aided by buoyant revenue performance. On the spending side, the adjustment has fallen disproportionately on public investment, which declined to 16 percent of total spending in the first nine months of 2017, compared with an average of 25 percent during 2012–16. While effective in the short term, this approach is not necessarily sustainable over time, as Vietnam needs significant infrastructure investment to support future growth. Meanwhile, low inflation and ample liquidity have contributed to favorable conditions in the domestic bond markets with bond yields at record lows, allowing the government to meet its financing needs while extending the maturity and reducing the cost of domestic debt.

Structural reforms to enhance the competitiveness and productivity of Vietnam's economy remain a central priority. Vietnam's rank in the World Bank's Doing Business improved markedly to 68th in 2017 (from 91st in 2015) and to 55th in the 2017 World Economic Forum's competitiveness index (from 60th in 2016), reflecting improvements in Vietnam's overall business environment and competitiveness. Continuing reforms to improve regulatory quality and to ensure consistent, efficient, and fair enforcement is crucial for Vietnam to create an enabling environment for private sector investment, economic growth, and job creation. While progress has been slower than expected, reforms of the still large state-owned enterprise (SOE) sector continue, with planned divestments from large profitable state companies and further steps to strengthen SOE governance and transparency.

Vietnam's dynamic economy continues to create jobs and rapid real wage growth, leading to broad-based welfare gains and poverty reduction. Real disposable household incomes are benefiting from low inflation, an expanding wage sector, and a robust nominal wage growth. Over the last three years, Vietnam added 1.6 million new manufacturing jobs (net), especially in export-oriented sectors. Labor demand in construction, retail, and hospitality sectors was also buoyant, with these sectors together adding another 700,000 jobs. Strong job creation helped reinvigorate structural transformation and reallocation of labor to higher-productivity activities, thereby boosting aggregate labor productivity. Labor demand also contributed to rapid wage growth, with average nominal wages increased by 8 percent on average between Q1 2014 and Q1 2017. As a result, poverty continued to decline, with extreme poverty now estimated to have fallen to less than 2 percent, using the international poverty line (US$1.90 per day).

Medium-term outlook, risks, and policy implications

Vietnam's near-term outlook has improved since the July Taking Stock report. Aided by favorable external and domestic conditions, GDP growth is now projected to accelerate to 6.7 percent in 2017 (compared to 6.3 percent forecast in July). Over the medium term, growth is projected to stabilize at around 6.5 percent, as the impact of some cyclical and one-off factors that propelled growth this year dissipates. Inflation is projected to remain moderate but to pick up somewhat over the medium term, as rapid credit and wage growth lift core inflation.

Externally, Vietnam is projected to retain a current account surplus, albeit at a lower level due a sustained recovery in imports. This year's fiscal deficit is on track to come in at around 4 percent below the government's target of 4.8 percent of GDP, but following the sharp adjustment this year, the pace of fiscal consolidation is expected to slow over the medium term.

Key macroeconomic indicators

	2015	2016e	2017e	2018f	2019f
GDP growth (%)	6.7	6.2	6.7	6.5	6.5
Consumer price index (annual average, %)	0.6	2.7	3.5	4.0	4.0
Current account balance (% of GDP)	0.1	4.1	2.5	2.0	1.6
Fiscal balance (% of GDP, GFS definition)	-6.2	-6.3	-4.0	-4.2	-4.1
Public and publicly guaranteed debt (% of GDP, GFS definition)	57.2	60.0	59.6	60.7	61.3
Public and publicly guaranteed debt (% GDP, MOF definition)	61.0	63.6	62.6	63.7	64.2

Source: GSO, MOF, SBV, IMF, and WB.

Despite the stronger near-term outlook, risks remain elevated. On the upside, a sustained recovery in global demand and resultantly stronger manufacturing growth could lift GDP growth above the projected baseline. On the downside, a slow-down in structural reforms could weaken the ongoing recovery and weigh on Vietnam's medium term potential growth, especially given weaker labor force, productivity and investment growth. Fiscal risks also remain pronounced, particularly with regard to the quality and pace of fiscal consolidation, which could undermine investment in infrastructure and human capital needed for future growth. Risks in the banking sector—while somewhat more muted—pertain to a combination of relatively thin capital buffers, unresolved NPLs, and rapid credit growth, which could result in renewed financial instability, especially in case of economic shocks. Externally, strong trade and investment links expose Vietnam's economy to risks associated with a potential rise in protectionism and a possible weakening of external demand in case the ongoing global recovery loses momentum. Vietnam is also exposed to heightened geopolitical tension on the Korean peninsula, given its significant FDI and trade relationship with the Republic of Korea. Finally, tighter global financial conditions could ignite balance-of-payment pressures, especially given the lack of full exchange rate flexibility and relatively low external reserve coverage.

These risks call for a continuing focus on enhancing macroeconomic resilience and structural reforms to lift potential growth over the medium term. Macroeconomic resilience could be strengthened by further enhancing exchange rate flexibility, a further buildup of foreign reserves, fiscal consolidation, and responsive monetary and macroprudential policies that moderate credit expansion and bolster capital buffers in the banking sector. On the fiscal front, there continues to be a need for deeper revenue and expenditure reforms that lead to real efficiency gains, including broadening tax bases and strengthening tax administration, right-sizing the public administration, and higher value for money in public investment and procurement of goods and services (see special topic note). Steps to solidify macroeconomic stability need to be accompanied by progress on structural reforms to lift productivity and potential growth, including steps to reform the SOE sector, improve the regulatory environment, and enhance factor markets, including for land and capital.

Special Topic

With public debt close to the statutory limit of 65 percent of GDP, Vietnam's government faces tight budget constraints for several years to come. The Government has already responded by curtailing expenditure growth, especially of investment and other discretionary spending. These measures, while effective in the short term, are not necessarily sustainable over time, as they may harm necessary investment in infrastructure and human capital. This special topic note looks at more fundamental expenditure reforms in key public services to identify opportunities for constraining expenditure growth through improvements in productivity while at the same time mantaining equal access to key public services, especially for the poor and near poor at risk of losing out from expenditure reforms.

There is significant scope to achieve efficiency gains in recurrent and investment spending:

- *Public sector employment, compensation and deployment:* Key policy options in the area of public employment and wage bill management include: (i) developing medium-term recruitment plans to balance staffing demand and supply better; (ii) granting administrative and service units more autonomy in staff recruitment and deployment consistent with existing norms and regulations; and (iii) jointly developing a recording and reporting system to collect data on employment, compensation and the wage bill and its financing at both central and local levels.

- *Value for money procurement*: Key actions in the area of procurement include strengthening the competitiveness and transparency of the bidding process, ensuring the independence of complaints handling and resolving conflicting instructions in contract implementation (in light of the Procurement Law 2015).

- *Public Investment prioritization and efficiency:* Greater selectivity and stricter selection mechanisms could contribute to reducing the existing high levels of fragmentation of capital spending across a large number of projects. Quality and timeliness of reporting on public investment could also be improved through developing a centralized monitoring system and database on investment projects. One immediate step could be to receive information on project execution and commitment controls from the Treasury and Budget Management Information System (TABMIS).

In addition, there are also opportunities to enhance service delivery and spending efficiency through reallocation of resources within several sectors:

- *In the education sector:* (a) Review teachers working hours and consider increasing them to an internationally comparable level in association with education and curricula reforms (average teaching time per teacher in general education is the lowest in ASEAN and is 25 percent below the ASEAN average for primary schools); (b) Provide financial incentives for schools to rationalize their work force; and (c) Simplify salaries and allowances schemes for teachers to reduce over reliance on seniority as a pay factor.

- *In the health sector:* (a) Reduce drug prices through careful implementation of nationally centralized procurement and price negotiations on pharmaceuticals[1]; (b) Strengthen capacity in independent supervision and cost-effectiveness analysis in the use of health services; (c) Strengthen investment in health preventative

[1] Experience from pharmaceutical procurement reform in Eastern Europe suggests that potential savings of more than 30 percent could be made in total pharmaceutical spending.

care and health care delivery at grassroots level; and (d) Gradually move from the fee-for-service payment system to other health financing methods (including capitation and case based payment).

- *In the transport sector:* (a) Avoid construction cost overrun through accelerating land acquisition and ensuring sufficient funds allocation for approved projects, while promoting more competition in bidding for road construction contracts and increasing the size of each contract; (b) Reduce road maintenance unit costs (currently 3 times higher than in Laos, 1.5 times higher than in Cambodia and closer to unit maintenance unit costs in OECD countries), which is critical particularly when the maintenance budget can only meet approximately 50 percent of estimated needs at the moment.

- *In the agriculture sector:* (a) Increase water productivity (the rice output per unit of irrigation water in Vietnam is only half that of China and one-third that of India) and consider measures to charge irrigation fees to improve water productivity; and (b) Promote other functions such as agricultural services, while continue spending on irrigation.

- *In the science and technology area:* (a) Gradually change from budget allocation for regular operations to competitive state contracting, ordering of services and block grant budgeting for the delivery of scientific and technological mandates; (b) Strengthen the set of performance indicators linked to the performance and quality of service delivery applied for S&T organizations; (c) Revise regulatory framework to be enabling for public S&T organizations to fully exercise their right to autonomy and organizational responsibility; and (d) Adopt a roadmap to gradually phase out state budget recurrent expenditure in S&T organizations.

While promoting spending efficiency, targeted spending on pro-poor services and infrastructure should be maintained. There is robust evidence that shows the pro-poor benefits of Vietnam's investment in ensuring equal access to key public services, namely health, education and rural infrastructure. Reduced budget financing to pro-poor services therefore entails a risk of widening inequities in access to basic services. Vietnam is actively pursuing a set of interrelated policies, including socialization, designed simultaneously to improve the performance of government service delivery, increase citizen choice, reduce the financial burden upon the state. The overall goal is to gradually rationalize the role of the state in the provision of public goods. While these reforms can enhance incentives for efficiency gains both for service providers and service users, it is crucial to assess and -if needed- mitigate the potential adverse distributional impacts of these policies on the poor and vulnerable.

SECTION 1

RECENT ECONOMIC DEVELOPMENTS

External Economic Environment

1.1. The global economy continued to strengthen in 2017. Manufacturing activity has picked up, goods trade is rebounding, financing conditions remain favorable, and commodity prices have strengthened. Global GDP growth is expected to accelerate to around 3 percent in 2017. The pickup in global activity reflects a recovery in advanced economies and improving conditions in commodity exporting emerging markets and developing economies (EMDEs). Among advanced economies, growth rebounded in the United States as consumer spending recovered amid a tightening labor market. Growth in the Euro area has also strengthened more than expected, supported by a broad-based improvement in activity across countries, with increases in household spending and gross fixed capital formation. In Japan, a pickup in private consumption and robust private investment helped boost growth. Among EMDEs, in Brazil and the Russian Federation, growth has rebounded following deep recessions, while growth has remained stable in China. Global merchandise trade growth, which began to recover in mid-2016 after two years of pronounced weakness, has remained robust in 2017, expanding by about 4 percent in 2017. The recovery in global trade was broad-based, with export growth trending upward in advanced economies and remaining firm in EMDEs. The global Purchasing Managers' Index (MPI) remained firmly expansionary in Q3 2017, suggesting continued momentum in Q4 2017.

Figure 1.1: Global GDP growth (%)

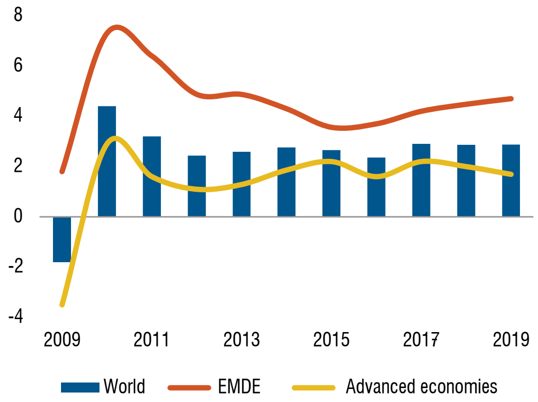
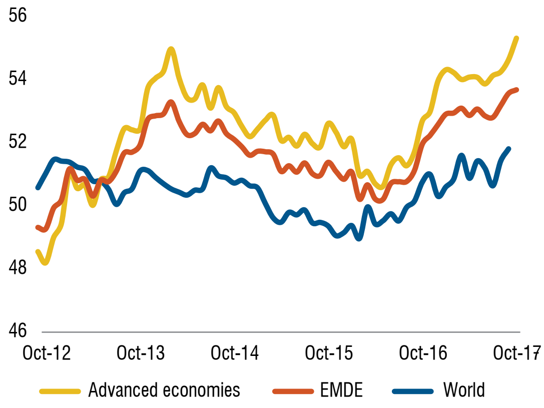


Figure 1.2: Manufacturing PMI



Source: World Bank, East Asia And Pacific Economic Update October 2017.

1.2. Developing East Asia and the Pacific also continued to perform well in the first half of 2017. The region grew more rapidly than almost all other developing regions. Overall, GDP growth for the region is projected to accelerate to slightly 6.4 percent in 2017. China's GDP growth has been stronger than expected, remaining flat at 6.7 percent. Outside China, growth remains robust supported by a combination of resilient domestic demand, a rebound in exports and stronger activity in commodity exporting economies.

Table 1.1: East Asia Pacific GDP Growth Forecast (%)

			Forecast		
	2015	2016	2017	2018	2019
Developing EAP	6.5	6.3	6.4	6.2	6.1
China	6.9	6.7	6.7	6.4	6.3
Developing EAP excl. China	4.9	4.9	5.1	5.2	5.2
Indonesia	4.9	5.0	5.1	5.3	5.3
Malaysia	5.0	4.2	5.2	5.0	4.8
Philippines	6.1	6.9	6.6	6.7	6.7
Thailand	2.9	3.2	3.5	3.6	3.5
Vietnam	6.7	6.2	6.7	6.5	6.5
Cambodia	7.0	7.0	6.8	6.9	6.7
Lao PDR	7.4	7.0	6.7	6.6	6.9
Myanmar	7.0	5.9	6.4	6.7	6.9
Assumptions about the external environment					
World	2.7	2.4	2.9	2.9	2.9
Advanced economies	2.2	1.6	2.2	2.0	1.6
Emerging and developing economies	3.6	3.7	4.2	4.5	4.7

Source: World Bank, Global Economic Prospects 2018. Upcoming.

1.3. Risks to the global and regional growth outlook remains more balanced but still tilted to the downside. On the upside, stronger-than-expected growth in the largest advanced economies and EMDEs—reflecting, for instance, more pronounced investment-led recovery in the United States and the Euro Area, or a sharper recovery in large commodity exporters—could have substantial positive international spillovers in the short term. Key downside risks include an increase in trade protectionism, a disorderly tightening of global financial conditions, which could affect vulnerable emerging markets, and the potential for volatility derived from political and geopolitical uncertainties. A disruption of global trade and capital flows resulting from an inward shift in policies in some advanced economies could disrupt global value chains, deter investment, reduce productivity, and lower global growth.

Recent Economic Developments in Vietnam

Aided by favorable external and domestic conditions, Vietnam's economy gathered momentum

1.4. Vietnam's economy gathered further momentum in 2017 reflecting strong domestic demand, robust export-oriented manufacturing, and a gradual rebound of agriculture. After a moderation during the first quarter, growth started to rebound to 6.2 percent (y/y) in the second quarter and accelerate to 7.5 percent in the third quarter, bringing y/y growth to 6.4 percent for the first nine months of the year. Low inflation and strengthening consumer confidence supported an uptick in private consumption while investment was bolstered by robust foreign direct investment and an expansion of credit growth. At the same time, the recovery in external demand helped Vietnam's export oriented manufacturing and agricultural sectors with exports up 21 percent in value term during the first three quarters of the year.

Figure 1.3: Quarterly GDP growth (%, y/y)

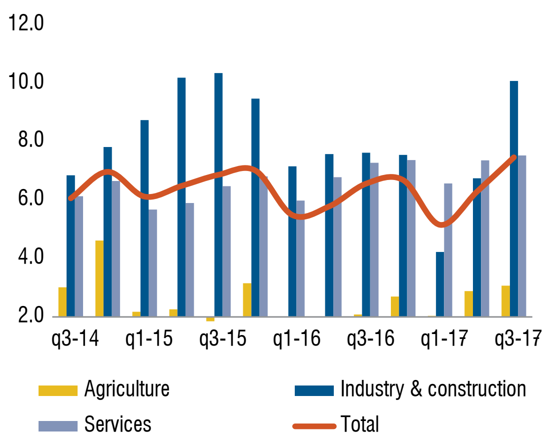
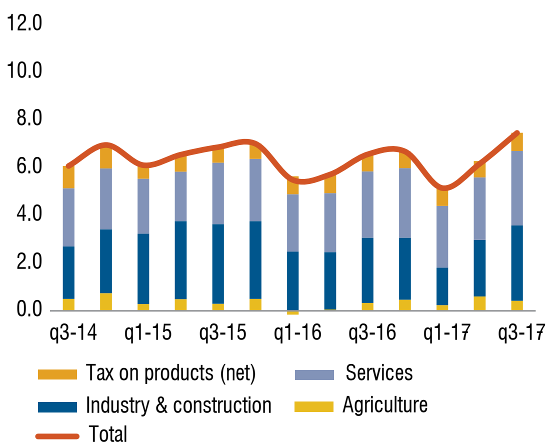


Figure 1.4: Contribution to GDP growth (pp)



Source: GSO.

1.5. On the production side, growth was led by a pick-up in manufacturing. Vietnam's industrial production expanded by 8.6 percent (y/y) during the first ten months of 2017– much higher than the same period last year (7.3 percent). Strong performance in manufacturing sector, which grew 13.6 percent, compensated the decline in mining sector which is down 7.4 percent y/y. Manufacturing output recovered from one-off factors such as the Samsung recall and a decline in steel production by Formosa. The headline Vietnam Manufacturing Purchasing Managers' Index (PMI) rose to 53.3 in September from 51.8 in August (the strongest performance since March 2017), marking the 22 consecutive months of strengthening and signaling sustained improvement in business conditions.

1.6. The agricultural sector also rebounded gradually from the severe drought last year. Agricultural output expanded by 2.8 percent (y/y) in the first nine months 2017 compared to 0.6 percent during the same time of 2016. The fishery sub-sector increased 5.4 percent while agriculture rebounded more gradually to 1.96 percent.

1.7. Activity in the service sector also strengthened on account of strong retail growth and tourism sector. Low inflation and strengthening consumer confidence supported an uptick in private consumption where retail sales increased 10.7 percent (y/y) in nominal terms (9.4 percent in real term) during the period from January to October 2017. Tourist entries also increased to 10.5 million, with the sector expanding at 28 percent during the first three quarters of the year.

Figure 1.5: Retail sales growth (%, y/y)

Souce: GSO.

1.8. The economic recovery over the past three years was associated with a pick-up in job creation, especially in manufacturing. Over the past three years Vietnam added 1.6 million new manufacturing jobs (net) – a significant pick up in manufacturing job creation. Within manufacturing, jobs were primarily created in export oriented sectors i.e. textiles and electronics. Labor demand in construction, retail and hospitality sectors was also buoyant with these sectors together adding another 700,000 jobs. These four sectors together accounted for 80 percent of all jobs created, with the manufacturing sector contributing to more than half of all new jobs between 2014 and 2016. They absorbed labor from agriculture, contributing to a net out flow of labor from the sector, reinvigorating structural transformation and contributing re-allocation of labor to higher productivity activities.

