

The World Bank

Making The Whole Greater Than The Sum Of The Parts:
A Review of Fiscal Decentralization in Vietnam

Summary Report
October, 2014

Abbreviations

BVT	Business Value Tax
CBFA	Committee on Budgetary and Finance Affairs
CBRC	China Banking Regulatory Commission
CBIS	Community Boards for Investment Supervision
CIT	Corporate Income Taxes
DOF	Department of Finance
DP	Development Partner
DSA	Debt Sustainability Analysis
GDP	Gross Domestic Product
GOV	Government of Vietnam
HIFU	HCMC Investment Fund for Urban Development
LDIF	Local Development Investment Funds
LG	Local Government
LGfV	Local-Government Financing Vehicles
MOET	Ministry of Education and Training
MOF	Ministry of Finance
MOH	Ministry of Health
MOHA	Ministry of Home Affairs
MPI	Ministry of Planning and Investment
NA	National Assembly
NTP	National Target Program
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
PAPI	Provincial Governance and Public Administration Index
PEFA	Public Expenditure and Financial Accountability
PER	Public Expenditure Review
PFF	Public Financial Funds
PIBs	People's Inspection Boards
PIT	Personal Income Tax
PM	Prime Minister
PPC	Provincial People's Committee
PSE	Public Sector Efficiency
PSP	Public Sector Performance
SBL	State Budget Law
SEDP	Socio-Economic Development Plan
SOE	State Owned Enterprise
UNDP	United Nation Development Program
VAT	Valued Added Tax
VBSP	Vietnam Bank for Social Policies
VDB	Vietnam Development Bank
VHLSS	Vietnam Household Living Standard Survey
WB	World Bank

Foreword

This report provides a review of fiscal decentralization policies in Vietnam and their impact on the Government's development objectives. It aims to inform reform of central-local fiscal relations in Vietnam to further promote growth and poverty reduction. The report was prepared under the overall guidance of Victoria Kwakwa (Country Director, WB Vietnam), Sudhir Shetty (Chief Economist, WB East Asia and Pacific Region), Rob Talierno (Lead Economist, WB), Sandeep Mahajan (Lead Economist, WB), James A. Brumby (Practice Manager, WB), and Deepak Mishra (Lead Economist, WB) by a core team including:

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Vietnam Fiscal Decentralization Review: Summary Report

BACKGROUND: Local authorities in Vietnam are responsible for over half of total government spending, thanks to fiscal decentralization policies implemented over the past eighteen years. Total government spending in Vietnam is close to 30 percent of Gross Domestic Product; local authorities' spending is close to 17 percent of GDP. Study of fiscal decentralization therefore is central to understanding government spending in Vietnam and its significant impact on the country's successful record of economic growth and poverty reduction.

MOTIVATION: To date however there has been little analysis of how fiscal decentralization has enabled local authorities to effectively, efficiently and accountably spend money on public services for development. Spending decentralization has grown more quickly than information on the effectiveness of local fiscal policies. This has prompted a number of questions from the National Assembly, the Central Government, and other stakeholders. This report tries to answer some of these questions to help inform future changes to central-local fiscal relations:

How are local spending choices aligning with national level objectives? How much spending responsibility do local authorities have? Are current policies and institutions sufficient to ensure that the money is spent well and in line with citizens' needs? How much do different provinces spend on delivering the same public services and what might explain the differences? What results are being achieved? How effectively are local authorities able to raise revenues to finance local spending? Are fiscal transfers sufficient to effectively cover all local spending needs? Are transfers being equitably distributed? Are there more opportunities for provinces to borrow to meet investment needs?

KEY FINDINGS AND RECOMMENDATIONS:

There has been significant spending decentralization both in terms of spending assignments and autonomy over resource allocation decisions. Fiscal decentralization policies have helped to channel more spending to the poorest parts of the country where development needs and costs of service delivery are higher. There is also evidence that decentralization has on the whole moved in line with administrative capacity.

Institutions of fiscal transparency and accountability however have not kept pace with greater spending responsibility. The revision to the State Budget Law 2002 offers an important opportunity to enhance transparency and public participation in local budgets, and ensure clearer accountabilities in a nested budget system that otherwise leads to overlaps and confusion.

The report finds that spending efficiency of local authorities can improve by imposing more discipline on budget implementation. For example, evidence shows that practices such as large carry overs and flexibility on the use of over-realized revenue reduce spending efficiency. The report recommends to significantly reform these practices as part of the SBL 2002 revision process.

Despite strong spending decentralization, local authorities have little to no revenue autonomy. Evidence shows that the current arrangements do not have a discernable negative impact on revenue collections. Yet revenue autonomy is an essential part of fiscal decentralization to promote greater accountability and increased investments in high growth potential areas. The report recommends some gradual steps that Vietnam can take to phase in some independence for local authorities on revenue policy decisions.

Evidence shows that intergovernmental fiscal transfers are equalizing both from the center down to provinces, but also from provinces down to districts. This has helped to close large imbalances across provinces and across districts. This in turn has contributed significantly to development particularly in the poorer provinces. There is scope to further strengthen the allocation norms used to determine spending needs, which in turn feed into estimates of balancing transfers, for which the report makes a number of recommendations. The report also points to ideas for strengthening the system of targeted transfers from an input driven approach to a more performance-based one.

Current limits on local borrowing have helped to maintain local debt at prudent levels, but these limits are not based on economic rationale. Evidence shows that provinces such as HCMC could potentially borrow more and maintain prudent levels of debt. However, higher borrowing also needs to be matched by increased revenue autonomy to make sure that local authorities do not run into liquidity problems. It will also require local debt to be brought onto the budget. This is critical for transparency. Based on the above, the report recommends a revised approach to debt ceilings.

CONCLUSION: *A combination of these measures should help to maintain the government's successful redistributive policies to meet social objectives, and enable high economic potential provinces to invest in growth enhancing initiatives, whilst enhancing transparency to ensure accountability. Lack of transparency and coordination in intergovernmental fiscal relations can lead to fragmentation and unequal development across the country. Intergovernmental fiscal relations should ensure that development efforts of all provinces exceed the sum of their individual parts so that they can help eliminate extreme poverty and promote shared prosperity in Vietnam.*

1

Introduction

The State Budget Law 2002 (SBL 2002) has enabled decentralization of important fiscal responsibilities to local authorities over the past ten years. This report responds to demands for more analysis of fiscal decentralization policies in Vietnam and the extent to which these have delivered on their stability, equity and efficiency objectives. It aims to inform future changes to the system of intergovernmental fiscal relations through revisions to the SBL 2002 and adoption of 2016-2020 Stability Period regulations.

The SBL 2002 establishes the key principles for spending assignments, revenue arrangements, and intergovernmental fiscal transfers. It also grants provincial authorities a fair degree of autonomy to determine fiscal relationships with districts and communes within their jurisdiction. The current system allows a reasonable level of differential treatment across provinces to take account of their specific circumstances.