Figure 1.6: Net employment creation by sector, 2010-2016

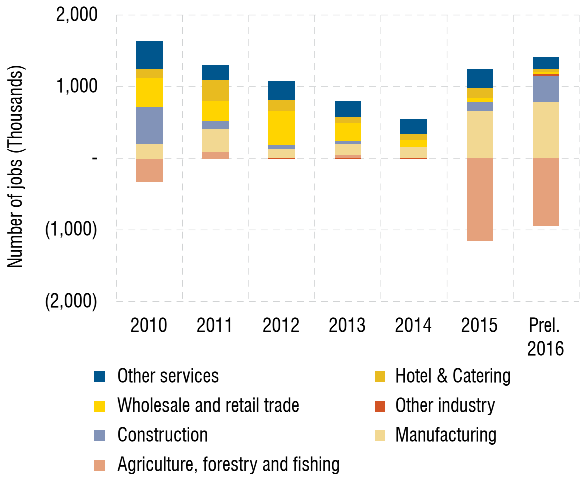
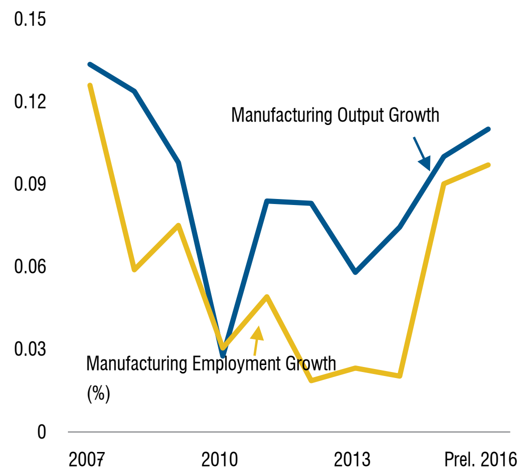


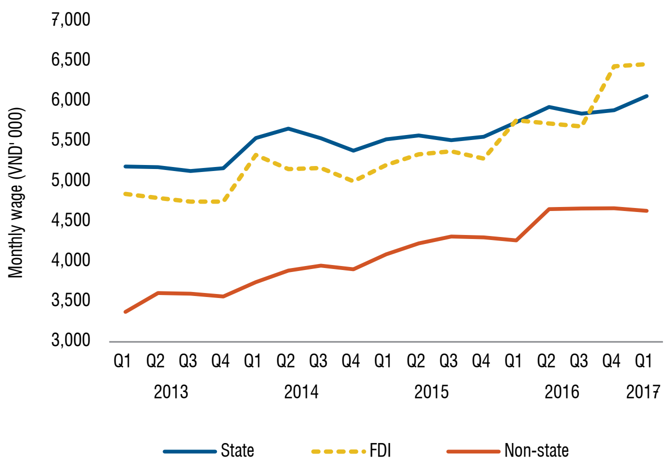
Figure 1.7: Manufacturing Output and Employment Growth (%)



Source: GSO

1.9. Strong labor demand also lifted real wages. Average nominal wages increased by 8 percent on average between Q1 2014 and Q1 2017. Average monthly nominal wages in the domestic and FDI private sector grew rapidly expanding at an average rate of 8.4 percent. Meanwhile wages in the public sector grew only by an average 3 percent, reflecting the government's efforts in reining in the public-sector wage bill. Wages grew in all sectors but expanded fastest in industry where demand for labor was strongest. High wage growth in both the domestic and FDI sector and across all industries, underpinned household income growth for all groups, agricultural or non-agricultural.

Figure 1.8: Buoyant Wage Growth Nominal Wage Growth (seasonally adjusted)



Source: Authors calculations based on GSO Labor Force Survey Quarterly Reports.

1.10. Vietnam's model of export led growth in labor intensive sectors paid off in reducing poverty. An expanding wage sector and growth in labor incomes is the main driver of poverty reduction in Vietnam. Previous estimates showed that growth in wage income explained more than 80 percent of poverty reduction in Vietnam during 2010-14. Poverty is thus expected to have declined much more since 2014, given the subsequent high growth in wages across all sectors and a net shift of labor into the more productive non-agriculture sectors. The reduction in poverty is also expected to be broad based because wage growth was high across all sectors. Resultantly, poverty continued to decline with extreme poverty now estimated to have fallen to less than 2 percent, using the international poverty line (US$1.9 per day).

Figure 1.9: Real and Potential GDP Growth (%)

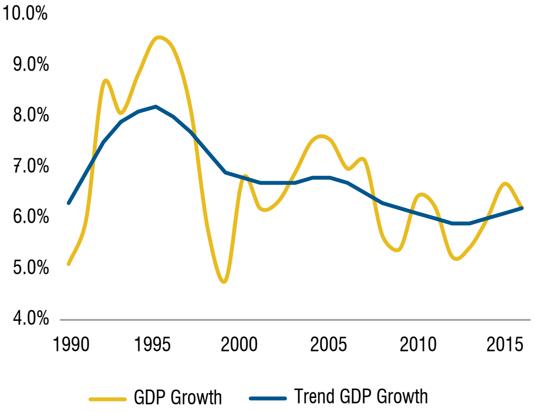
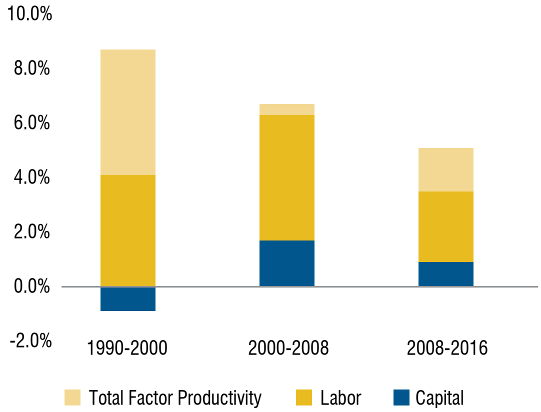


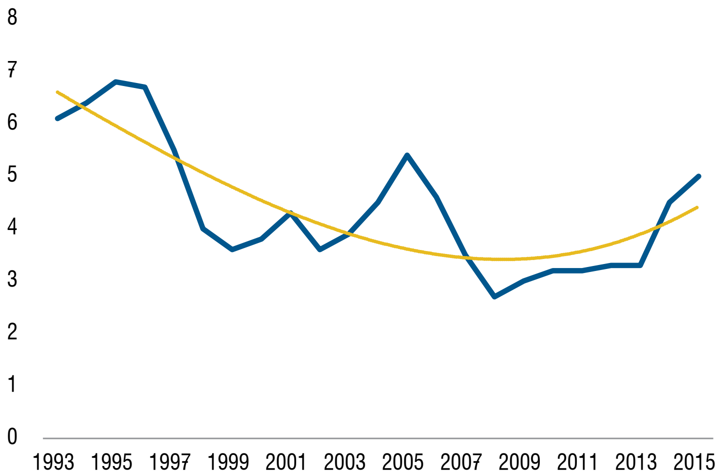
Figure 1.10: Contributions to GDP Growth



Source: Authors calculations based on GSO data.

1.11. While productivity growth appears to have recovered somewhat, weaker labor force and investment growth weigh on medium-term potential growth. Despite the cyclical recovery, trend growth remains below its long-term trend and perhaps more importantly- it is too low to achieve Vietnam's own ambitions of achieving upper middle income status by 2035. Subdued potential growth reflects the combined effect of deceleration in productivity, labor force and investment growth, albeit to different degrees. Productivity growth has recovered somewhat since the global financial crisis but is still relatively weak, reflecting persistent inefficiencies in the allocation of resources in the economy. Demographic trends are also starting to weigh on potential output. While the working age population and labor force will continue to expand for another two decades, the rate of increase has slowed to about 1 percent per annum - markedly lower than average 2.5 percent expansion during 1990 to 2013.

Figure 1.11: Labor Productivity Growth (Output per worker, 3-year moving average)



Source: Bank staff estimates.

1.12. Investment growth is recovering gradually with rebalancing towards private investment. In the first 9M of 2017, total investment expanded by 12.1 percent (y/y) in nominal terms. Investment is driven by robust FDI disbursement which rose 13.5 percent (y/y), accounting for nearly a quarter of total investment outlays of Vietnam. In addition, the private domestic investment accelerated by 16 percent, supported by positive sentiment of domestic investors and expansion banking credit. In contrast, government investment spending has slowed markedly due to fiscal constraints. At around 26 percent Vietnam's gross capital formation remains below its long-term trend and below domestic savings. While this correction from excessive investment rates prior the 2008 global financial crisis, slower capital accumulation is adding downward pressure to productivity and potential output growth.

Figure 1.12: Investment composition (% GDP)

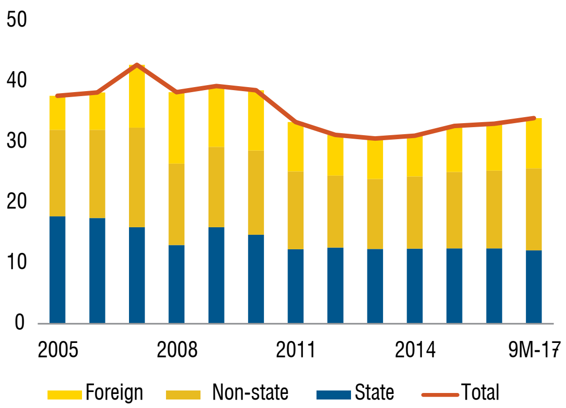
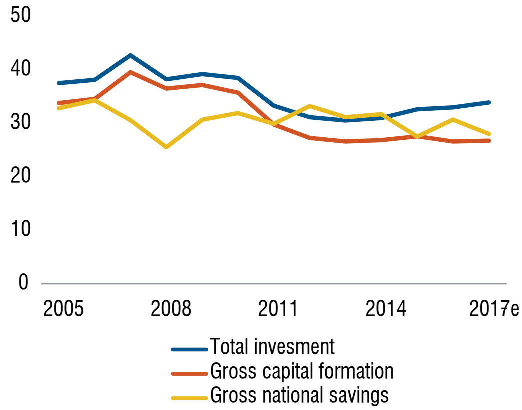


Figure 1.13: Investment and saving (% of GDP)



Source: GSO, WB and IMF.

Amidst muted prices pressures, looser monetary conditions continue to fuel credit growth

1.13. Reflecting low food prices and stable core inflation, headline consumer price inflation remains subdued. October headline CPI rose 0.41 percent (m/m), bringing the y/y CPI rate to a moderate 3.0 percent. Food prices remain subdued thanks to abundant supply. Administrative price hikes (mainly healthcare and education) have been coordinated relatively well among agencies and across provinces to help to smooth impacts at nationwide level. Meanwhile, core inflation (excluding food, fuel and administrative-managed prices) remains stable at 1.3 percent (y/y).

Figure 1.14: Consumer price index (%, y/y)

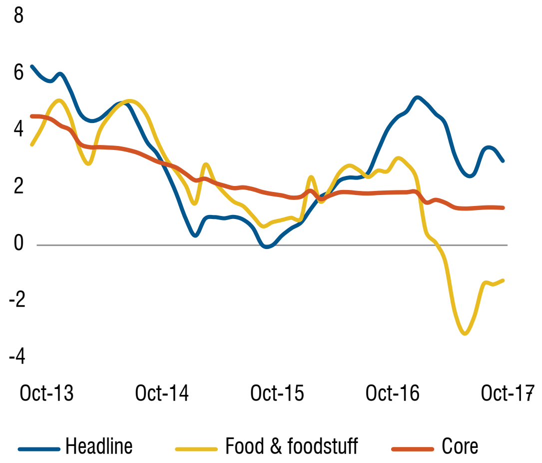
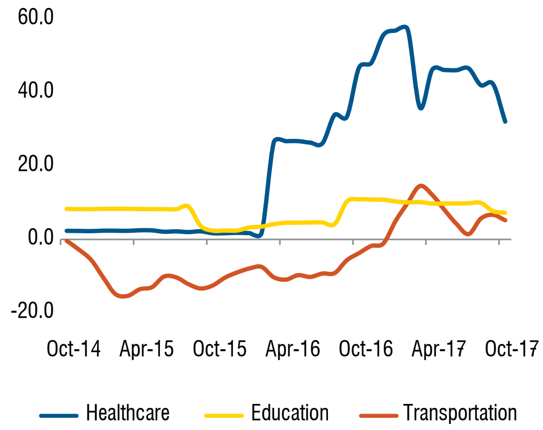


Figure 1.15: Administrative prices (%, y/y)



Source: GSO.

1.14. Amidst subdued price pressures, the authorities have proactively eased the monetary policy stance to support economic growth. With moderate inflation, the State Bank of Vietnam in July eased monetary stance, cutting its rediscount rate and refinancing rate by 25 basis points to 4.25 and 6.25 percent respectively - first rate adjustment in three years. Accommodative monetary policy contributed to easy liquidity conditions in the banking sector with interbank rates at less than one percent – significantly below historically low policy rates. Credit expansion remained elevated at around 18.5 percent (y/y) in October 2017, almost double nominal GDP growth. While credit expansion may be driven by rapid income growth, rising demand for housing and investment in productive capacity, rapid credit growth, especially if driven by administrative credit growth targets may induce excessive risk taking, poor credit allocation and lead to associated deterioration in asset quality. Indeed, the credit intensity of growth is rising, implying that it takes more credit to achieve the same incremental output gains.

Figure 1.16: Elevated credit

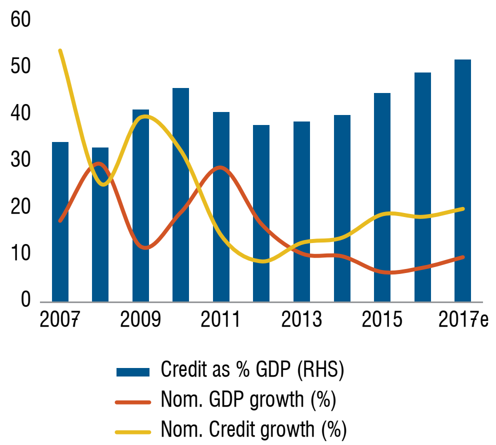
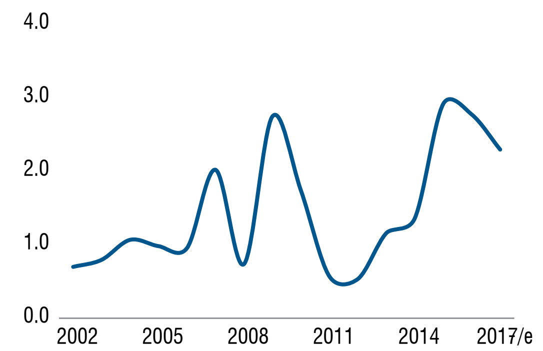


Figure 1.17: Incremental Credit Output Ratio is rising

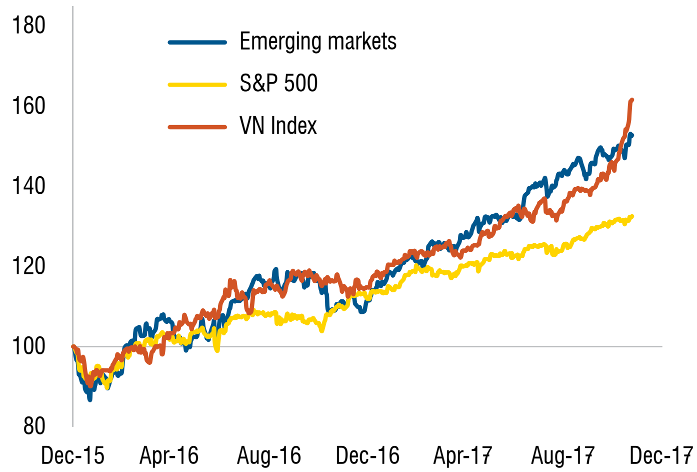


Source: GSO and SBV.

1.15. Banking sector stability continued to improve, reflecting favorable macroeconomic conditions and some progress with NPL resolution. Resolution of bad debts has been impeded by legal constraints on collateral sale and restructuring, insufficient capacity of AMC, and inability to recognize losses. The recently passed resolution 42, which was approved by the National Assembly in June 2017, removed some of these legal impediments to effective loan resolution. It includes measures to improve lenders' ability to more efficiently enforce collateral security to enable banks to seize collateral and foreclose bad loans. It also enhances the trading of bad debt in the secondary market. However, despite progress, the stock of unresolved NPLs remains sizable and capital buffers continue to be relatively thin in some banks compared to international standard. Moreover, there is also concern with regards to the impact of the expansion in credit on credit quality. The revisions to the Law on Credit Institutions were also approved by the NA in the November session. Resolution 42 and the revised Credit Institutions Law form the foundation of the recently approved Banking Restructuring Plan 2016-2020. Regulations guiding the implementation of Basel II principles are also being prepared and are envisaged to improve risk management in the banks and address critical risks in banking sector activities. The SBV is also dedicating efforts to identify weak banks and address the extent of the systemic risks posed by these institutions.

1.16. Stock prices remain elevated propelled by strong liquidity and rising corporate profits. Year-to-date VN index - a capitalization-weighted index of all the companies listed on the Ho Chi Minh City Stock Exchange rose by nearly 43 percent reflecting upbeat sentiment on Vietnam's potential growth. In addition, the recent booming of Vietnam's equity market has also been supported by the disinvestment of state holding from "blue-chip" SOEs like Vinamilk and Sabeco.

Figure 1.18: Vietnam Stock Exchange (Dec 2015=100)



Source: HOSE and WB.

Vietnam's external position remains robust driven by strong exports and FDI inflows

1.17. Improved external demand strengthened Vietnam's already strong export performance. Vietnam's total export turnover between January and October 2017 is estimated at $174.5 billion, up 21.3 percent from the same period last year. Primary commodity exports increased significantly because of a recovery of commodity prices. Crude oil exports rose by 26 percent compared to a substantive decline last year. The export value of agricultural commodities also increased strongly by about 17.5 percent. Manufacturing exports continued to grow robustly, especially in such technology categories as cell phones, electronics, and computers which expanded 32 percent but also traditional labor-intensive manufacturing exports like garments, footwear, luggage and wood products which expanded by 16 percent.

Table 1.2: Vietnam's merchandise exports

	Share of total (%)		Growth (%, y/y)	
	2016	10M-17	2016	10M-17
Total export value	100.0	100.0	9.0	21.3
Crude oil	1.3	1.4	-36.5	26.0
Non-oil	98.7	98.6	10.1	21.2
Agriculture products	12.6	12.3	7.7	17.5
Rice	1.2	1.3	-22.4	23.2
Fisheries	4.0	3.9	7.4	19.5
Low-value manufacturing	48.9	46.8	8.3	16.2
Garment	13.5	12.3	4.6	9.0
Footwear	7.4	6.8	8.3	13.1
High-value manufacturing	31.8	34.7	15.3	32.4
Phones and parts	19.4	21.1	13.8	29.7
Computer and electronics	10.7	12.1	21.5	39.4
Domestic sector	28.5	27.6	5.4	16.9
Foreign invested sector	71.5	72.4	10.5	23.1
Foreign invested sector (excl. oil and phones)	64.0	64.5	11.5	20.4

Source: General Department of Customs.