There is general acknowledgement that the SBL 2002 has provided a solid framework for public finance management including intergovernmental fiscal relations. At the same time, after 10 years of implementation a number of issues arise such as: clarity of spending responsibilities and local level accountability including for national priorities and objectives; spending performance of local authorities; the effectiveness of local revenue arrangements in meeting spending needs and the potential for increased revenue autonomy for provinces; the extent to which provincial authorities are promoting or impeding central government's redistribution efforts; and the potential for increased debt financing for local authorities.

This report builds on existing research and aims to provide new analysis and perspectives on the above areas through extensive study of available data, consultations with central and local authorities, and reviews of laws, regulations and policies at central and local levels. It covers the following five pillars of fiscal decentralization: (i) expenditure decentralization and accountability; (ii) expenditure performance of local authorities; (iii) local revenue arrangements; (iv) intergovernmental fiscal transfers; and (v) local borrowing.

INTRODUCTION

Local fiscal policies have a significant impact on Vietnam's development. This report looks at the extent to which fiscal decentralization policies have achieved their development objectives

Local authorities have been granted increasing levels of fiscal responsibilities since the adoption of the State Budget Law (2002). Local fiscal policies in Vietnam have a significant impact on the country's record of economic growth and poverty reduction. They determine decisions on public service delivery and the overall development trajectory of the country. Poor spending or revenue decisions at local level, coupled with lack of transparency can lead to inefficient spending, unequal development across the country and reversal of the country's successful track record in delivering inclusive growth.

Despite the importance of fiscal decentralization in Vietnam's development, there has been little study on the successes and failure of policies and institutions in this area. This report responds to demands for more analysis of fiscal decentralization policies in Vietnam and the extent to which these have delivered on their intended objectives of equity and efficiency to promote economic growth and poverty reduction. It aims to inform future changes to the system of intergovernmental fiscal relations through revisions to the SBL 2002 and adoption of 2016-2020 Stability Period regulations.

The report aims to inform changes to the SBL 2002 and 2016-2020 Stability Period regulations, which provide the frameworks for intergovernmental fiscal relations in Vietnam.

The SBL 2002 establishes the key principles for spending assignments, revenue arrangements, and intergovernmental fiscal transfers. It also grants provincial authorities a fair degree of autonomy to determine fiscal relationships with districts and communes within their jurisdiction. There is general acknowledgement that the SBL 2002 has provided a solid framework for public finance management including intergovernmental fiscal relationships.

After 10 years of implementation of the SBL 2002, a number of issues arise in relation to the system of intergovernmental fiscal relations, such as: clarity of spending responsibilities and local level accountability including for national priorities and objectives; spending performance of local authorities; the effectiveness of local revenue arrangements in meeting spending needs and the potential for increased revenue autonomy for selected provinces; the extent to which provincial authorities are promoting or impeding central government's redistribution efforts; and the potential for increased debt financing for local authorities within prudent limits.

This report builds on existing research and aims to provide new analysis and perspectives on the above areas through extensive study of available data, consultations with central and local authorities, and reviews of laws, regulations and policies at central and local level. It analyzes five pillars of fiscal decentralization to assess the extent to which these are promoting or hindering the government's development objectives. These five pillars are: (i) expenditure decentralization and accountability; (ii) expenditure performance of local authorities; (iii) local revenue arrangements; (iv) intergovernmental fiscal transfers; and (v) local borrowing.

2

Expenditure decentralization and accountability

Key issues: local authorities in Vietnam have historically accounted for a significant share of total public sector spending, which has increased further since the adoption of the SBL 2002. Feedback from implementation of the SBL 2002 and earlier studies have highlighted that transparency and accountability of local budgets have not kept pace with the rising delegation of spending responsibility.

Objectives: the objectives of this chapter are to assess the extent to which public spending decisions have been decentralized in Vietnam, and options for strengthening the institutional arrangements around spending assignments and accountability to promote allocative and productive efficiency.

Key findings: local authorities in Vietnam represent a large share of the local economy, particularly in poorer provinces. The latter have also seen higher levels of per capita spending compared to richer provinces, thanks to the redistributive nature of fiscal transfers in Vietnam.

Local authorities in Vietnam are responsible for around 55 percent of general government spending. They account for over 75 percent of total capital spending, and in key social service delivery areas such as education (90 percent), economic services (80 percent) and a growing share of health (from 72 percent of recurrent spending in 2006 to 88 percent in 2011).

Decentralization within provinces, down to district authorities has also increased in the 2006-2011 period. In half of all observations, district spending represents more than 45 percent of total local spending. District authorities account for the majority of recurrent spending in both health and education within provinces, though decentralization of capital spending has been less pronounced.

An institutional review of expenditure assignments across different tiers of government suggests that the current arrangements would benefit from some specificity, including on: exclusive spending mandates of central government, exclusive responsibilities of different tiers of government within one jurisdiction; and exclusive responsibilities of local authorities.

On budgeting and accountability, the chapter finds that the compressed budget calendar and current appropriation structure warrant review to strengthen legislative oversight. At the same time, there is considerable scope for improving budget transparency and participation through clearer communication of budget policies, and publication of the draft budget proposals.

There is currently limited participation in the budget preparation process in Vietnam, when evidence from elsewhere, and partly also from Vietnam shows better outcomes and satisfaction with service delivery when participation is promoted.

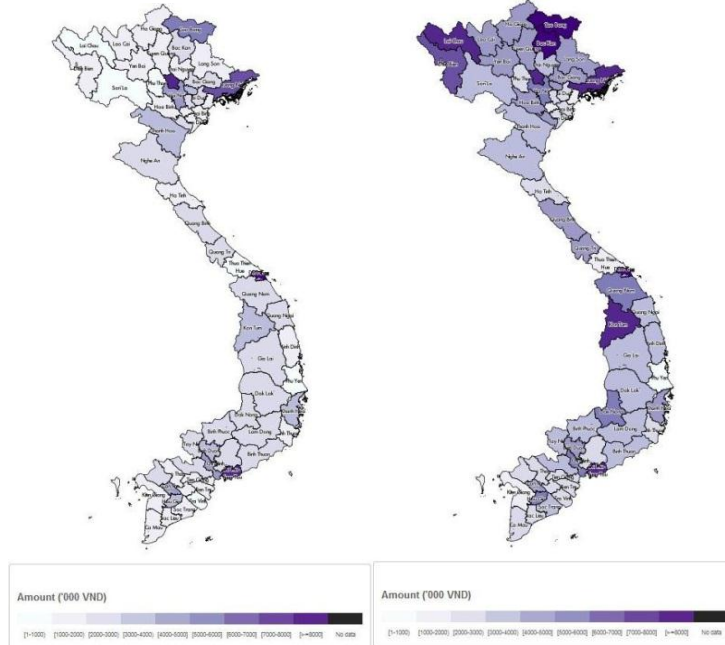
Recommendations: (i) more explicit assignments on service delivery for different tiers of government within a jurisdiction; (ii) decompression of the budget preparation calendar; (iii) greater autonomy over budget approval authority of people's councils and clearer provisions on budget appropriations; (iv) elimination of minimum allocation requirements for sectors; and (v) increased transparency and participation in the budget process.

EXPENDITURE DECENTRALIZATION

Local government spending has played an important role in delivering services to the poorest parts of the country.

Local government spending constitutes an important share of provincial economies in Vietnam. It has played a particularly important role in poorer provinces that are sparsely populated. This reflects efforts to expand service delivery into poorer areas, where costs of service provision are also higher. Central transfers to local authorities have helped in this redistribution process (figures 2.1 and 2.2).

2.1 Per capita spending pre central transfers 2.2 Per capita spending post central transfer



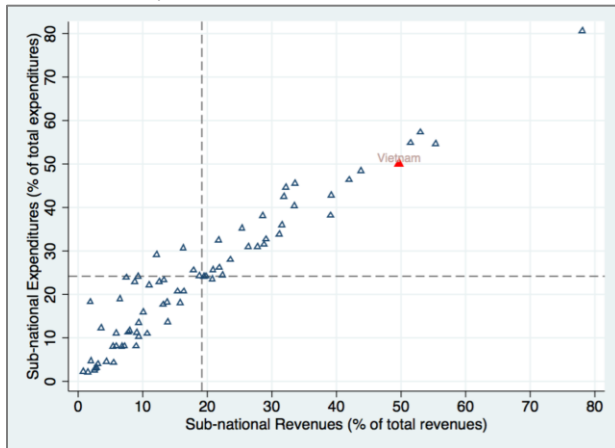
Local authorities are responsible for over half of total government spending, which is high by international standards.

Local authorities are now responsible for just over half of total government spending, which is high by international standards (figure 1.3). In Vietnam, although higher levels of spending have also been matched by higher levels of local revenue, local authorities have little to no autonomy over revenue policy and administration. Despite this, with decentralized revenue and unconditional balancing transfers accounting for more than 75 percent of core spending on average across all provinces, local authorities have had a fair amount of discretionary resources at their disposal.

Over three quarters of recurrent spending in social sectors is under the control of district authorities.

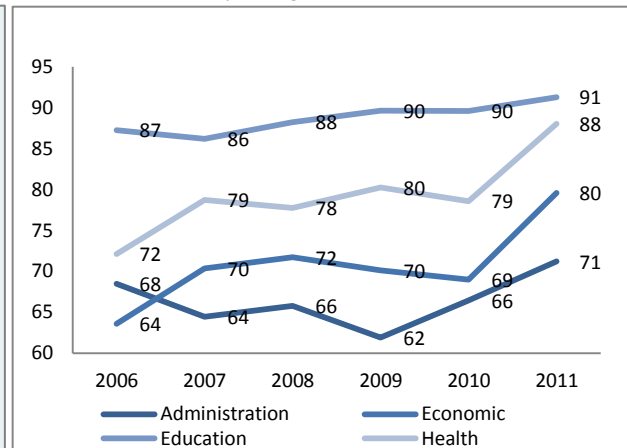
Local authorities' share of total government recurrent spending in important areas like education, health, economic services, and public administration has been high and increased further between 2006 and 2011. For education, local authorities account for 80-90 percent of total recurrent spending and for health the ratio is around 75-80 percent. Decentralized revenue and unconditional balancing transfers help to cover over three quarters of local spending, suggesting high level of discretionary resources available to local authorities.

2.3 Expenditure and revenue decentralization



Source: Staff estimates based on published State Budget data

2.4 Local recurrent spending in selected functions (% of total)



There is significant decentralization within provinces, bringing resource allocation decisions closer to the people.

Vietnam exhibits a high degree of spending decentralization within provinces, which has increased over the last two Stability Periods. Half of all observations in 2011 showed that districts were spending at least 45 percent of total local recurrent spending. District authorities have been responsible for most of the recurrent spending in both education and health within most provinces. Districts' share of local recurrent spending in education has remained relatively high and constant in the last two Stability Periods, but in health there has been a marked shift in spending decentralization to districts. In contrast, most of the capital spending (around 70 percent on average) is carried out by provincial authorities.

Higher capacity local authorities have higher levels of spending responsibilities.

In Vietnam, the evidence shows that on average higher capacity local authorities have higher levels of spending responsibilities. Experience in other countries has shown that decentralization too quickly can have serious adverse impacts when local administrative capacities are low. The evidence in Vietnam also shows that the share of rural population is also positively linked to the level of decentralization within a province. This is also important as predominantly rural provinces have less densely populated areas. Therefore centralizing spending decisions may fail to adequately take account of local preferences.

There is scope for clarifying spending responsibilities between center and province.

The SBL 2002 currently assigns the same expenditure responsibilities to both central and provincial authorities i.e. most spending assignments are shared/concurrent. Sector legislation in health and education for example provides some clarity in terms of assigning exclusive responsibility for regulation to central government. In general, however, having so many shared functions between center and province causes ambiguity over spending assignments.

Some functions should rest exclusively with central government.

Some functions should rest exclusively with central authorities because their costs and benefits are national in scope e.g. national defense and security, foreign policies). In Vietnam, however, local authorities are also expected to participate in funding of these services. Several local authorities have

indicated that this creates ambiguities and pressures on local budgets, which should be addressed through clearer assignment of exclusive responsibilities to central government. In the case of non-exclusive/shared functions, the explicit responsibilities of center and provincial authorities should be clearly set out based on agreed criteria.

Within a jurisdiction, service delivery responsibility should rest with only one level of government.

Provincial level resolutions on revenue and expenditure assignments have provided significant clarity on spending and revenue assignments for provincial, district and commune authorities. However, in many cases, both province and district authorities are also assigned the same service delivery responsibility. Therefore unlike center-province division of responsibilities, there are explicit assignments for authorities within provinces; but in some cases, all tiers within the province are explicitly responsible for the same services. Whilst different orders of government can be responsible for different tasks within a jurisdiction, it is better to avoid assigning different orders of government to perform the same task within a jurisdiction. This leads to overlap and unduly complicates planning and budgeting.

The nested budget system complicates budget preparation and monitoring. Some SBL 2002 provisions also dilute accountability to People's Councils.

Although the SBL 2002 has introduced significant clarity on the roles and responsibilities of different actors, the nested budgeting system complicates budget preparation and monitoring. Vietnam is one of few countries that still operates such a nested system, which creates several challenges. Firstly, the multi-layered budget approval process significantly compresses the budget calendar. This makes it difficult for Provincial Councils to adequately scrutinize the draft budget. Secondly, the authority of, and therefore accountability to, local councils is diluted by the following provisions in the SBL 2002: "veto rights" of higher levels of government over budgets approved by lower tiers (Article 47); and the lack of formal requirement to seek legislative approvals before the executive makes changes to budget appropriations.

Central fiscal rules and norms on minimum allocations impact adversely on local autonomy.

Despite increased responsibility over spending, central fiscal rules and norms affect local autonomy over budget decisions in selected areas and distort resource allocation. There are minimum allocations set for education and science and technology without due consideration of actual needs or the level of service provision by central authorities within a province. A minimum allocation to an area such as science and technology without link to capacity can lead to waste. Rules on the need to spend 50 percent of over-realized revenue on wages and 50 percent on capita fail to take advantage of recognized budget priorities and leads to the inefficient use of resources.