1.18. Despite improved export performance of the domestic sector in 2017, exports continue to be dominated by the FDI sector. Vietnam's exports continue to gain global market share, in part reflecting overall cost competitiveness and the ability to attract export-oriented-foreign direct investments. Thus, the engine of strong export performance generally originated in the foreign-invested sector, which contributed 72.4 percent of total non-oil exports and grew at 23 percent in the first 10 months of 2017. The sector also boosted import demand for machinery and equipment for investment expansion as well as materials and intermediate goods for export processing and manufacturing. While the sector recorded a significant trade surplus (about 9 percent of GDP in 2016), its increasing share of imported intermediate inputs reflected the limited domestic value addition and weak linkages with local suppliers (see box 1 on constraints to linkages).

Box 1: Constraints to backward linkages from FDI in Vietnam

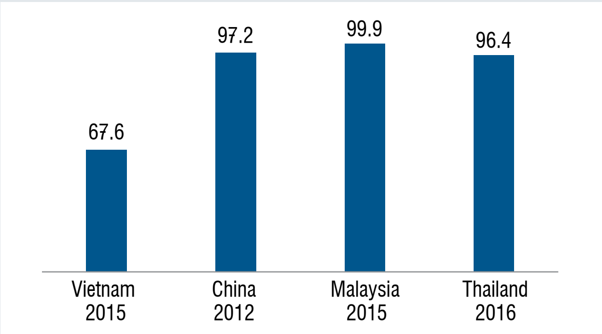
The latest Vietnam Enterprise Survey 2016 covers several aspects of business environment along with measures of firm performance. The findings help identify some of the characteristics of Vietnam's foreign-invested sector.

Foreign direct investment, along with international trade, is one of the most important vehicles for the international transfer of technology and knowledge to the local firms. Multinational enterprises (MNEs) provide proprietary technology and knowledge to affiliates in the host country and enable the latter to compete successfully with local firms. The spillovers from the foreign affiliates can affect the host country's economy— thus boosting the human capital and productivity of local firms. These spillover effects typically operate through forward and backward linkages that connect local and foreign firms in the supply chain. In Vietnam, there is evidence that these linkages remain underdeveloped due to various constraints associated with the demand and supply side, quality, access to finance and skills

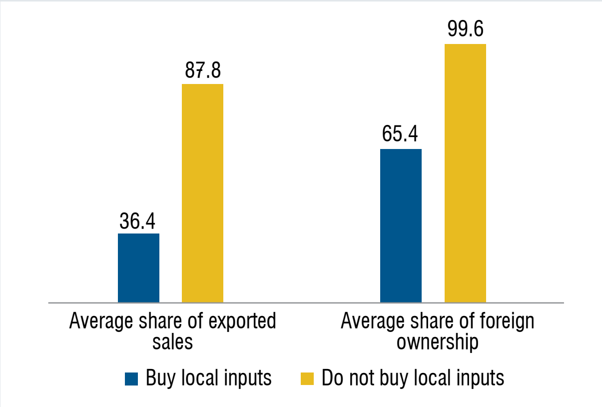
Demand side: The proportion of firms with foreign ownership using domestically produced inputs appears to be significantly lower in Vietnam than in comparator countries – while most FDI firms in China, Malaysia and Thailand source some inputs locally, only two thirds of them do so in Vietnam. Moreover, the propensity for FDI firms to buy local inputs appears to be negatively linked with the share of direct exports in their sales and the share of foreign ownership in their capital. This would confirm previous finding that market-seeking FDI and joint ventures are more likely to establish backward linkages.

Supply side: Differences between domestic firms which managed to establish FDI backward linkages and those which did not can inform the design of programs aiming to further develop those linkages. This is attempted here, using the Enterprise Survey's measure of indirect exports. Several constraints and weaknesses of the domestic private sector are looked at, including the quality of products, access to finance, innovation, skills, etc. Finally, the main business environment constraints perceived by firms are presented, distinguishing between linked and non-linked firms.

Proportion of foreign-owned firms using domestic inputs



Local input sourcing



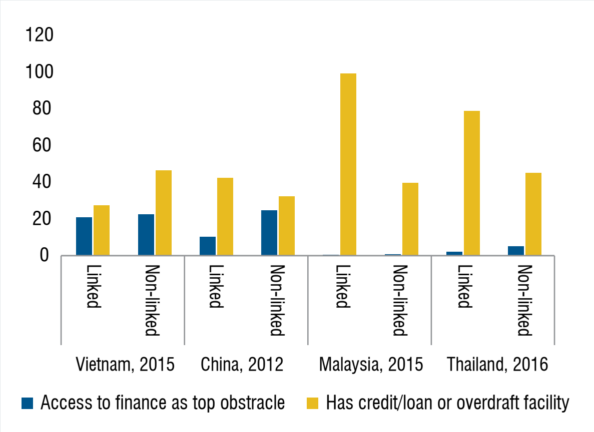
Quality: The lack of potential suppliers' ability to conform to MNEs' quality, price and reliability standards has been identified as one of the major constraints to backward to linkages in Vietnam. The latest Enterprise Survey data show that, while half of foreign-invested firms hold an internationally-recognized quality certification, such as ISO 9001 on quality management systems, less than 10 percent of domestic firms do. However, this proportion increases to almost a quarter for domestic "linked" firms. To the extent that imported inputs have a higher quality/price ratio or embody better technology than domestic ones, linked domestic firms' heavier reliance than non-linked firms on such imported inputs, in Vietnam like in comparator countries, may also be a source of higher competitiveness.

Access to finance: Access to finance is perceived as one of the top business constraints by firms surveyed in Vietnam, with a significantly higher proportion of firms declaring it as their main constraint than in Malaysia, Thailand and China. However, the fact that there is no large difference between linked and non-linked firms, as well as that the proportion of non-linked firms having a credit/loan or overdraft facility is higher in Vietnam than in comparator countries, suggests lack of access to finance may not be a major obstacle for firms to establish linkages.

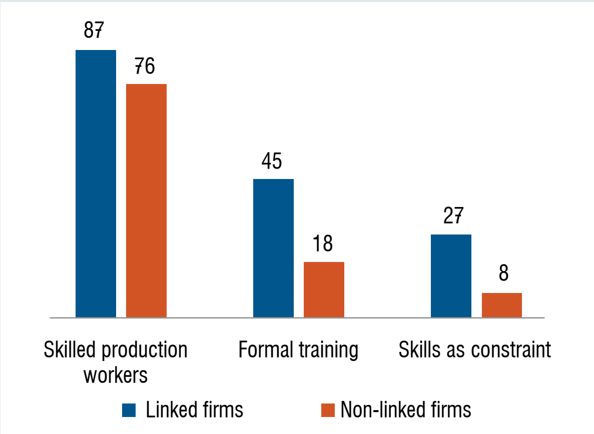
Skills: Compared to non-linked firms, on average linked firms are found to (i) have a slightly higher proportion of skilled production workers, (ii) provide much more formal training to their employees, and (iii) consider that an insufficient skills and education level of the workforce is a major constraint. Furthermore, while no obvious pattern emerges in terms of the type of skills linked and non-linked firms say are most difficult to find, the primary focus of their training efforts does not seem to be geared towards addressing these needs. For instance, skills such as foreign languages, work ethic, writing, management and leadership are sought after but do not appear to be the object of much of the training provided by firms.

Use of quality certification

Access to finance



Skills



Source: World Bank, Vietnam: Enhancing Enterprise Competitiveness and SME Linkages - Lessons from international and national experience.

1.19. Imports rebounded significantly in 2017 after sluggish growth in 2016. Imports, especially of capital and intermediate goods, continued to surge, reflecting the uptick in investment activity and high import content of some of Vietnam's exports. The import bill for first ten months is estimated at $172 billion, up 21.6 percent year-on-year compared to 5.4 percent growth during 2016. Imports of the foreign-invested sector continue to grow solidly while imports of domestic companies, which were unusually weak last year, have gradually rebounded. Machinery, equipment, raw material and intermediate goods are among the biggest import items expanding by 22.7 percent during the first ten months of the year. Growth especially in imported capital goods is a positive development, indicating ongoing capacity extension of production facilities and contributing to higher potential growth and future export potential of Vietnam.

Table 1.3: Vietnam's merchandise imports

	Share of total (%)		Growth (%, y/y)	
	2016	10M-17	2016	10M-17
Total import value	100.0	100.0	5.4	21.6
Petroleum	3.5	4.0	-11.4	40.5
Machinery and equipment	16.2	16.2	2.9	22.7
Materials and intermediate goods	65.7	66.4	6.5	22.0
Fabrics	6.0	5.4	3.2	8.4
Metal	9.5	9.0	2.0	13.7
Plastic materials	3.6	3.5	5.0	19.4
Consumer products	9.2	8.6	7.8	12.1
Domestic sector	41.4	40.1	5.3	18.9
Foreign invested sector	58.6	59.9	5.4	23.5

Source: General Department of Customs.

1.20. Vietnam's trade performance is underpinned by a diversified set of trade relationships. Vietnam is a member of 16 bilateral and multilateral trade agreements. This has enabled Vietnam's exports to serve a broad set of destination markets. Among trading partners, the United States continue to remain Vietnam's largest, accounting for 20 percent of Vietnam's total exports. This is followed by the North East Asian markets (Japan, Korea, Taiwan and Hong Kong), EU and ASEAN. Vietnam has successfully maintaining stable market shares for its exports. However, Vietnam's imports are quite concentrated. The top 10 partners account for 83 percent or more of Vietnam's total imports. China remains the largest source of Vietnamese imports, following by Korea and Japan. These top three partners accounted for nearly 58 percent of Vietnam's total import value. A more diversified market would help Vietnam to sustain gains from its exports as well as mitigate economic risks from external economic fluctuations.

Table 1.4: Vietnam trading partners (% of total)

	2015	2016	10M-17
Exports by destinations			
China	10.6	12.4	15.2
North East Asia	19.8	19.5	19.7
USA	20.7	21.8	19.8
EU	18.9	19.0	18.0
ASEAN	11.3	9.9	10.3
Other	18.7	17.3	17.0
Imports by sources			
China	29.9	28.7	27.1
North East Asia	32.8	34.3	36.9
USA	4.7	5.0	4.4
EU	6.2	6.3	5.7
ASEAN	14.4	13.7	13.2
Other	12.0	12.0	12.6

Figure 1.19: Vietnam trade concentration[1]

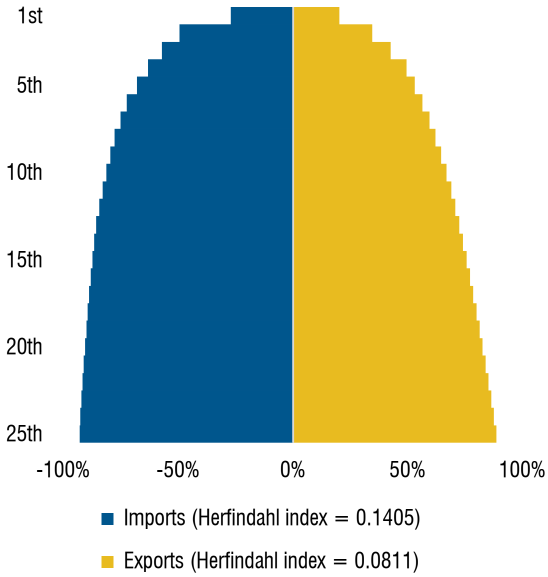


Figure 1.20: Partner concentration in exports

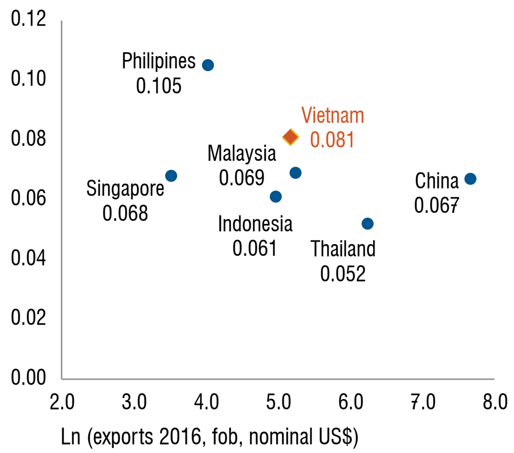
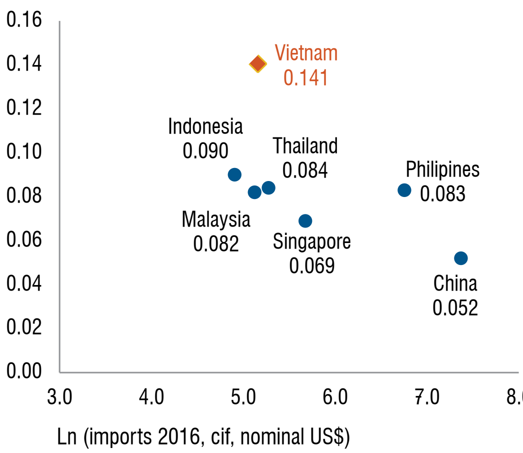


Figure 1.21: Partner concentration in imports



Source: Staff estimates based on Vietnam's General Department of Customs and COMTRADE data.

1.21. Foreign direct investment further accelerated in recent months, reflecting fundamental competitiveness and positive investor sentiment. In the first ten months of 2017, foreign investors committed US$ 28 billion to Vietnam – a 37 percent increase compared to the same period last year. It is worth to note that the commitment reached the highest level since its peak of 2008. At the same time, foreign-invested firms disbursed US$ 14.2 billion – an increase of 11.8 percent in nominal terms over the previous year. By October 2017, Vietnam had investments from about 128 countries and territories, with total accumulated FDI commitments of nearly US$ 313 billion in a broad and diversified range of investment activities. The foreign-invested sector accounts for about 18

[2] Herfindahl index: This indicator is a measure of the dispersion of trade value across trading partners. A higher index indicates that trade (imports and exports) are concentrated in fewer markets, whereas a country trading equally with all partners will have an index close to 0.

percent of Vietnam's GDP, nearly a quarter of total investment, two thirds of total exports, 18.5 percent of total budget revenue and millions of direct and indirect jobs. It is also consistent and strong driver of GDP growth.

Figure 1.22: Foreign Direct Investment ($billion)

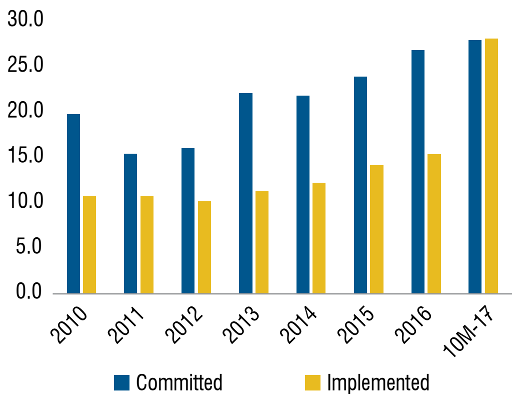
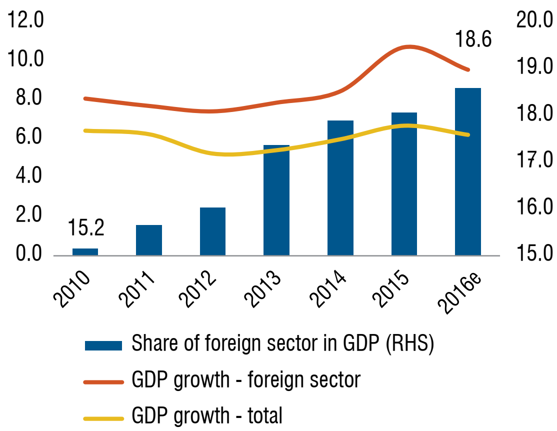


Figure 1.23: The dual-track economy



Source: GSO

1.22. Vietnam's balance of payments remains in surplus, underpinned by a trade surplus, resilient remittances and large FDI inflows. The current account posted a surplus of about 1.5 percent of GDP (annualized) during the first half of the year, slightly shallower than last year. The capital account also remained in surplus, owing in large part to significant FDI inflows as well as inflows of official financing.

Figure 1.24: Balance of payments (% of GDP)

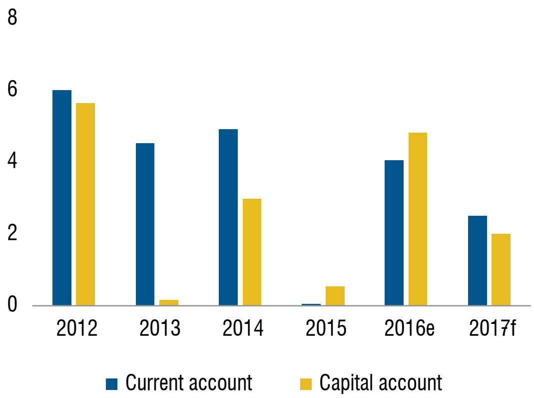
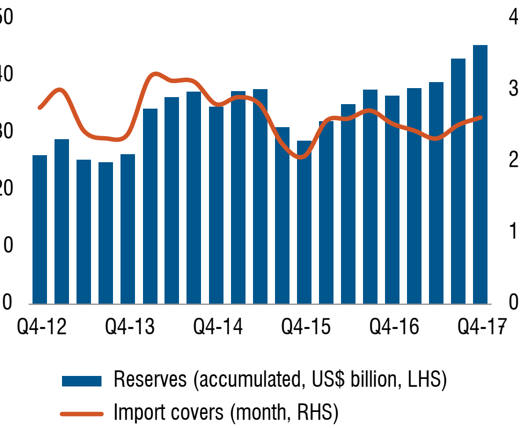


Figure 1.25: International reserves



Source: SBV and WB estimates.

1.23. Bolstered by the strong external position, the exchange rate has been stable and foreign reserves continue to accumulate. The SBV has kept the nominal US$ dong exchange rate within a narrow trading band with year to date devaluation of the reference rate of 1.4 percent. This helped contain real effective exchange rate appreciation of the dong and allowed the SBV continue to shore up foreign reserves of nearly US$ 5 billion during the first three quarters, bringing gross international reserves to around US$ 42 billion[2] by the end of September, equal to just below 3 months of imports.

[3] Data provided by SBV

Figure 1.26: Dong exchange rate (Dec 2010=100)

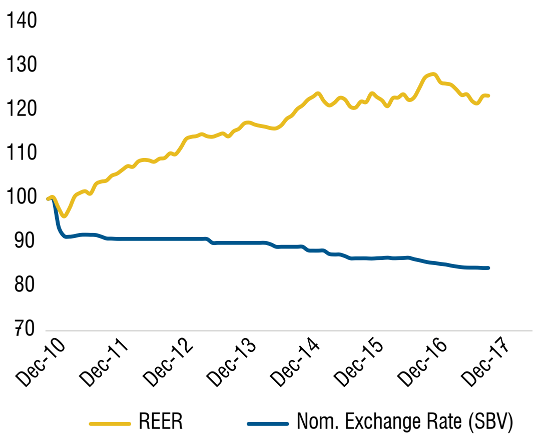
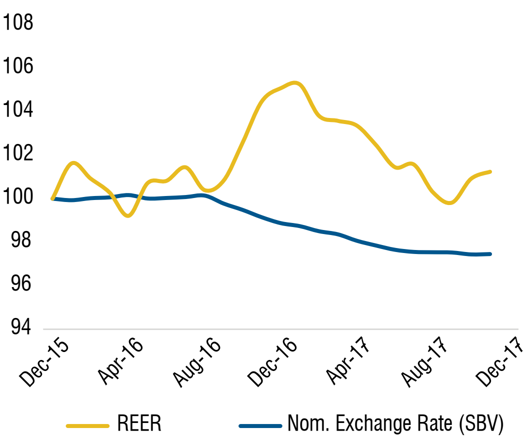


Figure 1.27: Dong exchange rate (Dec 2015=100)



Source: SBV and World Bank.

Fiscal consolidation is underway, but the quality and sustainability of the adjustment could be improved

1.24. The budget deficit narrowed significantly in 2017. The budget deficit for the first 9 months of 2017 is estimated to less than 2 percent of GDP (annualized). This helped contain public debt accumulation and ensured compliance with 65 percent of GDP statutory debt limit. On the revenue side, deficit reduction was aided by buoyant revenue performance. On the spending side, the adjustment has fallen disproportionately on public investment which declined to 16 percent of total spending in the first nine months of 2017, compared with an average of 25 percent over 2012–2016. While the focus on efficiency of public investment is welcome, across-the-board curtailment of investment spending raises concerns as Vietnam needs significant infrastructure investment to support future growth.

1.25. Revenue performance improved in the first nine months of 2017. Nominal revenue growth in the first nine months of 2017 is estimated at 13.9 percent (y/y) reaching 67 percent of the annual plan. Oil revenue rose 15 percent (y/y) thanks to the gradual improved oil price, slightly increasing the share of oil in total revenue from 3.6 percent in 2016 to 4 percent in September 2017. Nominal tax collection also improved, expanding 12.7 percent, while capital revenue and non-tax sources together rose by nearly 19 percent.

Figure 1.28: State budget revenue

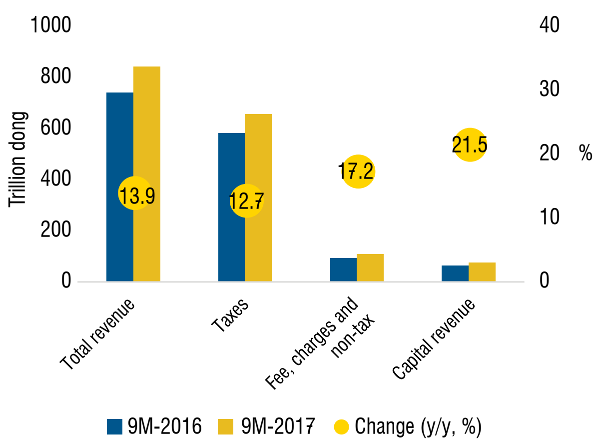
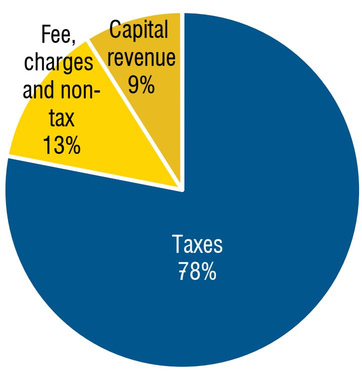


Figure 1.29: Composition of revenue



Source: MOF.

1.26. Buoyant tax revenue helped stabilize revenue mobilization. Nominal tax collection increased by about 12.7 percent in the first nine month of 2017 compared to the same period last year. Among key taxes, the value-added tax (VAT), which makes up around a third of total tax revenue, increased by 25 percent partly driven by strong private consumption and a recovery of imports. Corporate income tax collection remains subdued expanding by 7.5 percent nominally, despite the pick-up in economic activity. Personal income tax (PIT) collections increased by nearly 20 percent due to a gradual expansion of the tax base, as more workers join the private sector. Natural resource revenue also accelerated thanks to a higher oil price.

Figure 1.30: Tax collection by types

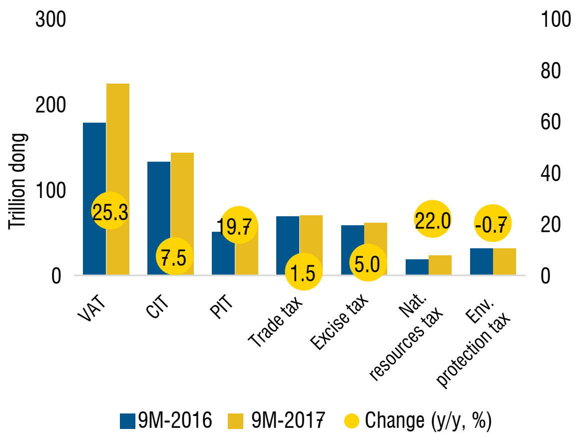
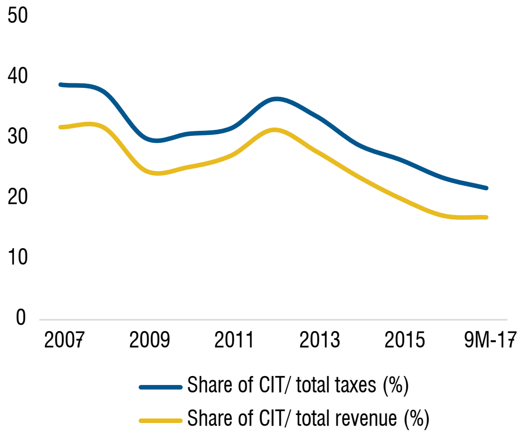


Figure 1.31: Corporate income tax (CIT)



Source: MOF.

1.27. Driven in large part by curtailment of public investment, public expenditure growth moderated. During the first nine months, total expenditure increased in nominal terms by 6.6 percent, with recurrent and investment spending increasing by 7 and 4 percent, respectively. The share of investment spending in total expenditure declined to 16 percent of total spending in the first nine months of 2017, compared with an average of 25 percent over 2012–2016. However, interest payments continued to rise rapidly by 15.6 percent, reflecting the increased public debt burden.

Figure 1.32: Budget expenditure (billion dong)

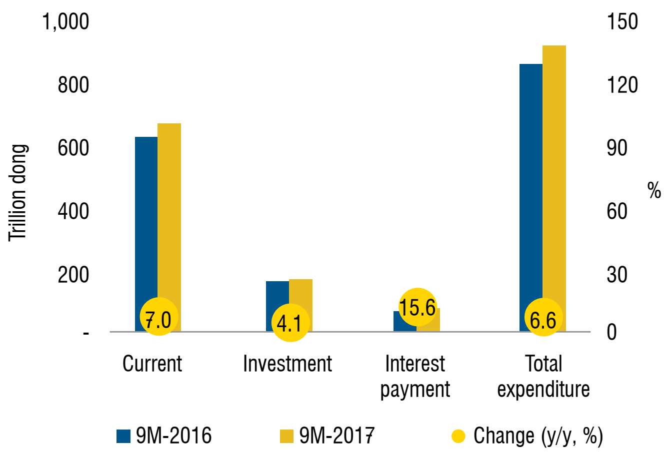
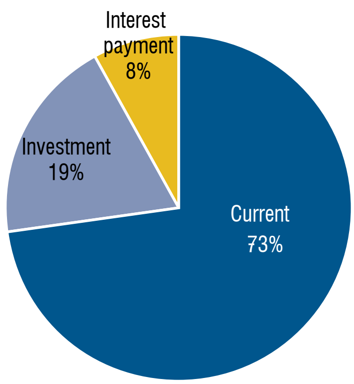


Figure 1.33: Composition of expenditures



Source: MOF.

1.28. The reduction in budget deficit contained public debt accumulation. Vietnam's total public debt increased markedly by nearly 12 percentage points of GDP from 50.8 percent in 2012 to an estimated 62.6 percent[3] in 2017, approaching Vietnam's statutory limit of 65 percent of GDP. The lower deficit this year helped contain further increases in public debt and stabilized the public debt to GDP ratio.

Figure 1.34: Public debt (% of GDP)

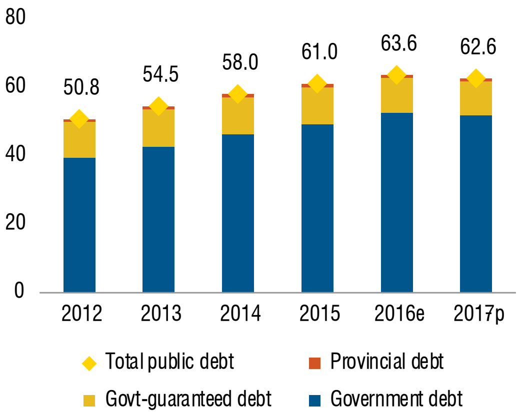
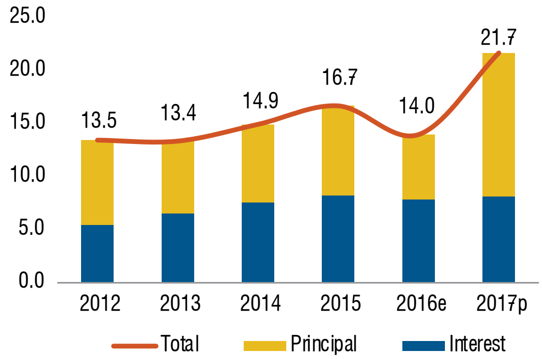


Figure 1.35: Public debt service burden (% of total revenue)



Source: MOF.

1.29. Meanwhile, low inflation and ample liquidity have contributed to favorable conditions in the domestic bond markets with bond yields at record lows. Benefitting from low inflation and ample liquidity, Government bond yields have trended downwards across the yield curve. In addition, the maturity premium for longer tenures has fallen, allowing the government to extend the average maturity of domestic debt. Yields for 15 year bonds have recently declined to less than 6 percent. This allowed the government to meet its financing needs while extending the maturity and reducing the cost of domestic debt. In the first ten months of 2017, the State Treasury issued 153 trillion dong (approximately USD6.7 billion) of Treasury bonds or about 83 percent of the annual plan) to finance the fiscal deficit.

1.30. While effective in the short term, the current composition of the fiscal adjustment is not necessarily sustainable over time. There continues to be a need for deeper revenue and expenditure reforms. On the revenue side, broadening tax bases and strengthening tax administration remain short term priorities. On the spending side, across-the-board retrenchment of capital spending should be replaced with more targeted reforms that lead to real efficiency gains, including right-sizing the public administration (which in turn requires deep service delivery reforms, including in health and education) and higher value for money in public investment and procurement of goods and services (see special topic note).

Further improvements of business environment are fundamental to foster domestic private sector

1.31. Vietnam is making progress in improving its business environment. Thanks to the government's efforts (a series of Resolution 19 from 2014 to 2017), the business climate has been improved steadily. As a result, Vietnam moved up in the World Bank's Doing Business from rank 90 (of 189 countries) in DB2016 to rank 82 (of

4 By definition of the Ministry of Finance

190 countries) in DB2017 and to rank 68 (of 190 countries) in the most recently released DB2018. Nevertheless, Vietnam is still lagging compared to more advanced countries in the region, including Singapore, Malaysia and Thailand.

Box 2: Significant reforms to improve business environment

- 2018 Doing Business survey ranked Vietnam 68nd out of 190 economies worldwide thanks to several reforms making it easier to do business: Getting Electricity, Getting Credit, Paying Taxes, Trading across Borders and Enforcing contracts. Last year Vietnam was ranked 82st in the same survey.

- Vietnam's key reforms in DB2018:

  ✓ *Getting Electricity:* Vietnam increased the reliability of power supply by rolling out a Supervisory Control and Data Acquisition (SCADA) automatic energy management system for the monitoring of outages and the restoration of service.

  ✓ *Getting Credit:* Vietnam strengthened access to credit by adopting a new civil code that broadens the scope of assets that can be used as collateral.

  ✓ *Paying Taxes:* Vietnam made paying taxes easier by abolishing the 12-month mandatory carry forward period for VAT credit and by introducing an online platform for filing social security contributions.

  ✓ *Trading across Borders:* Vietnam made exporting and importing easier by upgrading the automated cargo clearance system and extending the operating hours of the customs department.

  ✓ *Enforcing Contracts:* Vietnam made enforcing contracts easier by adopting a new code of civil procedure and by introducing a consolidated law on voluntary mediation.

- However, the significant ranking improvement still positions Vietnam behind some regional countries, such as Singapore (2nd), Malaysia (23rd), Thailand (46th) and Brunei (56th). Despite steady progress, Vietnam still has room to improve the regulatory environment in a number areas, including Resolving Insolvency, Getting Electricity, Investor Protection, Paying Taxes, Trading across Borders and Starting a Business. Continuing reforms to improve regulatory quality and to ensure consistent. efficient and fair enforcement is crucial for Vietnam to create an enabling environment for private sector investment, economic growth and job creation.

Figure 1.36: Ease of doing business
Vietnam vs. ASEAN

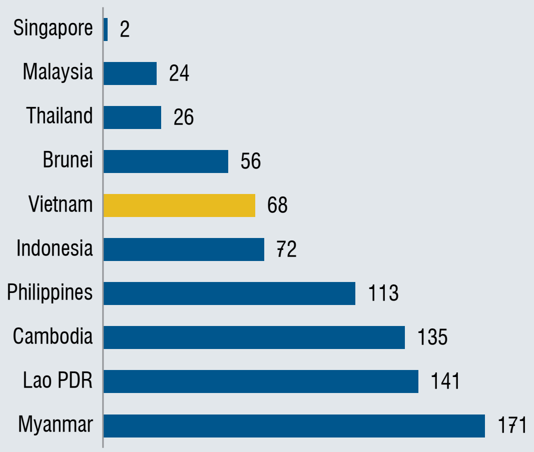
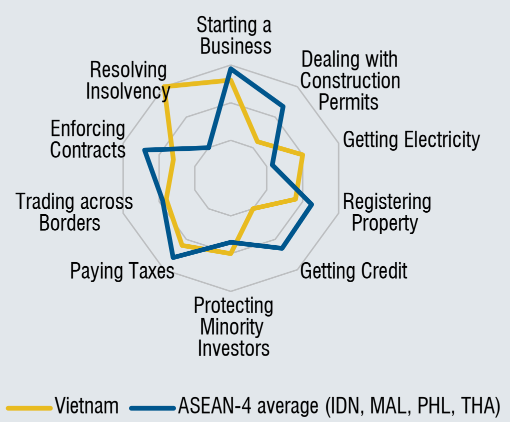


Figure 1.37: Ease of doing business
Vietnam vs. ASEAN-4



- Vietnam has made a commendable progress in Paying taxes. Economies around the world have made paying taxes faster, easier and less costly for businesses. Vietnamese authorities have strived to improve procedures and regulations that aim to simplify tax payments for firms over past years. The below table highlights the tax reforms that Doing Business has recorded in Vietnam since 2011. Thanks to the enormous efforts of the government, Vietnam currently stands at 86 in the rankings of 190 economies globally and above the EAP average on the ease of paying taxes.

Table 1.5: How has Vietnam made paying taxes easier?

DB year	Reforms
DB 2011	The government of Vietnam eased paying taxes by reducing corporate income tax rate.
DB 2014	Vietnam made paying taxes costlier for companies by increasing employers' social security contribution rate.
DB 2015	Vietnam made paying taxes less costly for companies by reducing the corporate income tax rate.
DB 2016	Vietnam made paying taxes less costly for companies by reducing the corporate income tax rate—and made it easier by reducing the number of procedures and documents for filing VAT and social security contributions, reducing the number of filings for VAT and replacing quarterly filings of corporate income tax with quarterly advance payments. On the other hand, Vietnam increased the rate for social security contributions paid by employers.
DB 2017	Vietnam made paying taxes easier and less costly by streamlining the administrative process of complying with tax obligations and abolishing environmental protection fees.
DB 2018	Vietnam made paying taxes easier by abolishing the 12-month mandatory carry forward period for VAT credit and by introducing an online platform for filing social security contributions.

Figure 1.38: Ranks in the paying taxes

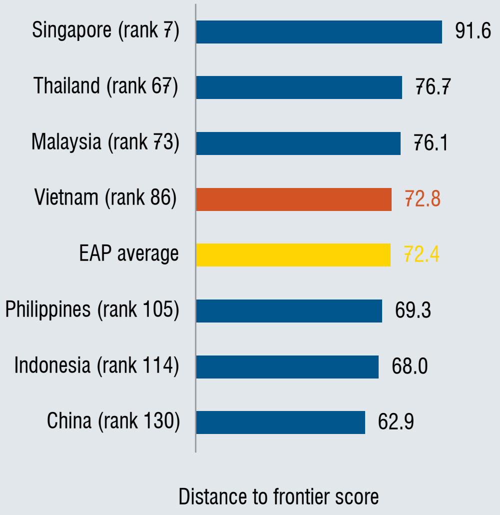


Table 1.6: Vietnam cut time for paying taxes

	Paying Taxes - Payments (numbers per year)	Paying Taxes - Time (hours per year)
DB2016	43	770
DB2017	31	540
DB2018	14	498

Source: Doing Business 2018, World Bank.

Medium-Term Economic Outlook and Risks

1.32. Vietnam's near term outlook has improved since the July Taking Stock report. Aided by favorable external and domestic conditions, GDP growth is projected to accelerate to 6.7 percent in 2017 (compared to 6.3 percent forecast in July). Over the medium term, growth is projected to stabilize around 6.5 percent, as the impact of the current cyclical uptick dissipates. On the production side, growth is expected to continue to be led by service and manufacturing sectors, fueled by continued FDI inflows. Inflation is expected to remain moderate on the account of soft global energy and food prices before rebounding somewhat in the medium term, as rapid wage and credit growth lift core inflation. The trade balance is projected to remain positive despite strong import growth which will help Vietnam retain the current account surplus, albeit at lower level. Robust FDI inflows will keep the capital account in surplus as well. The fiscal deficit is expected to come in at around 4 percent of GDP this year. However, following this year's sharp adjustment, the pace of fiscal consolidation is expected to slow down in medium term.

Table 1.7: Key macro-economic indicators

	2015	2016e	2017e	2018f	2019f
GDP growth (%)	6.7	6.2	6.7	6.5	6.5
GDP growth (%) as indicated in July 2017 TS	6.7	6.2	6.3	6.4	6.4
Consumer price index (annual average, %)	0.6	2.7	3.5	4.0	4.0
Current account balance (% of GDP)	0.1	4.1	2.5	2.0	1.6
Fiscal balance (% of GDP, GFS definition)	-6.2	-6.3	-4.0	-4.2	-4.1
Public and publicly-guaranteed debt (% of GDP, GFS definition)	57.2	60.0	59.6	60.7	61.3
Public and publicly-guaranteed debt (% GDP, MOF definition)	61.0	63.6	62.6	63.7	64.2

Source: GSO, MOF, SBV, IMF and WB.

1.33. Despite the stronger near-term outlook, medium-term risks remain significant. On the upside, a sustained recovery in global demand and resultantly stronger manufacturing growth could lift GDP growth above the projected baseline. On the downside, a key challenge relates to the combined effect of a deceleration in productivity, labor force and investment growth which may weaken Vietnam's potential growth. Fiscal risks also remain pronounced, particularly with regard the quality and pace of fiscal consolidation which could undermine investment in infrastructure and human capital needed for future growth. Risks in the banking sector -while somewhat more muted- pertain to a combination of relatively thin capital buffers, unresolved NPLs and rapid credit growth which could result in renewed financial instability, especially in case of economic shocks. Externally, strong trade and investment linkages expose Vietnam's economy to risks associated with a potential rise in protectionism and a possible weakening of external demand in case of ongoing global recovery loses momentum. Vietnam is also exposed to heightened geopolitical tension on the Korean peninsula, given its significant FDI and trade relationship with South Korea. Finally, tighter global financial conditions could ignite balance of payment pressures especially given the lack of full exchange rate flexibility and relatively low external reserve coverage.