There is much budget information in the public domain but limited public participation.

Great efforts have been made to ensure publication of budgetary information, but current practices on budget disclosure do not encourage participation. The general public is not able to contribute to the budget preparation process as the budget is only published after it is approved by the legislature. The current budget classification structure, budget table templates, and coverage of fiscal activities in budget documents do not encourage active citizen participation in scrutinizing public finances and providing meaningful feedback to local authorities. The highly technical presentation of budget documents

prevents the public from understanding let alone analyzing budget policies.

Budget policies should be clearly communicated to promote participation

Budget disclosure should be complemented with efforts to encourage citizen participation as disclosure by itself will have limited impact on accountability for service delivery. At a minimum this would involve publication of the draft budget submitted to the National Assembly and People’s Councils. But in addition, the government should look at publishing Citizens’ Budgets, which are summaries of the State Budget communicated in a simple way so that it is understood by as many people as possible. Evidence from the PAPI survey show a very clear link between participation in public finance and project design and satisfaction with service delivery at the local level.

Recommendations on expenditure decentralization

	Issues	Recommendations
State Budget Law 2002	Lack of exclusive spending assignments for central government in SBL 2002 leads to local authorities taking on the responsibilities of central government.	Simplify Articles 31 and 33 in the SBL 2002 stating that all tiers may spend on any functional area but that some functional areas are the exclusive responsibility of central government. This may also need to be addressed in the upcoming Law on Local Government.
	The current budget preparation calendar is too compressed to enable local councils to scrutinize the draft budget.	Review Article 45 of SBL 2002 to decompress the budget calendar, including earlier start to budget preparation process.
	SBL provisions that give upper tier authorities “veto rights” over budgets approved by lower tier governments dilute local councils’ authority.	Review Article 47 of SBL 2002 to assign more clearly authority to local councils for budgets at their own level.
	SBL provisions on changes to budget appropriations, undermines accountability to local councils as the latter are not required to approve re-appropriations.	Review Article 49 of SBL 2002 to indicate that any adjustments to appropriations need to be mandates by the legislature, or clarify delegation of authority to approve re-appropriations.
	The general public is not able to contribute to the budget preparation process as the budget is only published after it is approved by the legislature.	Require publication of budget proposal when it is submitted to the legislature.
Stability Period regulations	The lack of explicit assignments between center and province for service delivery can lead to ambiguity and undue pressures for local budgets.	Each provincial resolution should set out the explicit responsibilities of center versus provincial authorities within that jurisdiction.
	For shared functions, enabling multiple orders of government to provide the same service/perform the same task within a jurisdiction can lead to overlaps and poor planning and budgeting.	Provincial resolutions on revenue and spending assignments should set explicit responsibility for specific tasks within a jurisdiction.
	Central fiscal rules and norms affect local autonomy over budget decisions and distort resource allocation.	Reconsider minimum allocation norms for sectors or types of expenditure in the next Stability Period.
State Budget Law regulations	The current budget classification structure, budget table templates, and coverage of fiscal activities in budget documents.	Develop Citizens’ Budget to communicate in a more accessible manner budget policies of local authorities.

3

Expenditure performance of local authorities

Key issues: *Earlier studies have indicated a lack of credibility in public spending plans, due to current policies on use of over realized revenue, extra budgetary financing and carry over practices. This leads to a loss of budget transparency, which can impact negatively on productive efficiency. This is a matter of prime concern to policy makers now as Vietnam faces tightening fiscal conditions with slowing revenue mobilization.*

Objectives: *The objectives of this chapter are to determine if the above spending management practices are impacting on spending efficiency, and the implications for reform to promote greater budget credibility and transparency.*

Key findings: *Local spending plans lack credibility when compared to actual outturns. This is particularly the case for capital spending, which is often more than 50 percent of what was budgeted, well above good practice guidelines of maintaining spending within 5 percent of budget.*

The lack of credibility arises partly due to the flexibility accorded to the executive to change budget appropriations approved by the legislature, which was discussed in chapter 2. However there are also several institutions and policies embedded in the SBL 2002 that enable the executive to take advantage of the flexibility over budget appropriations, including: use of over-realized revenue; access to extra budgetary financing; and carry over practices. These can impact on productive efficiency.

Analysis of productive efficiency finds that there are some clear differences across provinces. On average, provinces in the Northern Mountains spend 42 percent more and those in the Central Highlands 35 percent more to achieve the same outputs/outcomes as the most efficient provinces. In the South East and the Mekong River Delta on the hand, the average is closer to 7 percent and 9 percent respectively.

Some of these disparities are associated with differences in population density, and therefore conditions that local authorities cannot control. But poorer performers within a region also tend to have less credible spending plans and higher levels of carry overs compared to their peers in the same region. The share of wages and salaries in recurrent spending also seems to play a role, including in terms of crowding out other critical spending.

Recommendations: *(i) spending of over-realized revenue should not be tied to specific categories and should be approved by legislature; (ii) extra budgetary activities should be integrated into the overall budget; (iii) limit the level of carry over spending as a share of budget and to capital spending only; (iv) introduce population density criteria in allocation norms to estimate spending needs of local authorities; (v) review wage bill and application of salary reform policies.*

EXPENDITURE PERFORMANCE

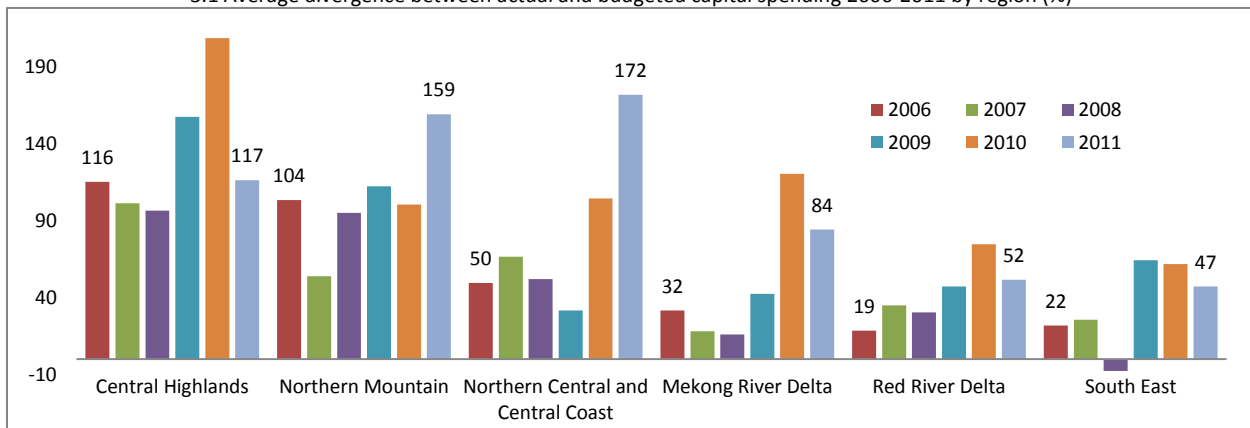
With increased spending decentralization there is more demand for spending performance information.

With increased spending responsibility delegated to local authorities, it is important to look at expenditure performance across provinces. This has been a topic of high interest, particularly for the National Assembly and central authorities because reporting on service delivery performance has not kept pace with the increased spending decentralization. In addition to this, tightening fiscal conditions in Vietnam calls for a better understanding of how much different provinces are spending to deliver the same services, which should help identify areas of potential efficiency gains.

Local spending plans lack credibility, which reduces transparency and impacts on efficiency.

The study finds that local spending plans lack credibility, which reduces transparency and impacts on efficiency. This is particularly the case for capital spending, which is often more than 50 percent of what was budgeted, well above good practice guidelines of maintaining spending within 5 percent of budget (figure 3.1). The lack of budget credibility is partly due to the flexibility accorded to the executive to change budget appropriations approved by the legislature. As recommended in chapter 2, this warrants review of Article 49 in the SBL 2002 to clarify rules on changes to appropriations. The higher than budgeted spending is also due to spending from contingency reserves, and extra budgetary funding sources for capital investment projects.

3.1 Average divergence between actual and budgeted capital spending 2006-2011 by region (%)



Source: Staff estimates based on published State Budget data

Policies on over realized revenue, off-budget financing, and carry overs reduce budget credibility.

There are several institutions and policies embedded in the SBL 2002 that enable the executive to take advantage of flexibility over budget appropriations, and which this study recommends be reviewed. The first is around use of over-realized revenue, for which, according to regulations, half has to be channeled to salaries and the other half to capital regardless of actual spending needs. The second policy area is on the use of off-budget financing mostly for capital investments, which ranges from 5 to 20 percent of the budget. These extra-budgetary sources lack transparency and create a distorted picture of budget allocations. The third policy area contributing to lack of credibility in spending plans relates to the practice of carry overs. Unlike other countries, there are currently no limits on the level of carry overs,

which can go up to 50 percent for some provinces.

Lack of spending plan credibility dilutes link between budgets and plans.

The above institutions and policies on budget management can impact adversely on the efficiency of spending. Maintaining a credible spending plan is a necessary, albeit not sufficient, condition to promoting more effective and efficient government spending. In addition, poor credibility of spending plans dilutes the link between local development plans and local budgets. Despite the strong role of local spending in provincial economies in Vietnam, the role of public finances is insufficiently covered in local development plans reviewed during this study.

Differences in spending efficiency across provinces are due to factors outside of province's control but also due to lack of credibility in spending plans.

The study looks at various measures of spending efficiency across provinces and the extent to which above budget management practices might affect those measures. Using available data on three sectors (education, health and transportation), the study computes Public Sector Performance indices, reflecting the outputs and outcomes achieved in the three sectors. It uses this to derive Public Sector Efficiency scores (figures 3.2-3.5). The analysis finds that within regions there are important disparities in efficiency between provinces. Some of these disparities are associated with differences in population density. But poorer performers also tend to have less credible spending plans and higher levels of carry overs compared to their peers in the same region. There are also cases where provinces are very efficient but are performing poorly on critical service delivery outcomes, meaning that these provinces could consider increasing local spending in those particular sectors and spending less in some others.