1.34. These risks call for a continuing focus on enhancing macroeconomic resilience and structural reforms to lift potential growth over the medium term. Macroeconomic resilience could be strengthened by further enhancing exchange rate flexibility, a further build-up of foreign reserves, fiscal consolidation and responsive monetary and macroprudential policies that moderate credit expansion and bolster capital buffers in the banking sector. On the fiscal front, there continues to be a need for deeper revenue and expenditure reforms that lead to real efficiency gains, including broadening tax bases and strengthening tax administration, right-sizing the public administration and higher value for money in public investment and procurement of goods and services (see special topic note). Steps to solidify macroeconomic stability need to be accompanied by progress on structural reforms to lift productivity and potential growth, including steps to reform the SOE sector, improve the regulatory environment and enhance factor markets, including for land and capital.

SECTION 2

IMPROVING EFFICIENCY AND EQUITY OF PUBLIC SPENDING

Improving Spending Efficiency for Sustainable Growth

2.1. With public debt close to the statutory limit of 65 percent of GDP, Vietnam's government faces tight budget constraints for several years to come. The Government has already responded by curtailing expenditure growth, especially of investment and other discretionary spending. These measures, while effective in the short term, are not necessarily sustainable over time, as they may harm necessary investment in infrastructure and human capital. This special topic note looks at more fundamental reforms in key public services, in order to identify opportunities for constraining expenditure growth through improvements in productivity.

2.2. To improve spending efficiency, it is important to (i) better align public spending with national priorities to maximize its impact and (ii) achieve efficiency gains on key inputs in key sectors of the economy. Vietnam's national priorities are for development to be characterized by rapid, equitable and sustainable growth underpinned by modern industries; a knowledge-based economy; a universally strong human-capital base; and modern state and governance institutions. Aligning spending to these priorities involves linking the budget with socioeconomic planning; linking sub-national allocations with government priorities; and ensuring that the transformational role of the state in the economy is taking place on the ground.

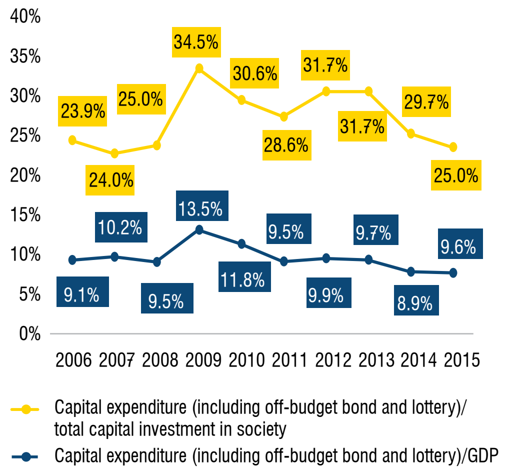
2.3 Robust economic growth supported by sound macroeconomic and pro-growth expenditure policies have lifted Vietnam from being one of the poorest countries in the world to a lower middle-income country. In the period 2011-15, total State budget spending accounted for 29.2 percent of GDP, increasing from 28.4 percent in the period 2006-10. Capital spending was highly prioritized towards infrastructure development. Indeed, it was an important contributor to high economic growth. Recurrent spending prioritized human development, social protection and security and poverty reduction. In the future, Vietnam will still be faced with strong demand for sustained spending on infrastructure and human resource development. This requires maintaining adequate levels of public investment, strengthening spending efficiency and making full use of existing assets as well as developing a highly skilled workforce and improving innovative capacity.

Strengthening efficiency of public investment as a major driver of growth

2.4. State budget capital spending, including investment financed by off-budget government bonds, fees and charges, has moderated as a share of total government spending. However, it remains an important driver of investment in society. Capital investment from the state budget accounted for 29.1 percent of total investment in the economy in the period 2011-15, slightly higher than the 28.4 percent in 2006-10.

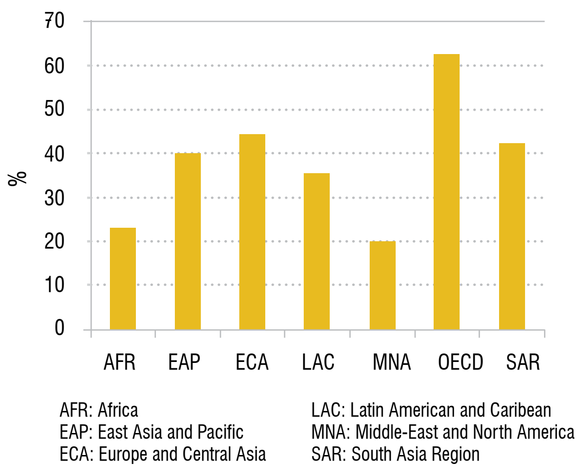
2.5. There has been a change in the proportion of central and local investment budgets. The proportion of central and sub-national total capital investment moved from 33:67 in the period 2006-10 to 27:73 in 2011-15[4]. The change was attributed to rapidly increasing sub-national investment sourced from sub-national budget contingency provisions and over-realized budget revenues (i.e. land and lottery revenues) as well as central budget transfers to sub-national governments. This contrasted to the 2003-08 period, when capital from government bonds focused mainly on investment in transport and irrigation projects led by the central government. The 2009-14 period saw the targeting of mostly local priorities (66 percent in 2010) such as rural roads, small hydro-electric works and other social programs. Sub-national public investment now represents about 40 percent of provincial budgets. The level of decentralization of capital spending in Vietnam is amongst the highest in the developing world (the average proportion for 2001-10 in developing countries was 38.4 percent. This has provided strong incentives for development at sub-national level and contributed to the development of rural infrastructure such local roads, clean water systems and the improvement of local education and health services.

Figure 2.1: The share of capital spending has decreased slightly



Sources: MOF.

Figure 2.2: Vietnam's level of decentralized capital spending is amongst the highest in the world



Sources: WB.

[5] Following receipt of balancing transfers and target transfers from the central government.

2.6. While devolution of public spending was intended to promote local governments to become stronger drivers of growth, the limited remaining share of central government's capital spending raises concerns about adequate investment in national infrastructure. Reduced investment by central government has diminished its capacity to concentrate resources on nationally important objectives and projects, particularly in the context of limited regional coordination. Having such a large share of investment in Vietnam being decided at the sub-national level runs the risk of fragmentation resulting in lower investment efficiency, unless there is strong coordination around large infrastructure projects, including cross-provincial projects. In the long term, it is important to review the socio-economic decentralization arrangements with a focus on their overall efficiency.

2.7. Capital investment is currently spread too thinly across too many projects, resulting in limited annual allocations that only cover part of project investment needs and cause delays, cost overruns and arrears. Tens of thousands of relatively small projects are approved every year. For example, the average project size in 2009 was VND 4.4 billion for provincial level projects and VND 8 billion for central projects. Financial affordability is sometimes not taken into account in project approvals. For instance, between 2001-08 the budget allocation only met 61 percent of the total cost of projects approved by the central government. Consequently, the annual allocation for each project was too low and many medium and small sized projects (Groups B and C) were only allocated around VND 1 billion a year, resulting in planned implementation periods of 2 or 3 years stretching out to 5 or 6 years before completion. Local authorities also accumulated payment arrears to construction companies, which in turn prevented them from servicing their debts and led to growing levels of non-performing loans in local banking systems. In 2011, arrears of around VND 91 trillion were reported by the State Audit of Vietnam (SAV). In 15 provinces, the volume of arrears exceeded their annual capital budget.[5] These issues have been addressed to a large degree by the Prime Minister's Directive 1792 (2012) reducing the stock of arrears to VND 43 trillion in 2013. However, it will take time to fully rectify the situation.

2.8. Underlying inefficiencies in the public investment are weak appraisal and selection processes. Until 2015, when the Public Investment Law was enacted, many projects were included in the budget without being subject to adequately detailed costing or appraisal. In many cases, appraisal was only undertaken after a project had already been included in the budget and at this stage a negative assessment would not result in its rejection. The screening and formal appraisal of projects, which in many cases were a formality, was carried out by the agencies that are responsible for completing the projects. Increased decentralization and limited oversight has resulted in unrealistic investment portfolios and insufficient project preparation. Consequently, in the past, many projects had longer implementation periods than initially anticipated and needed to have their allocations adjusted accordingly, ultimately incurring losses and creating inefficiency.

2.9. To address these inefficiencies, priority should be given to improving the allocation of capital spending and its efficiency, rather than increasing capital spending. The emphasis moving forward may be better focused on retaining the current level of capital spending, but giving increased attention to improving its efficiency. There should also be stronger incentives for the non-state sector to increase the proportion of private investment in total capital investment.

2.10. A number of steps are essential to strengthen fiscal discipline, allocative efficiency and technical efficiency to improve the credibility of the capital budget and help to reduce arrears. This should include a stricter project selection process and improved preparation and costing of projects. This will ensure that contracts are not initiated without having resources allocated to them in the medium-term budget and that there is an

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6 Map of capital arrears is from: http://tuoitre.vn/Kinh-te/567953/giat-minh-voi-91-000-ti-dong-no-dong.html

improvement in contract recording practices. Greater selectivity and stricter selection mechanisms will contribute to reducing the existing high levels of fragmentation of capital spending across a large number of projects. Quality and timeliness of reporting on public investment could be improved through developing a centralized monitoring system and database on investment projects. One immediate step could be to receive information on project execution and commitment controls from the Treasury and Budget Management Information System (TABMIS).

Ensuring proper maintenance of assets to maximize their value and enhance investment efficiency

2.11. A long-standing issue in Vietnam related to investment efficiency is the lack of connection between capital investment and recurrent operational and maintenance (O&M) expenditure. This is apparent in almost all sectors and is particularly serious in the transport sector. In the transport sector over-spending on capital and under-spending on maintenance at both national and provincial levels have long been a concern. Preserving a road in good condition is less costly than neglecting it and having to rehabilitate or reconstruct it. Underspending on maintenance reduces the lifespan of infrastructure and thus increases the lifecycle costs of assets. It is estimated that maintenance costs multiply by eight times after three years of neglect and by 15 times after five years of neglect. Whilst Vietnam has a complete road network with a relatively high road density (of about 0.87 km of road per km^2), the full potential of such a network is hindered by its poor condition due to low levels and financing of maintenance.

2.12. Government transport strategies and plans highlight maintenance as a priority. However, the amount of resources allocated to transport infrastructure maintenance indicate otherwise, with a shortfall of at least 50 percent in the necessary O&M expenditure at both national and local levels. In 2012, maintenance expenditure represented only about 18 percent of total transport expenditure. In the roads subsector, maintenance to total road expenditure ratio in Vietnam is only 11 percent, compared with 22 percent in Bangladesh, 30 percent in OECD countries, and 37 percent in Indonesia.

2.13. The misallocation between capital and recurrent expenditure is also apparent in the agriculture sector. In past years, the Government invested heavily in building infrastructure in the agriculture sector, particularly for irrigation. This led to agricultural growth, ensuring food security and reducing rural poverty. Investment in irrigation was not only for agricultural production but also for residential purposes. Now that the irrigation network has been well established a key challenge is that the condition of irrigation canals is deteriorating and affecting their potential operational capacity. This is due to irrigation spending being focused more on capital spending than on O&M. The allocation of recurrent expenditure for O&M activities is substantially lower than the need and has brought about negative impacts on the operational capacity and performance of irrigation systems.

2.14. This situation and its challenges are similar in almost all other sectors. In the education and health sectors, maintenance budgets are not increased when new capital projects are planned and implemented, resulting in shortfalls in maintenance spending and a shorter life of education and health physical assets. There are also cases where new schools and hospitals have been built without sufficient funds being allocated for the recruitment of teachers and doctors.

2.15. The misallocation between capital and recurrent expenditure is also present at the sub-national level. From 2009-12, there was a modest improvement in the transport sector, where maintenance spending grew by 25 percent per year, twice as fast as capital spending. Maintenance spending therefore appears to be inadequate.

2.16. In the future, it is recommended that for long-term preservation and efficient use of assets O&M expenditure be gradually increased through multi-year programs supported by the Medium-Term Financial and Budgetary Plan. Coordination between planning and finance authorities should be strengthened to ensure that the required O&M spending is also adequately accounted for in capital project budgeting and included in the outer-year budgets.

- ***In the transport sector:*** it is recommended to re-allocate capital and recurrent expenditure in the annual and medium-term frameworks to increase road maintenance expenditure to between 20 and 25 percent of total road expenditure (i.e. double it). Actual maintenance spending should be budgeted and prioritized on the basis of road condition and usage data which should be updated regularly through asset management systems. The Roads Maintenance Fund may help to support increased O&M spending in the roads sector. However, there is scope for improvement in legislation to improve transparency and efficiency of the Fund. O&M spending in other transport subsectors such as railways and inland waterways should also be re-prioritized.

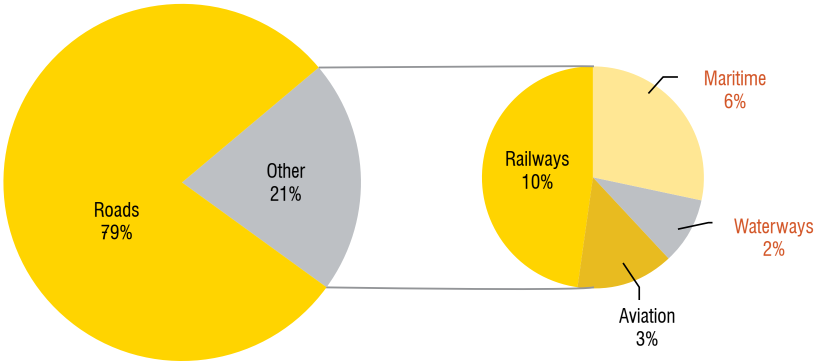
- ***In the agriculture sector:*** it is recommended to move some resources from capital to recurrent O&M spending, particularly for irrigation, whilst simultaneously adopting sustainable strategic agricultural initiatives to reduce the cost burden on the State budget. Some irrigation O&M costs should be shared between the state budget and water users.

Rationalizing intra-sectoral allocations to meet opportunities for greater growth

2.17. Reallocation of resources within sectors could help enhance the effectiveness of spending and its impact on growth. This suggests the need to reconsider sub-sectoral spending allocations to create better alignment with sectoral development strategies and a more optimal balance between the subsectors; that is, one more consistent with Vietnam's comparative advantages and changing development needs. In the past transport and agriculture spending has been prioritized to support growth and poverty reduction. It is time to review the intra-sectoral allocation to take into account their advantages and development potential.

- ***In the transport sector, road transport represents approximately 89 percent of the overall public transport budget.*** There is relatively low spending on maritime, waterway and rail transport despite their transport costs per kilometer being considerably lower than for roads (Figure 2.3). Whilst road transport remains the most important mode accounting for over 90 percent of passenger and 70 percent of freight volumes between 2009-12, it remains the costliest form of domestic freight transport. Despite this high proportion of total transport investment, road transport costs are still high compared with the rest of the Southeast Asia region and expressway density is one of the lowest in the region. Inland waterway and maritime transport are advantageous to Vietnam, have the lowest transport costs for domestic freight transport and the most efficient budget-to-volume ratios. Optimizing the alignment of capital expenditure with current volumes and potential demand would improve the value for money of investments across transport types. It will also be important to improve infrastructure intermodal connections for better logistics, especially between maritime, inland waterways and railway connections.

Figure 2.3: Public expenditure 2012 by mode of transport



Sources: MOF.

Table 2.1. A continued large share of agriculture expenditure is on irrigation (2009-12)

	% of GDP				% of Total Agriculture Expenditures			
	2009	2010	2011	2012	2009	2010	2011	2012
Cultivation	0.06	0.07	0.13	0.07	4.27	4.18	7.65	3.95
Breeding	0.03	0.04	0.05	0.03	1.98	2.31	2.62	1.97
Cultivation and mixed husbandry	0.04	0.03	0.03	0.03	2.62	2.11	1.95	1.69
Agriculture services	0.09	0.10	0.08	0.10	5.86	5.92	4.82	5.53
Veterinary works	0.04	0.06	0.05	0.05	2.89	3.55	2.74	2.80
Irrigation	0.96	1.04	1.12	1.22	64.64	64.43	63.92	70.21
Forestation	0.10	0.12	0.09	0.09	6.85	7.57	5.17	5.03
Forestry services	0.02	0.02	12.15	0.02	1.60	1.50	1.32	1.19
Resettlement and new economic zones	0.06	0.06	0.06	0.06	4.06	3.90	3.29	3.35
Fisheries	0.08	0.07	0.11	0.07	5.08	4.35	6.40	4.06
Timber and other forestry products	0.00	0.00	0.00	0.00	0.16	0.16	0.14	0.21

Sources: MOF.

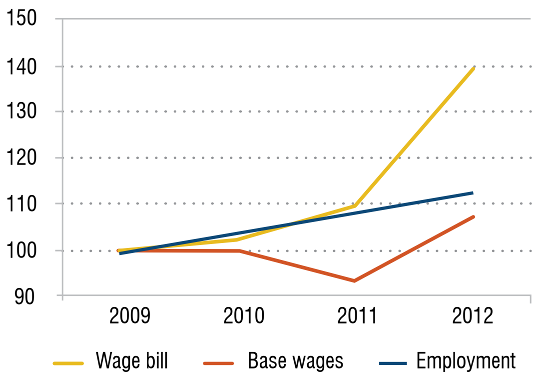
- ***Given the continued emphasis on irrigation as a driver of agricultural growth, it has continued to absorb the majority of the sector's budget.*** Between 2009-12 public expenditure on irrigation increased from 65 percent to 70 percent of total agricultural expenditure (Table 2.1). The bulk of public spending in agriculture aims to maintain food security and generates ever increasing levels of rice production. However, this policy results in a low value addition and an over-emphasis on investment in the development of large irrigation schemes for land dedicated to rice cultivation. This increase is a concern if it indicates the crowding-out of public resources for other priority areas such as cultivation, agricultural services, forestation, veterinary care and other priorities outlined in the Agricultural Reform Plan (ARP). It is recommended that some public spending be reallocated away from irrigation to other areas such as cultivation and agricultural services. This reallocation will be important to increase agricultural productivity and to promote agricultural diversification and exports.

- ***Another efficiency issue in the agriculture sector is the regional allocation of resources.*** The Red River Delta region receives the highest rate of public expenditure on agriculture in relation to key variables (e.g., irrigation, forestry and fisheries) compared with other regions. However, it creates the relatively low value added. Conversely, growth and development in agriculture is occurring in those regions where public expenditure is lower such as Mekong River Delta, South East and Central Highlands. For instance, these regions have much higher agriculture GDP/expenditure ratios (8.92; 5.47; and 5.19 in 2014 respectively), compared to Red River Delta, Northern Mountain and Central Coast regions (1.86; 1.76; and 1.82 respectively). They spent relatively less on agriculture (including lower irrigation unit cost per hectare) than the other regions, but generate larger agriculture GDP. In the future, it will be important to consider whether the current distribution of public resource allocations to regions is optimal in meeting the objectives of the ARP. This will require assessment of the comparative advantages and role of each region in contributing to the vision of sustainable agricultural transformation. For instance, more spending for the Mekong River Delta would likely increase the volume of higher value-added products, such as marine products and fruit. Increased spending is also recommended for agricultural services, particularly for farming and processing.

Enhancing efficiency gains on inputs in key areas and sectors

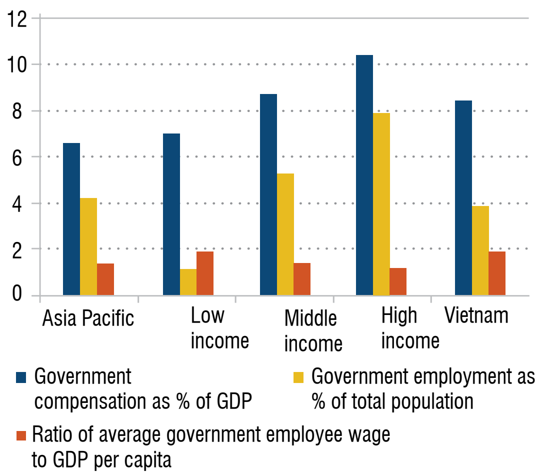
2.18. The administrative wage bill has been expanding significantly, accounting on average for 20 percent of total budget spending. Although base salaries have increased by only 2.3 percent per year (below the average nominal GDP growth of 6.2 percent), growth in non-base salaries and allowances have been the main drivers of salary increases (Figure 2.4). Growth in spending at both central and sub-national levels was especially strong in 2011 and 2012, when a large number of primary teachers and commune administrative staff were formalized in the government wage bill. Vietnam's total government wage bill is high compared with other countries in the region, but similar to middle-income countries (Figure 2.5). Its share of GDP (6.5 percent on average during 2009-12) is about the same as that in Mongolia, but twice as high as that in Indonesia and the Republic of Korea and three times higher than that in Singapore. On average, compensation is 6.6 percent of GDP in all Asia and Pacific countries and 8.7 percent in all middle-income countries.

Figure 2.4: The government wage bill is growing quickly mainly due to non-base wage and headcount increases



Sources: MoF and Ministry of Home Affairs.

Figure 2.5: Vietnam's current government compensation and employment are between those of low- and middle-income countries



Sources: Figures for Vietnam are for 2012 and from GoV; all others are for various years 2000 to 2008 and from IMF (2010).

2.19. Public sector employment has increased rapidly, contributing significantly to rapid growth in the wage bill. The number of central government civil servants grew by 2.8 percent per year and public employees by 3.9 percent per year from 2008 to 2011. The number of provincial civil servants grew by 5.1 percent per year between 2009 and 2013. The increase in public sector employment appears to be much faster than population growth (1.1 percent) in the same period. This outcome seems inconsistent with the administrative and civil service reform agenda, which intends to pay for government salary increases by rationalizing employment levels. Currently, civil servants to population ratio in Vietnam is slightly lower than the average of other countries in the region and middle-income countries, but at present levels of growth there is a risk that it could reach and surpass middle-income averages within a few years.

2.20. Average public sector wages in Vietnam do not seem particularly low compared with earnings elsewhere in the economy. The ratio of average government employee compensation to GDP per capita in Vietnam is 1.9 times. For all countries in the Asia Pacific region, the ratio is 1.4. For low income countries, the ratio is 1.9 and for middle income countries 1.4. Whilst it is recognized that Vietnam's GDP per capita is relatively low given the large share of the population working in agriculture and the informal sectors, this outcome casts doubt on one of the main rationales for increasing civil service salaries, i.e. that they are paid significantly lower than those in other sectors. The caveat is that these wage and income averages may mask significant differences across sectors and job positions, for which data is unavailable. Further analysis is needed to benchmark government salaries with those in the private sector.

2.21. Although the current size of the wage bill and overall public sector employment are not excessively high in comparison with other middle income countries, continued increases would not bode well for public finances. A further increase in public sector employment will have a longer-term effect and once in place will be very hard to reverse. Based on current trends, Vietnam's wage bill could easily outstrip middle-income averages in a short period of time. Improving the performance of government employees has received insufficient attention. An in-depth review of the efficiency of public sector employment and compensation would be desirable before any further increases are made in the wage bill. Application of a forecasting model of future pay and employment would be helpful to illustrate the scenarios and provide full and reliable information to policymakers.

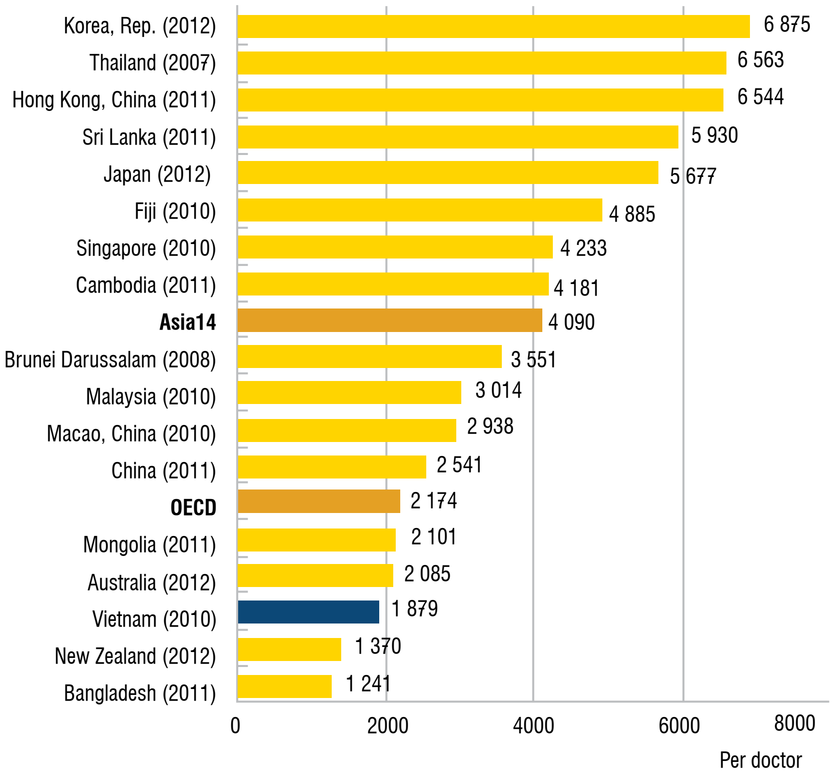
2.22. The efficiency of deployment of human resources in several sectors of public service delivery is not satisfactory, most notably in education and health. Average teaching time per teacher in general education is the lowest in ASEAN (and is 25 percent below the ASEAN average for primary schools). As observed in general education and particularly in lower-secondary education, there is room to restructure teachers' working time and programs to increase the teaching load. More efficient use of education resources, especially teacher deployment, would increase access to education without affecting its quality by providing more services with the same resources. Similarly, on average a doctor in Vietnam sees far fewer patients per year than in other countries, suggesting possible scope for more efficient use of human resources. Patient visits at grassroots levels (districts and communes) are inefficient due to the poor quality of health provision at these levels. This results in under-utilization of resources at grassroots level and overloading at the central and provincial levels. Also, the ratio of nurses to doctors in Vietnam is the lowest amongst 12 comparator countries, suggesting that making greater use of less costly nurses would enhance efficiency.

Figure 2.6: Teaching hours in Vietnam are the shortest in ASEAN

Country	Grade 5 Teaching hours
Vietnam	1,015
Indonesia	1,120
Lao PDR	1,160
Cambodia	1,200
Malaysia	1,320
Myanmar	1,400
Singapore	1,470
Thailand	1,500
Philippines	1,900
ASEAN avg.	1,343

Source: JICA (2013).

Figure 2.7: A typical doctor in Vietnam sees fewer patients per year than in other countries in East Asia



Note: Latest available year per country.

2.23. There is still a mismatch between personnel quotas and qualifications and actual needs. Personnel quota setting and actual employment are not well coordinated between the Ministry and Departments of Home Affairs (MoHA/DoHAs), line ministries and departments, sub-national People's Councils and public service delivery units (PSDUs). This results in mismatches between the quantity and composition of personnel made available and actual needs at both national and sub-national levels. Mismatches occur mostly in lower-secondary schools and are primarily due to a mismatch of teaching subjects and locations. As a result, many schools are left with little funding for non-salary recurrent spending. The revenue from school fees, though unevenly collected in different locations, has become an important source of non-salary spending.

2.24. Better coordination between applicable agencies is needed for more efficient mobilization of civil servants and public employees. Improved coordination is needed in: (i) developing medium-term recruitment plans to balance staffing demand and supply better; (ii) granting administrative and service units more autonomy in staff recruitment and deployment consistent with existing norms and regulations. This should include the possible sharing of staff between multiple units to make full use of their capacities; and (iii) jointly developing a recording and reporting system to collect data on employment, compensation and the wage bill and its financing at both central and local levels.

2.25. The ongoing exercise to rationalize the size of public service staffing is a key action to improve efficiency. This will help to restrain further growth of the wage bill, whilst protecting essential social sector spending and increasing its efficiency. A useful starting point would be to define sound job descriptions and corresponding employment needs. It would then be important to develop a pay and grading system that places more emphasis on actual job performance as opposed to the seniority criteria applied in the current rank-and-file system.

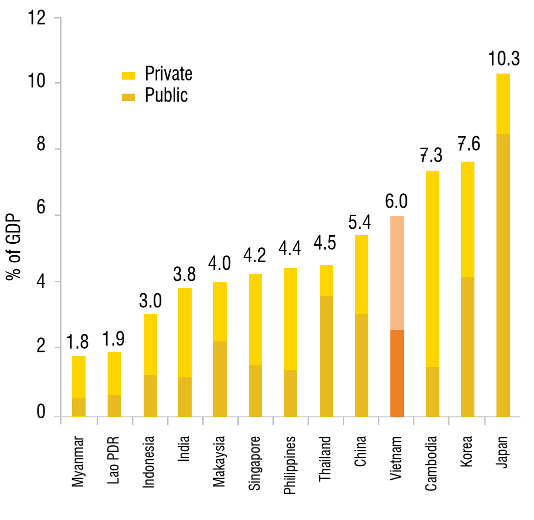
2.26. There is significant scope for the rationalization of other inputs in public service delivery sectors, such as education, health, etc. without jeopardizing service quality:

- ***In the education sector, there are signs of inefficiencies in the deployment of human resources.*** There should be a human resource adjustment plan to increase teaching hours per teacher linked to curricula reforms intended to achieve compatibility with international levels. Provincial Departments of Education and Training (DoETs) could play a greater role in developing a human resource plan that would include existing teacher profiles, future enrolment projections and the professional development needs of teachers. There could be financial incentives for schools to rationalize the teaching force. These measures would help meet the target of full-day school for 90 percent of students at the primary level and 50 percent at the lower-secondary level by 2020. It would particularly benefit disadvantaged students who cannot afford to pay for after-school classes. Furthermore, reforms in the curricula and improved textbooks and testing methods are also important to enhance spending efficiency and effectiveness in the sector.

- ***In the health sector, Vietnam has a very high level of health spending relative to GDP in comparison with its regional peers, but the outcomes are not optimal (Figure 2.8).*** The major drivers of inefficiency include provider payment mechanisms that do not offer appropriate incentives; an over-reliance on hospital centered service delivery at the central and provincial levels, instead of grassroots based and preventive health care; and high pharmaceutical spending. Spending on medicines in 2010 was 43 percent of total health spending or 2.7 percent of GDP, higher than in most countries in the region and well above the OECD average of 16 percent and 2 percent respectively (Figure 2.8 and Figure 2.9). Pharmaceuticals consistently comprise 60 percent of total reimbursements from health insurance. Decentralized procurement has led to a variation in prices across provinces. For instance, claims data from the Vietnam Social Security Fund (VSSF) in 2010 indicated up to a fivefold difference in procurement prices for the same drug across public hospitals.

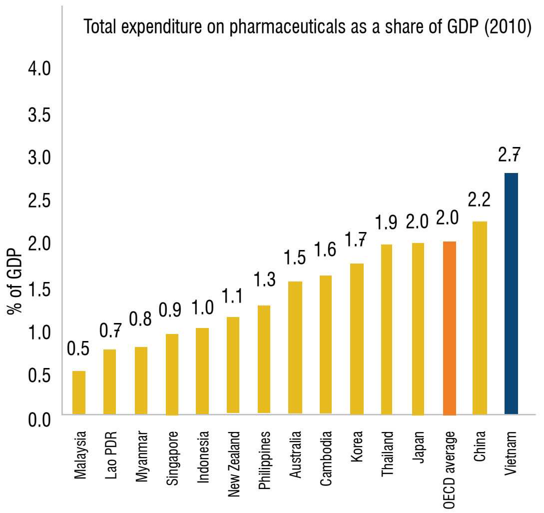
- ***Greater efficiency in health spending could be promoted through a number of measures.*** To reduce the cost of drugs, it is important to devise and carefully implement centralized procurement and price negotiations. For health services in general, the Government might consider enhancing the capacity of VSSF or a similar organization as an independent body to conduct robust cost-effectiveness analysis in the use of health services. Both of these measures would help improve spending efficiency in the health sector, through standardized and reduced prices for pharmaceuticals across provinces and health facilities and more robust controls on hospital spending. Experience from pharmaceutical procurement reform in Eastern Europe suggests that potential savings of more than 30 percent could be made in total pharmaceutical spending. Strengthening spending on preventive health care and health care delivery at the grassroots level could also be considered to improve patient examination and treatment. This could include a shift away from fee-for-service reimbursement to other health financing arrangements including relevant diagnosis related group (DRG) and case based payment.

Figure 2.8: Vietnam's total health spending is higher than most countries in Asia



Source: World Development Indicators (2010).

Figure 2.9: Vietnam's pharmaceutical spending is high relative to peer countries and the OECD average



Source: OECD (2014).

- ***In the transport sector, high unit costs of construction and maintenance are amongst the issues that have hindered the overall value for money of the road subsector in Vietnam.*** Whilst the initial unit cost of construction in Vietnam is generally comparable to other regions, there are two main elements that increase the costs: land acquisition and the spreading of limited funds over too many projects. The level of competition in construction and maintenance is much lower than in other regions of the world. Whilst local contractors dominate the market, the overall number of bids per contract is low and the lack of competition drives costs upwards. An increase in contract size is recommended to reduce overall road costs. Currently, the contract for a length of road is typically 2 to 10 times smaller than in Europe, Central Asia or Sub-Saharan African countries.

Between 2009 and 2013 there was a 68 percent increase in the already high overall maintenance costs per km which led to under maintenance. Unit Maintenance costs are substantially higher than their equivalent costs elsewhere in the region. Routine maintenance costs are approximately USD3,000 per km per year; 3 times higher than in Laos, 1.5 times higher than in Cambodia and closer to unit maintenance unit costs in OECD countries (e.g. USD3,500 per km in the UK and approximately USD4,500 per km in France). This increase in recent years was due to increases in the price of oil and cement based inputs for works construction, and an annual increase of 10 percent in the wages of workers involved in road construction. As maintenance activities are comparatively more labor-intensive in Vietnam than in other countries, the increase in workers' wages has had a greater impact on maintenance costs. This suggests that improvements should be made in maintenance practices and in the use of improved equipment. The analysis therefore suggests a need to streamline and professionalize the maintenance of roads in Vietnam. This will be critical particularly in the context of a widening gap between the maintenance budget and estimated needs (currently approximately 50 percent) as discussed further in paragraph 27 below.

In recent years, tremendous progress has been made in developing Vietnam's road network. The proportion of paved roads increased from 19 percent in 2004 to more than 50 percent in 2012 and paved road length increased by more than thirty percent in the period 2004-14. However, transport costs remain high for the level of development of the country. Road transport costs are comparable to China and Thailand in absolute terms. However, the costs compared with GDP per capita, are four times those of China, six times those of Thailand and three times those of India. Average road transport costs represented by trip time are the highest in the region after Indonesia and hold back Vietnam's competitiveness. This is because the density of expressways is lower than in most neighboring countries. Further analysis into the provision of freight services, tariffs and revenues of carriers is required.

- ***In the agriculture sector, whilst investment in irrigation may continue to be prioritized (currently about 70 percent of total agricultural spending), the focus should be moved to measures to increase water productivity and promote other functions such as agricultural services***. In the past public spending on irrigation in Vietnam focused on increasing rice production and less emphasis was placed on crop diversification to increase agricultural incomes. Irrigation continues to be prioritized and water productivity is still a relatively low priority in Vietnam compared with other countries. For instance, the rice output per unit of irrigation water in Vietnam is only half that of China and one-third that of India (Table 2.2). This suggests that increasing rice production is feasible with increased water productivity. It is also important to consider alternative strategic initiatives in the sector. They may include improving water productivity by reviewing the irrigation fee exemption policy to move to affordable irrigation fees; conditional fee exemption to improve water efficiency; and encouraging crop diversification to enhance agricultural incomes (Table 2.3). The performance of irrigation service providers can also be improved.

Table 2.2. Water productivity is relatively low in Vietnam compared with other countries

Country	Cropping Pattern	Output Per Service Area (USD/ha)	Output Per Unit of Irrigation Water (USD/m^3)
Vietnam	Rice	654	0.03
	Rice and Vegetables	1,051	0.11
	Rice and Sugar	3,603	0.34
	Vegetables	4,862	0.49
China	Rice	1,541	0.06
	Rice and Rapeseed	1,546	0.38
	Wheat/Corn	2,491	1.46
	Apples	4,163	1.20
India	Rice	988	0.09
	Rice/Chilli/Cotton	1,206	0.12
	Sugarcane	1,844	0.17
	Coconut and Sugarcane	2,165	0.12

Source: Burke et al (2015).

Table 2.3. Alternative crops to rice could provide higher margins (Chau Phu, An Giang, Mekong Delta, 2012)

Crops	Gross Revenue (VND)	Gross Margin (Mil.VND)
Bean	300.97	173.30
Chili	341.69	202.66
Gourd	159.94	133.84
Lotus	631.07	461.20
Flower	170.00	118.15
Rice		
WS season	36.61	17.26
SA season	33.38	13.39
AW season	39.63	20.20

Source: Le Canh Dung (2012).

2.27. Enhancing the efficiency of spending will also require key actions in the areas of procurement and project management. Great strides have been made in public procurement reform, but most of the achievements have been in establishing the legislative framework. Implementation remains a challenge. Direct contracting remains dominant, even though competitive bidding has proven advantages. For instance, competitive bidding has helped in recent years to save 20 percent of spending on medicines (overall), more than 20 percent of maintenance costs for national roads and 10 to 15 percent of the budget for contracting solid waste collection and transportation services in Ho Chi Minh City (HCMC). Key actions in the area of procurement include strengthening the competitiveness and transparency of the bidding process, ensuring the independence of complaints handling and resolving conflicting instructions in contract implementation (in light of the Procurement Law 2015).

Improving Equity in Public Spending

2.28. Fiscal policy can be a powerful tool for reducing poverty and inequality. Through a combination of transfers, subsidies and taxation of households, fiscal policy alters the disposable income of households. It changes households' future earning capacity too, as government spending on social services influences not just their quality, but how expensive and accessible they are. This translates into differences in how the poor and rich access and utilize services and accumulate human capital, with significant implications for social mobility. An important policy consideration then, is whether fiscal policy leaves society more unequal, or makes the poor better off. This is considered from two perspectives - whether the intergovernmental fiscal transfers direct resources to areas in need to distribute the benefits of growth more broadly and whether at the household level, the poor benefit from government spending.