Public Sector Performance and Efficiency Indicators across Provinces

Figure 3.2: Lower than average PSP and higher than average PSE

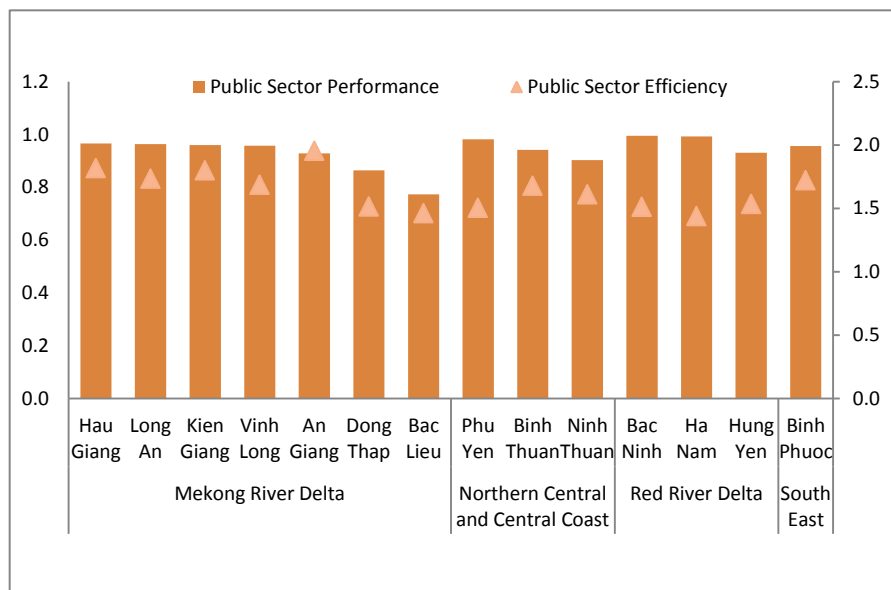


Figure 3.3: Higher than average PSP and higher than average PSE

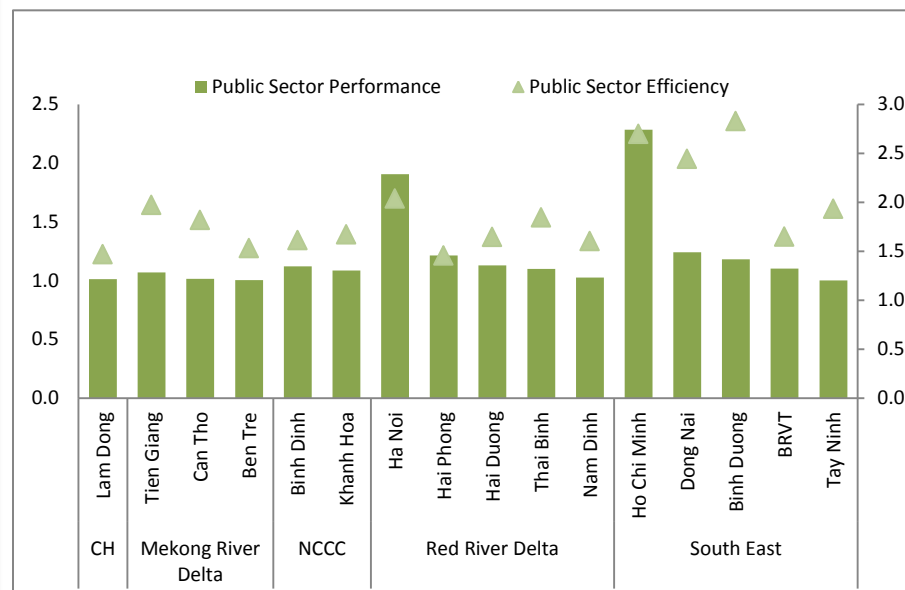


Figure 3.4: Lower than average PSP and lower than average PSE

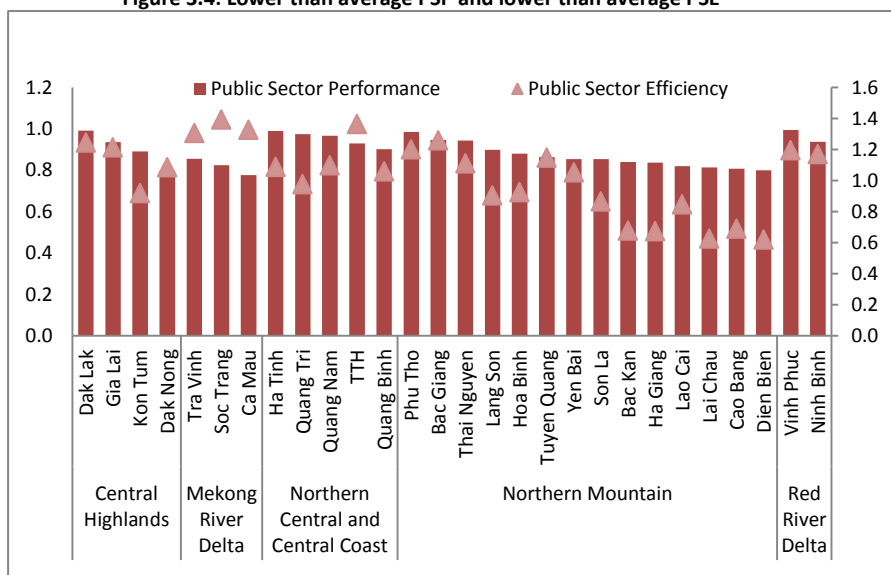
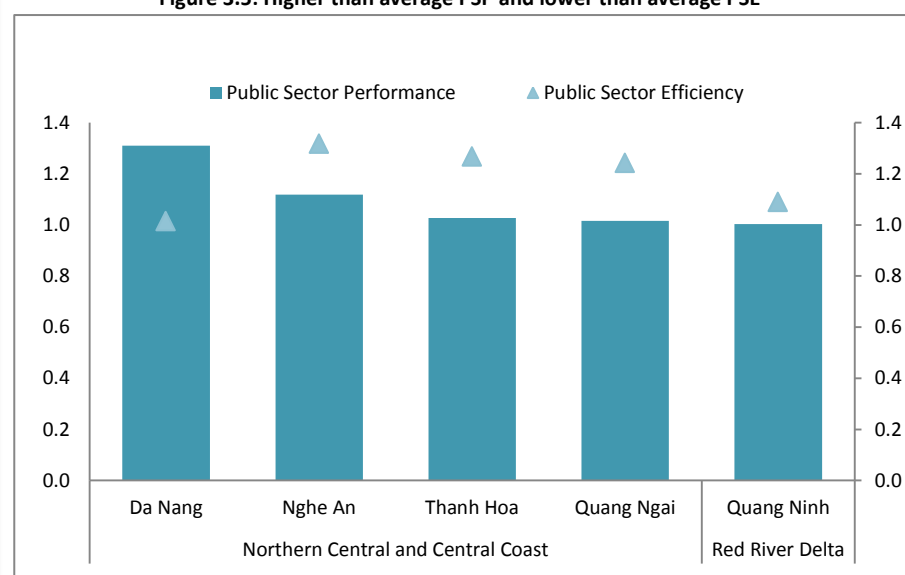


Figure 3.5: Higher than average PSP and lower than average PSE



Public Sector Efficiency

Public Sector Performance

On average provinces in poorer regions spend 35-40 percent to deliver the same level of services as the most efficient provinces.

Based on the above, a productive efficiency frontier is estimated based on the maximum level of output attained by local authorities in Vietnam for a given set of inputs. The purpose is to review the efficiency of provinces relative to such an efficiency frontier. The frontier is derived based on PSP scores against per capita spending of the most efficient provinces. This analysis provides an approximate idea of the difference in spending across provinces for achievement of a given level of outputs and outcomes. It finds that on average, provinces in the Northern Mountains region spend 42 percent more and those in the Central Highlands 35 percent more to achieve the same outputs/outcomes as the most efficient provinces. In the South East and the Mekong River Delta on the hand, the average is closer to 7 percent and 9 percent respectively. As noted above, some of these differences are associated with geographical characteristics and population density, but also partly due to budget management practices.

Within regions, provinces that are less efficient also have less credible spending plans.

Within the regions, the analysis finds a number of outliers for which productive efficiency is considerably lower than for other provinces in the same region (figures 3.6-3.11). For the poorer regions (Northern Mountains and Central Highlands), the outliers also happen to have the least credible spending plans and highest levels of carry over spending. In the Northern Central and Central Coast region, the province of Danang performs very well in terms of service outputs and outcomes, but it also spends much more despite high population density and urbanization.

Determinants of relative efficiency of provinces in Vietnam are in line with the fiscal decentralization literature.

Econometric analysis of possible determinants of the relative efficiency of provinces in Vietnam confirms some of the hypotheses in the fiscal decentralization literature. Findings show that dependence on transfers can impact negatively on efficiency. At the same time, population density, urbanization rates, and budget transparency have a positive impact. Surprisingly, higher per capita GDP was found to reduce efficiency, though this may point to residents in poorer localities being more active in monitoring the quality of service delivery. The credibility of spending plans has a slight negative impact on efficiency, and the share of recurrent spending in overall spending seems to have a strong negative impact on efficiency.