Enhancing equitable resource allocation to promote development across provinces

2.29. Intergovernmental fiscal arrangements in Vietnam have helped to promote greater equity in resource distribution, both across and within provinces. These arrangements define those areas with higher spending needs and then channel more transfers from the central to the poorer parts of the country where decentralized revenue is low and costs of service delivery are higher because of lower population density. These arrangements also enable richer provinces, which have higher revenue potential, to continue to have higher relative levels of spending. The incentives provided by the mechanism aim to stabilize the revenue-sharing ratio with central government within a period of 3 to 5 years. Similar budget allocation practices are observed within provinces with the same effects.

2.30. Central government has also supported sub-national spending to address poverty reduction through targeted transfer and matching grant systems. Between 2011-15 there were 61 target transfer schemes[6] and 16 National Target Programs (NTPs). Nearly 75 percent of spending on NTPs went into four programs: Job Creation and Vocational Training (12 percent); Sustainable Poverty Reduction (15 percent); Education and Training (17 percent); and Development of a New Rural Life (29 percent). During the period, approximately 56 percent of funding for all NTPs came from central authorities; 26 percent from local authorities; 5 percent from external donors; 4 percent from borrowing; and 9 percent from community contributions.[7] In addition, there were 28 other targeted programs.[8]

2.31. The transfer systems have demonstrated clear redistributive benefits between provinces (as demonstrated in Figure 2.10 and Figure 2.11). It can be seen that the poorer provinces, located in the Northern and Western mountainous areas, have benefitted significantly from the transfers (on a per capita basis). The systems include balancing transfers and targeted transfers which account for 16 percent and 19 percent of total budgets respectively.

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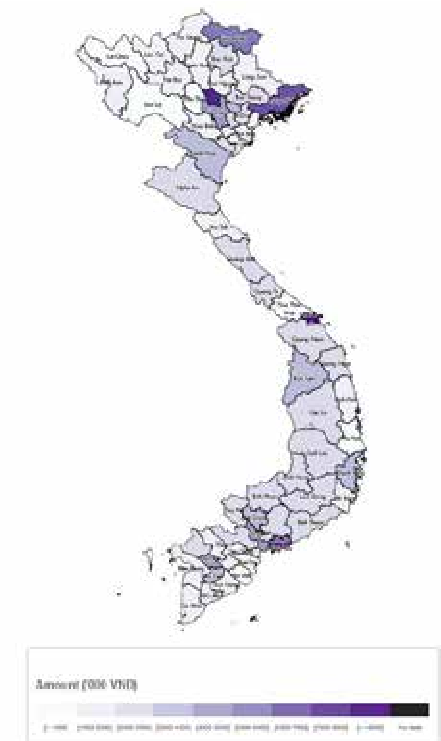
[7] This includes an investment program in the 62 poorest districts; specific infrastructure investment (e.g. dykes, research and development centers); economic development programs in the East Sea islands and border areas; and investments in provincial and district hospitals.

[8] GOV report to the National Assembly on implementation of NTPs (2011-13).

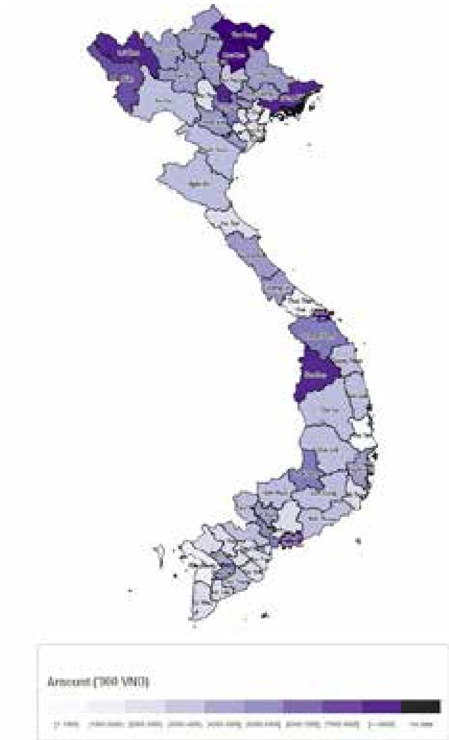
[9] The number of non-NTP target transfer schemes has fallen from 50 in 2007-11, to 28 in 2011-15.

Figure 2.10: Per capita spending before central transfers is higher in the wealthier eastern-coastal provinces



Source: WB staff estimates based on MoF data.

Figure 2.11: Per capita spending after central transfers is higher in the poorer northern mountainous and central highlands provinces

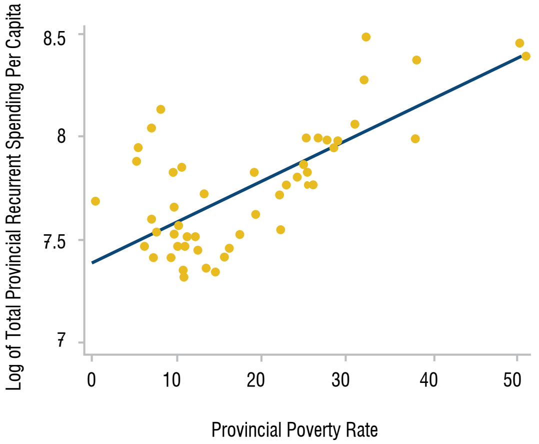


Source: WB staff estimates based on MoF data.

Note: The boundaries, colors, denominations and other information shown on any map in this work do not imply any judgement on the part of The World Bank concerning the legal status of any territory or the endorsement or acceptance of such boundaries.

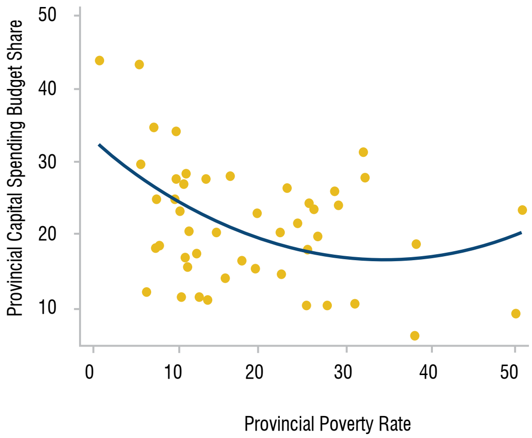
2.32. These arrangements have made recurrent spending largely pro-poor and equitable while capital spending balances equity and efficiency considerations. Sub-national recurrent spending is strongly pro-poor in the sense that recurrent spending per capita tend to increase with the poverty rate of the region (Figure 2.12). Sub-national capital spending per capita is comparatively significant at either low or high levels of poverty (Figure 2.13). As a result, sub-national capital spending drives total sub-national spending outcomes related to poverty. Total per capita spending by province is only pro-poor at the higher levels of poverty (Figure 2.14), contributing to the impressive record of poverty reduction.

Figure 2.12: Higher recurrent spending in poor provinces



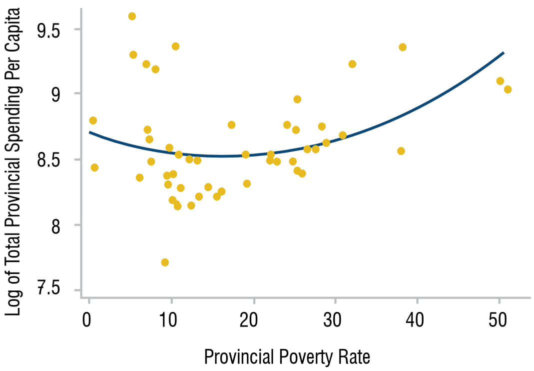
Source: WB staff estimates based on MOF data.

Figure 2.13: Relatively large capital spending at low and high levels of poverty



Source: WB staff estimates based on MOF data.

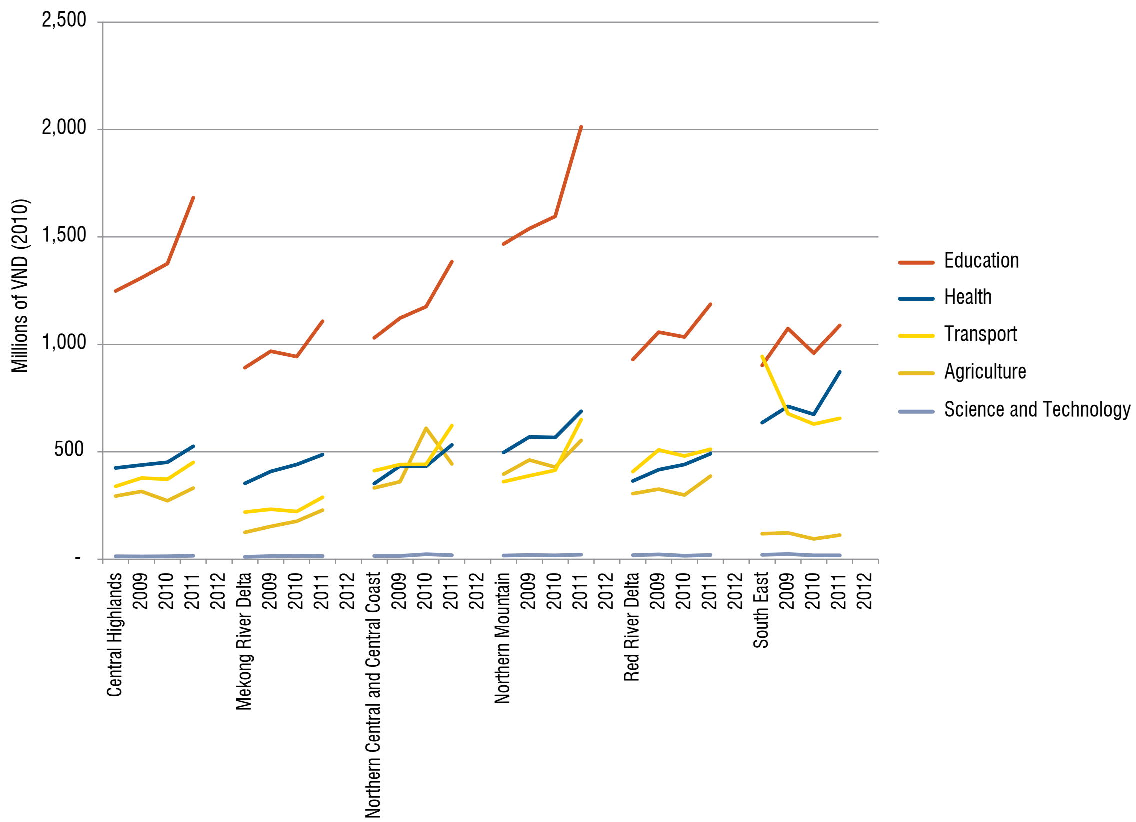
Figure 2.14: Total sub-national spending is pro-poor



Source: WB staff estimates based on MOF data.

2.33. On an aggregate basis, total spending of regions appears to be generally consistent with the Government's human capital equity objectives. In broad terms, poorer regions (i.e., the Northern Mountains, Central Highlands and Northern Central and Central Coast regions) tend to have higher levels of per capita expenditure on core functions such as education and health. The richest region (i.e., the South East) also has a high level of per capita spending on human capital, however, spending is comparatively low in the middle range of regions (i.e., the Mekong River Delta and the Red River Delta regions) (Figure 2.15).

Figure 2.15: Per capita sub-national human development spending by region, 2009-12



Source: MOF.

2.34. In the future, it will be important to nurture growth in decentralized revenue and strengthen the operation of the transfer system. Drivers of growth should be renewed by prioritizing investment in infrastructure and human capital development. These actions should help to sustain the drivers for the country's equitable growth, as well as assist the positive impact of redistribution policies across provinces. There is a risk that the gap between the poorer provinces and the more prosperous ones could widen as the poorer provinces tend to yield fewer public revenues. Unless proper incentives are put in place, these poorer provinces may over time become relatively more dependent on central transfers.

2.35. Consideration should be given to possible additional revenue autonomy and a more equitable revenue-sharing arrangement. These could include considering the introduction of property tax (which is a common local tax worldwide) and increasing local government autonomy over the determination of local user fees. This would help to raise additional resources, especially in high growth potential provinces. The distribution arrangements of major taxes also warrant review to improve their transparency and equity. More equitable revenue-sharing arrangements have been internationally proven to promote local economic performance and revenue performance equally across local areas. According to the State Budget Law (2015), indirect taxes (e.g. VAT and excise) are currently credited to the provinces where they are produced. Since these taxes are paid by consumers from many different provinces, it is recommended that it be shared in a more equitable manner. International experience indicates that some countries centralize their VAT revenue and distribute it to provinces using a formula-based approach, e.g. using provincial population, GDP and/or level of consumption per capita.

2.36. Vietnam's system of balancing (or unconditional) transfers is relatively transparent, rule-based and highly predictable. The key principle in determining spending needs (for both capital and recurrent expenditure) is through the use of allocation norms based on population and other criteria such as school-age population, geographic location, etc. Thus, the greater the population, the higher the budget expenditure allocation. Higher expenditure allocation is factored in for the population in disadvantaged areas, subject to its development level and higher costs of service delivery. The State Budget Law (2015) also allows the adjustment of annual balancing transfers for inflation. This is an important principle to ensure equity in budget spending as spending needs are more fairly determined and are not dependent on local revenue capacity. Under these arrangements, although budget revenues are not distributed evenly across provinces (about 80 percent of the national budget revenue is concentrated in a quarter of provinces), the allocation of budget expenditure ensures that poorer provinces are resourceful in making apparent progress in socio-economic development due to the fiscal transfer system.

2.37. However, there are some limitations in population-based allocations. The current budget allocation formula for education is not based on the number of students but on the school-age population. This is similar to health, training, culture, information, sports and athletic services, etc. The population based allocation is therefore not linked to the amount of available facilities that should be invested in and their utility. This budget allocation practice provides little incentive for provinces to enroll more students, rationalize the teacher/doctor workforce and initiate administrative reforms to achieve human resource efficiency gains. The allocation norms seem to favor sub-national governments with higher revenues, allowing them to adopt higher population-based allocation norms. Nevertheless, this practice is a way to provide additional resources for the sub-national governments in key economic hubs to address additional costs (e.g. in response to the needs for education, health care, infrastructure, social order and safety services) of non-residents or temporary immigrants.

2.38. It is critical to consider a gradual change in the existing budget allocation mechanism to better incentivize provinces to spend their budgets more efficiently. The population-based allocation should be combined with other more output based criteria. For example, the number of graduates, number of treated patients, and volume of public services delivered, etc. As a next step, it is recommended that provinces gradually move towards applying an intra-provincial budget allocation system taking into account the output indicators (students/patients) as a stepping-stone towards future nationwide application. The allocation of capital investment should be linked with the medium-term public investment plans agreed on the basis of development and infrastructure gaps. Program budgeting can be an appropriate approach and can be phased in through an appropriate roadmap. To retain the key principles of cost and population base of the budget allocation system, it is recommended that the costs of extraneous factors and provision of compensating transfers be considered, instead of increasing spending norms for provinces according to their revenue capacity. This will encourage infrastructure development and enrichment of the revenue base in potential high growth provinces.

2.39. Too many targets and programs may inevitably lead to overlaps, lack of predictability and lower management efficiency. NTPs are complex and fragmented and funding allocations are unpredictable. Overlapping target programs create high transaction costs, reduce flexibility and increase the burden of reporting. Implementation of NTP's is based on input rather than output guidance. The National Assembly and the Government recently attempted to consolidate the number of NTPs into two programs. However, whilst this is a worthy objective, it is important to focus further on outputs and outcomes in NTP allocation, execution, monitoring and evaluation.

Enhancing equitable benefits of public spending at the household level

2.40. Vietnam's system of direct cash transfers is progressively distributed, suggesting that targeting of transfers is relatively effective. Analysis of incidence of five direct cash benefits namely (i) an electricity "subsidy"; (ii) an emergency food "subsidy"; (iii) a "subsidy" to low-income government employees; (iv) a "subsidy" to people with merits; and (v) a "subsidy" to poor households, suggest these are mostly directed to the poor (Figure 2.16 and Figure 2.17). They are mainly concentrated among the bottom two quintiles, with the poorest quintile receiving 63 percent of all transfers and the second-poorest quintile receiving 19 percent. An exception is contributory public pensions which largely go to the better off. The top quintile received close to half of the total pension income available in 2014 for example. Direct transfers, excluding pensions, are received by households in the country's poorest regions. Finding that more than 80 percent of government spending on direct transfers other than pensions are received by the bottom 40 percent of the population suggests the government has a relatively effective targeting mechanism in place. This could be used to deliver other transfers in future.

Figure 2.16: Concentration and incidence of direct cash transfers and subsidies by quintile

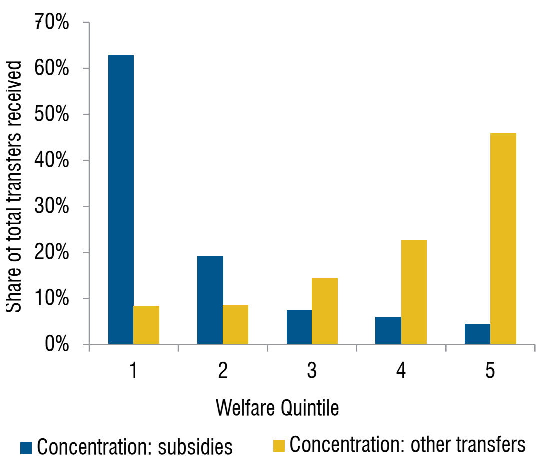
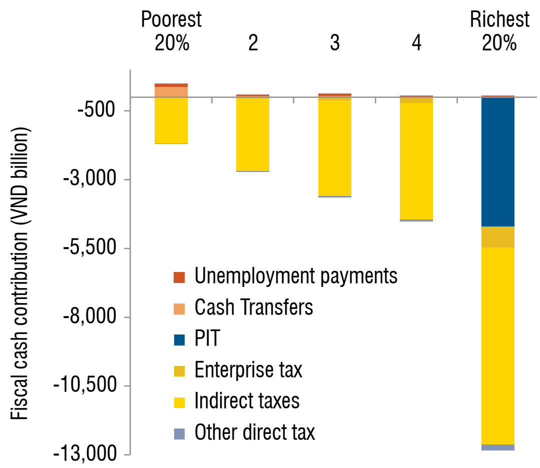


Figure 2.17: Net fiscal cash contribution by quintile

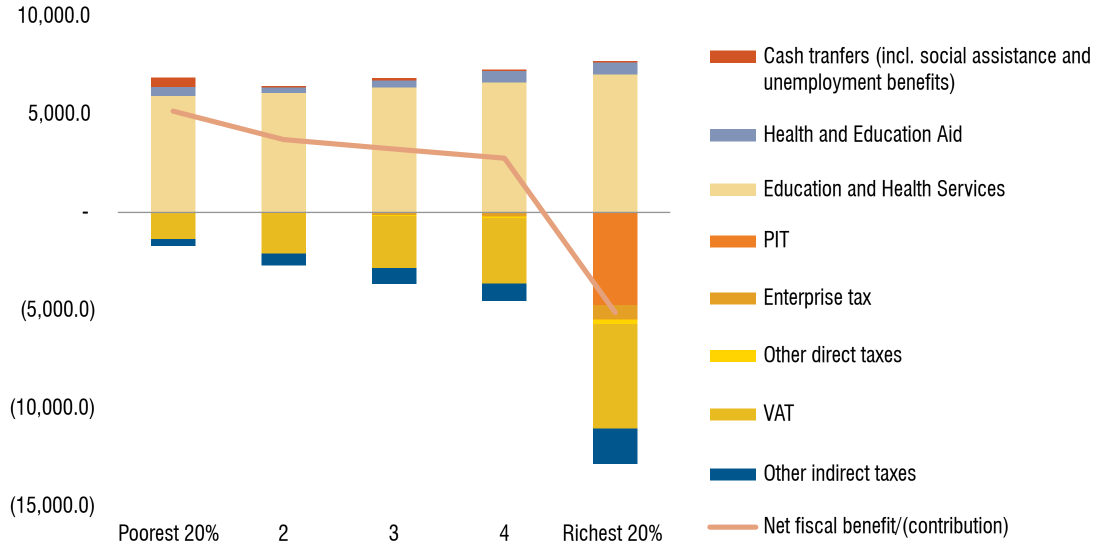


Source: Authors' estimates from VHLSS 2014.