Provincial performance against efficiency frontier across regions

Figure 3.6: Central Highlands Provinces against efficiency frontier

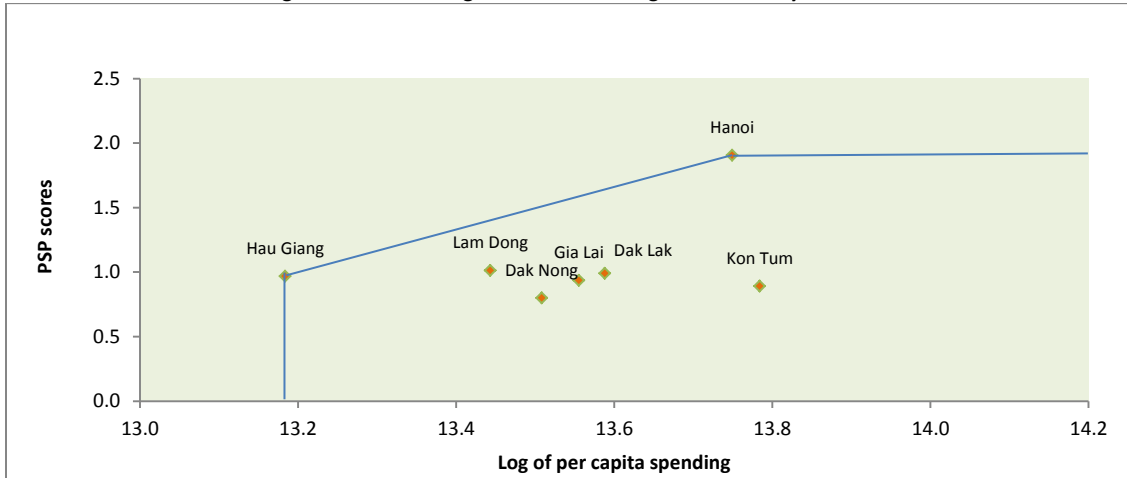


Figure 3.7: Mekong Delta Provinces against efficiency frontier

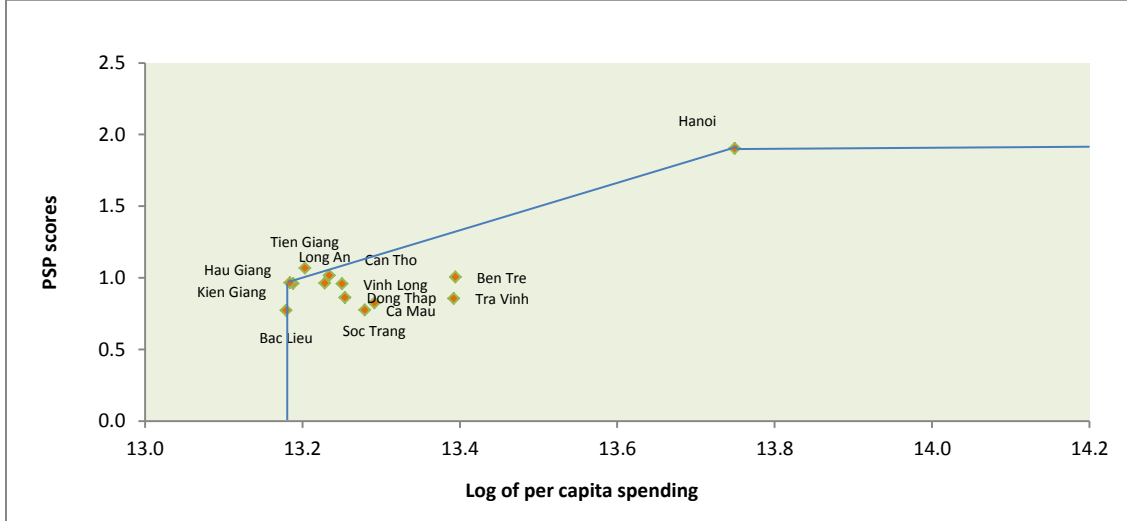


Figure 3.8: NCCC Provinces against efficiency frontier

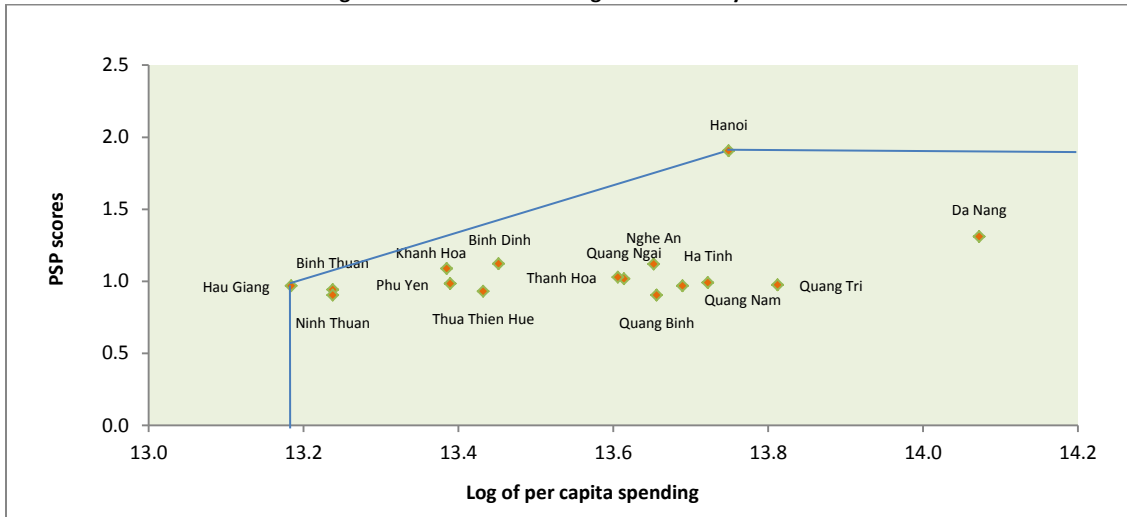


Figure 3.9: Northern Mountain Provinces against efficiency frontier

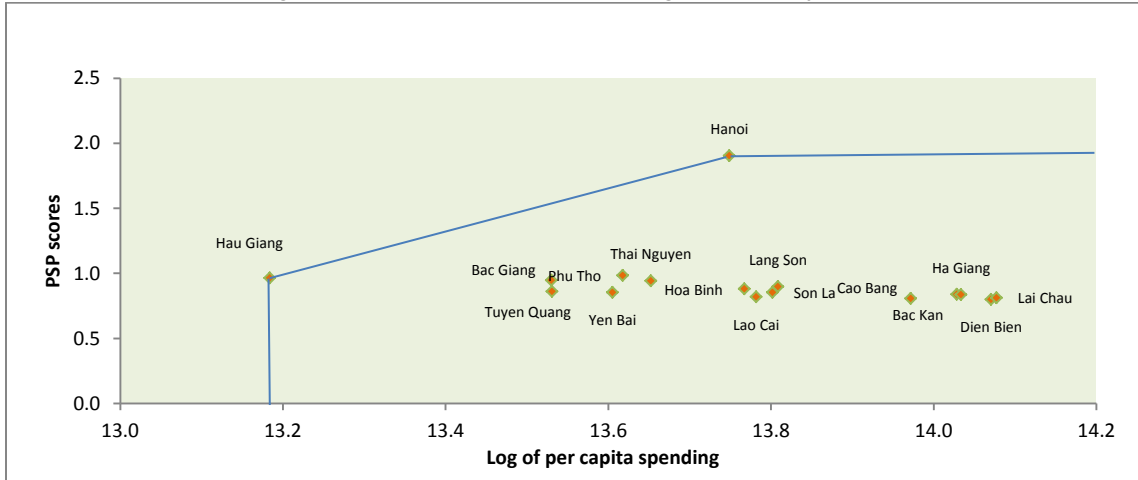


Figure 3.10: Red River Provinces against efficiency frontier

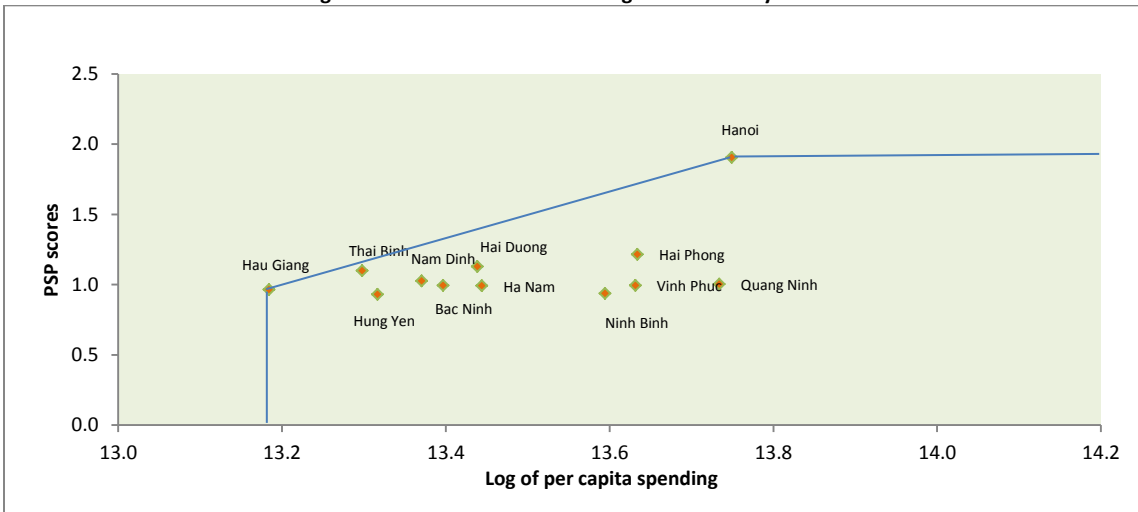
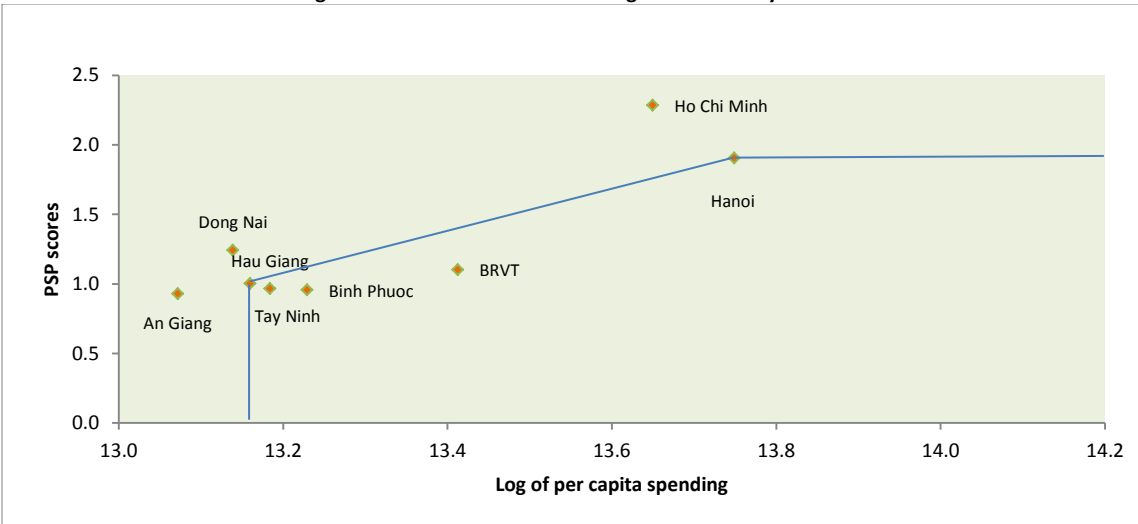


Figure 3.11: South East Provinces against efficiency frontier



Richer provinces tend to have leaner public service when measured by the share of wages and salaries to recurrent spending.

On the latter, the study looked specifically at how the composition of recurrent spending, in particular the share of salaries and wages in overall recurrent spending, interacts with productive efficiency across regions and provinces. Overall, provinces in wealthier regions not only have lower local spending as a share of the local economy, but also leaner public service as measured by the share of wages and salaries to recurrent spending. Within poorer regions, there are outliers in terms of high share of salaries and wages and low productive efficiency. It is important to review those cases in more detail to ensure that the wage bill is not crowding out critical operations and maintenance or goods and services spending, which would further exacerbate efficiency concerns.

Recommendations on expenditure decentralization

	Issues	Recommendations
State Budget Law 2002	<p>Policies on over-realized revenues in the SBL 2002 and associated regulations lead to lack of credibility of spending plans and loss of fiscal discipline.</p> <p>Off-budget debt financing is likely to increase over time, which would exacerbate problems of low credibility spending plans without stricter controls in the context of overall budget decisions.</p> <p>Carry over practices lead to loss of credibility in spending plans, and lack of transparency as carry over spending is not broken down in the budget.</p>	<p>Ensure in the SBL and associated regulations, that the approval of the use of excess revenues (by the NA or provincial Councils) for spending takes place in the context of a Supplementary Budget.</p> <p>Integrate all debt and other off-budget financed activities into local budgets to ensure transparency and comprehensiveness.</p> <p>Limit carry over spending in the SBL to only investment spending. Delete Article 63 allowing carry over of unspent revenue.</p>
Stability Period regulations	<p>Population density has a large and significant impact on the relative cost of service delivery.</p>	<p>Introduce population density criteria in allocation norms to estimate spending needs of local authorities (i.e. inversely proportional).</p>