2.41. What makes Vietnam's fiscal policy pro-poor, and a net positive contributor to household welfare, is government spending on public service provision. All households but those in the richest quintile, have a net positive value position, when government expenditures on public services in health and education are included.[9] Thus, most households receive more in value from public spending on services than they pay out in taxes, once monetized benefits from of publicly delivered health and education services are added to household consumption. Figure 2.18 shows the balance of fiscal receipts and payments including the value of in-kind benefits received in 2014, where value is created through public spending on the delivery of those services. It demonstrates that including the value of these in-kind services—which a household only benefits from when it utilizes the services—changes most households from a position of being net payers to a position of being net recipients. Only for the richest quintile do the benefits created from public spending on in-kind services amount to less that amounts paid in taxes. The fiscal net benefits are largest for the bottom quintiles, and decline for the better off with the richest quintile making a net contribution. This makes the fiscal system in Vietnam progressive.

[10] Without these, fiscal policy would be impoverishing. The net cash position of all households is negative as Vietnamese households pay out more in cash or cash equivalents than they receive in cash from the government. This reflects the relatively narrow scope of Vietnam's social assistance system with limited direct cash transfer programs.

Figure 2.18: Net fiscal benefit by expenditure and tax type



Source: Authors' estimates from VHLSS 2014.

2.42. Spending on education, and then health, has a high equalizing effect on household welfare. Publicly-provided health and education services together have the greatest fiscal impact on reducing inequality, reducing the Gini coefficient by 3 Gini points. Education services provide the greatest fiscal impact on reducing inequality among the in-kind services, contributing to 2 of the 3 Gini points drop. On aggregate, pro-poor fiscal policy and an equalizing effect of reducing inequality by 3.4 Gini points and more than 90 percent of this equalizing effect came from government spending on education and health.

Figure 2.19: Marginal contribution to total inequality reduction from fiscal policy

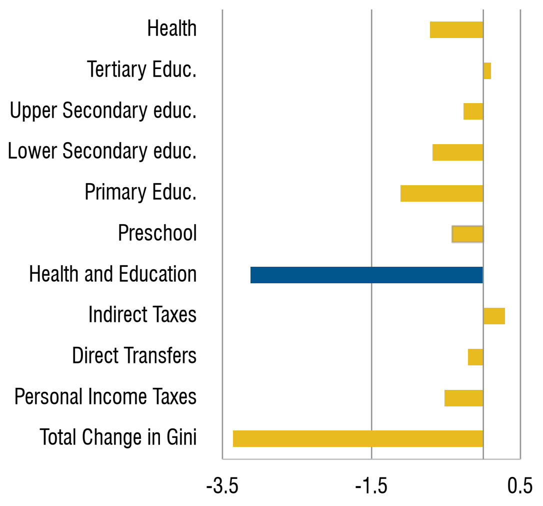
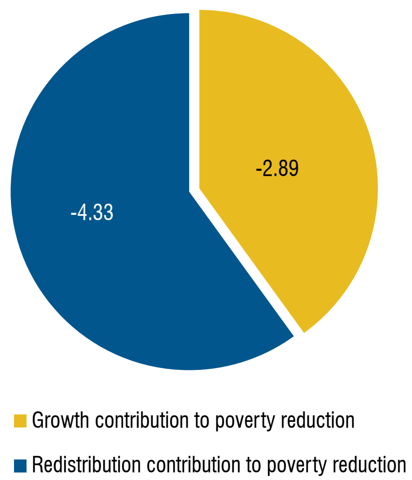


Figure 2.20: Contribution of income redistribution to reduction in poverty, 2010-2014



Source: Authors' estimates from VHLSS 2014.

2.43. Over time, the equalizing effect of government spending on public services reduced poverty. Changes in poverty can be decomposed into the contribution of average growth in household consumption and that of redistribution. This decomposition shows that redistribution contributed to 40 percent of the reduction in poverty between 2010 and 2014 (Figure 2.20). This implies the equalizing impact of government spending on social services has been instrumental for reducing poverty in Vietnam.

Addressing the risk of widening inequities in access to essential services

2.44. There is a risk of widening inequities in access to basic services if budget financing to pro -poor services is reduced. Vietnam is actively pursuing a set of interrelated policies, including socialization, designed simultaneously to improve the performance of government service delivery, increase citizen choice, reduce the financial burden upon the state. The overall goal is to gradually rationalize the role of the state in the provision of public goods. This package of reforms (coupled with autonomy policies) constitutes an ambitious reform agenda that has potential to benefit Vietnam's citizens. Significant progress has been made over the past 10 years, particularly in facilitating private sector participation in the provision of essential social services and development infrastructure and a gradual easing of subsidies from the state for these services. However, this important reform agenda is facing several challenges and posing a risk of widening inequity in access to basic services despite the proactive efforts by Government to support the poor and the near-poor.

2.45. There is a risk of excessive charges being imposed on service users in education, health, and transport sectors, which are currently the equalizing pillars of government spending. There is evidence that fiscal policy in Vietnam would be impoverishing once public financing for public services is reduced and replaced by a user fee based system. Any individual receiving benefits from fiscal expenditures will see his or her income increase, while any individual paying tax will see his or her income decrease. The Fiscal Impoverishment (FI) index first proposed by Higgins and Lustig, 2016 "tracks" the pre-fiscal income of households that become poor (or start poor and are made poorer) following the execution of a set of fiscal policies. Without benefits from public finances services, over 85 percent of the poor population would experience net fiscal impoverishment after deducting personal income tax (PIT), adding the benefits from the direct transfer system, and deducting indirect VAT and excise from their market income. On net, such people lose about 7 percent of their income. When in-kind benefits from utilization public financed services are added, 83 percent of the poor make net welfare gains of about 28 percent and the number of households with a net welfare loss is reduced to 33 percent (Table 2. 4). A move towards a fee based system translates into a withdrawal of monetized in-kind benefits, leaving most households closer their post-tax income level where most of the poor are worse-off.

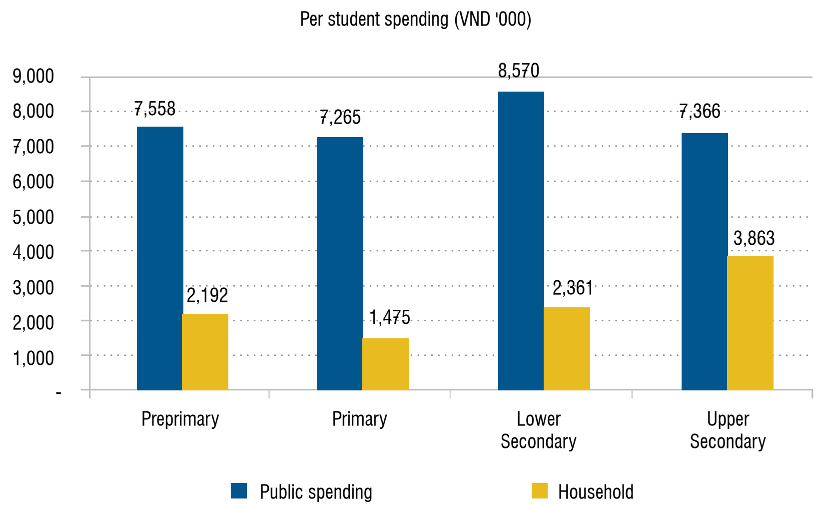
Table 2.4: The degree of impoverishment of households resulting from fiscal policy

From market income (incl. pensions) to:	Fiscal Impoverishment (FI)		Fiscal Gains to the Poor (FGP)	
	% (post-fiscal income) poor incurring net losses	Losses as a share of income (%)	% (pre-fiscal income) poor accruing net gains	Gains as a share of income (%)
Consumable income *(in-kind spending not included)*	85	7.1	20	41
Final income *(in-kind spending included)*	33	6.5	83	28

Source: Authors' estimates from VHLSS 2014.

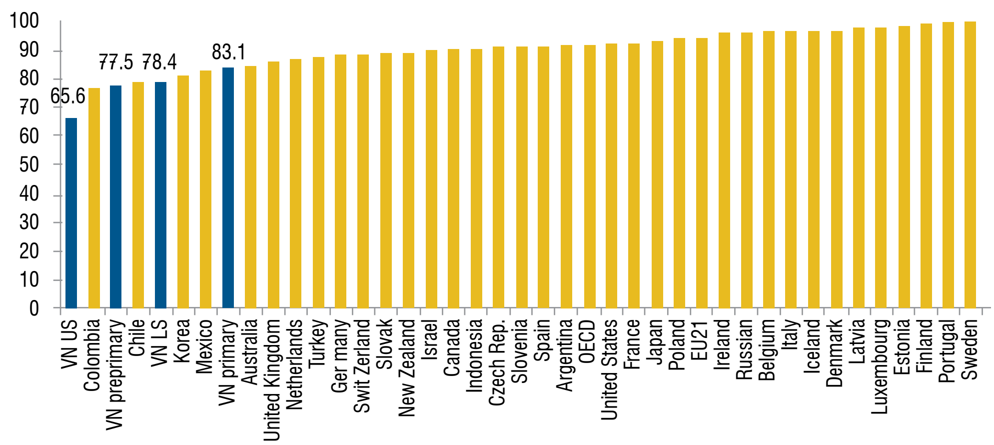
2.46. Withdrawal of public financing of public services also pushes up costs, yet household payments are at a high level compared with other countries. In recent years, the proportion of household spending on pre-primary and general education has been very high relative to public spending. The share of household spending on education is highest for upper-secondary education at 34.4 percent and lowest for primary at 16.9 percent (Figure 2.21). It is a matter for concern that the proportion of private spending on pre-primary and general education is amongst the highest in both the OECD and some non-OECD comparator countries (Figure 2.22). This is a disadvantage for children in poor families. Access to full-day schooling (FDS) depends to a high degree on parents' ability to pay school fees to finance additional sessions, lunch and other extra-curricular activities. This widens the gap between the rich and poor in accessing learning opportunities and further cost increases entrenches these gaps. Consideration should be given to providing additional funding for disadvantaged primary and lower secondary schools that are unable to move to FDS because of parental financial constraints.

Figure 2.21: The proportion of household spending on pre-primary and general education relative to public spending is very high in Vietnam



Source: VHLSS 2012 for private spending; authors' estimate for public spending based on data from MoF/GSO.

Figure 2.22: The share of public spending in total public and private/household spending on educational institutions in Vietnam is low relative to other countries



Source: OECD Education at A Glance 2014, Table B3.2b for all data except for Vietnam; author's estimates for Vietnam (2012).
Note: According to the OECD's definition, "private spending" includes all direct expenditure on educational institutions, whether partially covered by public subsidies or not.

2.47. By entrenching existing inequalities in access and quality of education, a shift to a fee-based financing especially for basic and secondary education will reduce social mobility. Access remains inequitable at pre-school and post-primary levels by location (urban and rural), region, income quintile and ethnic group. Among poorest 40 percent, less than a third of youth (15 -24 years old) enter the labor market with post-secondary education, in contrast to more than 70 percent among the top 60 percent. Evidence shows that poverty explains a drop-in enrolment to secondary education amongst the poor. The probability of dropping at lower secondary education is partly explained by pass rates for secondary completion examinations. This influenced by household spending on study support on instructional materials and coaching (Young Lives, 2013), an area in which the poor are outspent by the rich. Higher costs for accessing post-secondary education for the poor in remote areas are an additional impediment. These inequalities would be exacerbated in a fee-based system if mitigation measures are not put in place.

2.48. Because of existing inequalities in access, higher value services, such as hospital care or tertiary-level education, accrue mainly to the better off. Households in the top quintile account for 44 percent of all university and post-graduate public education spending while those in the bottom quintile account for just 3 percent. Nearly all the benefits from public spending on education received by the bottom quintile are from basic primary and secondary education. Their monetized benefits are equivalent to 30 percent of the poor's incomes. In contrast, more than one-quarter of the benefits from spending on education received by the richest quintile come from tertiary education, and nearly all (96%) of monetized health care benefits for the top quintile come from hospital care. With hospital care being more expensive, and accounting for a greater share of health expenditures, the overall public health care spending ends up being regressive due to differential utilization of hospital care between the poor and the better off. While this suggests that targeting higher-value services for "cost-recovery" or "fee-for-service" will have the least negative distributional effects, it also points to how cost can emerge as a barrier for the poor to access tertiary services once they have to pay even higher fees.

Figure 2.23: Access remains inequitable at pre-school and post-primary levels: School enrolment rate by welfare quintile, 2014

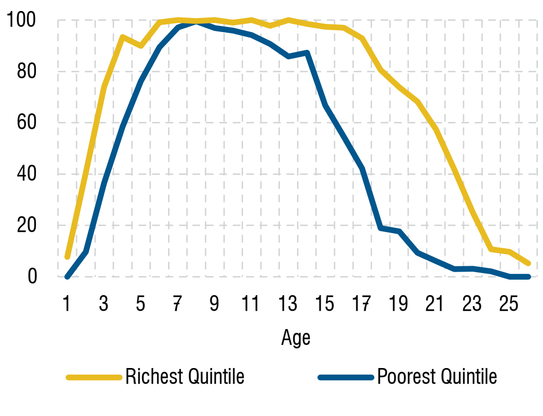
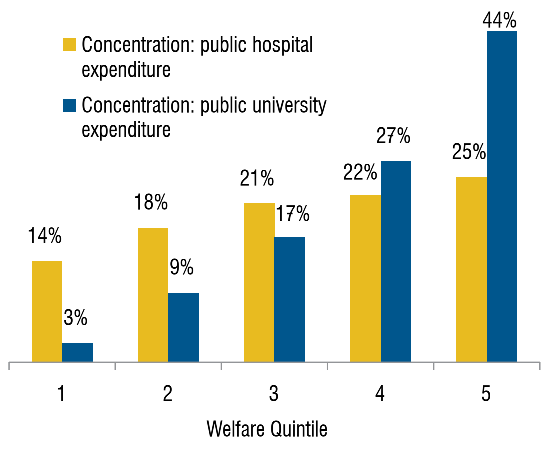


Figure 2.24: Concentration and incidence of hospital and university/post-grad expenditures by quintile



Source: Authors' estimates from VHLSS 2014.

2.49. Various concerns about equity in the health sector highlight how costs are a barrier to equal access to high quality care. Health financing policy in Vietnam in principle favors poorer provinces and the poor.[10] However, in practice, there are a number of poor households who do not have insurance cards as they are not willing to contribute the matching 30 percent health insurance premium. To address this issue, some sub-national governments have proposed to increase the level of budget support up to 70 percent. The poor and the near poor have limited access to high quality services because they are often outside insurance coverage or located at provincial or national levels which pose excessive travel costs for the poor patients. The poor therefore often tend to seek care from lower quality facilities at grassroots levels. Vietnam has higher out-of-pocket (OOP) payments than in most Asian countries, which makes the poor and the near poor more vulnerable when facing catastrophic health problems. As reported in a 2012 survey , 2.5 percent of households (about 2 million people) in Vietnam were impoverished due to OOP expenditure on health care.

2.50. There are shortcomings in the allocation of resources from Vietnam Social Security Fund (VSSF), which also result in inequality in access to health services by the poor and the near poor. The system of provincial VSS health financing to health facilities is based on differential capitation rates by insurance category (e.g. the poor, retired population, workers, etc.) on the basis of past utilization patterns instead of the actual demand for health services and the supply capacity of health facilities. This arrangement suggests that health spending is equalized for different categories of the population. However, the capitation rates are differentiated across beneficiary groups in the same province. For instance, in a surveyed province in 2012, the capitation rate for the poor was only one third of that for civil servants and other employees, because the poor have used fewer services in the past. Similarly, the capitation rates for the same category of people differ across provinces. For instance, in 2012 the capitation rate for the poor and near poor in the Northern Mountains region was only half that of the Red River region. Under these arrangements, health facilities are reluctant to apply highly technical services which may exceed the ceiling for the poor and the near poor lower capitation rates. This is especially true at provincial level hospitals where the number of referred patients (those with serious diseases with a higher cost of treatment) is likely to exceed the capitation ceiling.

2.51. To improve equity in health spending, it is recommended that the Government continue to pursue their policy of universal health insurance policy and full coverage of health insurance cards for the poor. This requires strengthening communication about entitlements, improving quality of health services, improving support to policy targeted groups. It is important to strengthen the quality of services available at grassroots level, where most of the poor seek care. This can be done by prioritizing investment in medical equipment for mountainous provinces where health services are underdeveloped and those with health insurance have less access to modern services than those in the plains and urban provinces. It is also recommended that provider payment reforms be introduced, including by gradually shifting away from fee-for-service to other health financing mechanisms such as rationalized capitation for primary care and case-based (DRG) financing for hospitals.

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[11] The state now fully covers the health insurance premiums of children under six, the elderly, those identified as poor, ethnic minorities and 70 percent of premium rates for the near-poor.

2.52. As Vietnam moves further towards market-based service pricing, improved and timely targeting practices should be adopted to mitigate the risk of increasing inequity in access to basic services. The Government has prioritized support to the poor and near-poor, either through overall budget allocation mechanisms or targeted transfer and subsidy programs. However, evidence suggests that any expansion of socialization policies should be conditional on having in place effective mechanisms to protect access to basic social services by the poor and near-poor. The impact on the poor and near-poor will depend on how good the targeting programs are and as learned from experience across the world and in Vietnam targeting errors are not insignificant in their effect.

2.53. In addition, it will be critical to pay closer attention to an appropriate division between public and private financing of public services. It will be critical to develop appropriate policy criteria to guide the imposition of user charges for services provided by PSDUs. Decree No. 16 (2015) sets out a roadmap for PSDU operational and financing reform by (i) moving away from direct budget financing of service providers to financing by payment for services, which will gradually be fully costed; (ii) providing direct support for policy targeted service users instead of offering service fee exemption by service providers; (iii) providing on-going budget support for PSDUs operating in selective sectors. There is therefore a need to develop lists of public services that are fully or partially financed by the State budget. For example, in most countries tertiary education is considered to provide benefits not only to the student (especially a higher future income), but also benefits society as a whole (an "external" benefit), principally by stimulating faster economic growth. For this reason, it is widely considered that it is appropriate for government to pay part of the cost of tertiary education for students in general, in addition to larger subsidies for disadvantaged students. Due to the quasi-public nature of tertiary education, failing to provide such a general subsidy and obliging the majority of students to pay the full cost will result in a level of tertiary education below that which would provide maximum social benefit.

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