Follow up analysis	<p>Productive efficiency differentials across regions are often related to level of development and population density, but within regions there are outliers, many of whom suffer from low credibility of spending plans and high carry overs.</p> <p>Several provinces in poorer regions exhibit high share of salary in recurrent spending and low productive efficiency.</p>	<p>Reaffirms earlier recommendations on addressing policies that lead to loss of spending plan credibility. It is also recommended to study some of the outlying provinces in more detail constraints to productive efficiency.</p> <p>Review wage bill and application of salary reform policies in outlying provinces.</p>

4

Local revenue arrangements

Key issues: local authorities in Vietnam have seen increased levels of local revenue in the 2006-2011 period, but continue to have little to no autonomy over revenue policy and administration. Provinces where sharing rates declined in subsequent stability periods may have disincentives to maximize revenue effort, which points to a review of the revenue sharing arrangements. These provinces also highlight a deficit in infrastructure financing, which points to a review of potential for increased revenue autonomy.

Objectives: the objectives of this chapter are to assess whether the current revenue arrangements are impacting on the revenue performance of local authorities, and how these could be addressed through reforms of the revenue sharing arrangement and the potential for more revenue autonomy in selected provinces.

Key findings: compared to other countries, decentralized revenues in Vietnam constitute relatively large shares of national GDP (9-10 percent) and general government revenue (33 percent excluding extra budgetary sources).

The share of decentralized revenue over total local revenue however has declined over time. This is partly because richer provinces have been making higher contributions of shared revenue to central government for the purposes of redistribution through transfers.

Analysis in this chapter does not suggest that this has had a significant negative impact on revenue effort by these net contributing provinces. On average provinces in Vietnam collect roughly a little over 60 percent of their potential estimated revenues.

But performance across provinces varies a lot due to factors such as local capacity and the level of revenue decentralization as measured by share of 100 percent locally retained revenue. This, together with the needs of richer, high growth potential provinces, highlights the need to consider opportunities for more revenue autonomy.

The revenue sharing arrangement also warrants review to improve its transparency and equity. In particular, major taxes end up credited to provinces where major firms are headquartered rather than where the output is produced or consumed.

Recommendations: (i) consider moving to sharing of VAT on a formula basis rather than on a derivation basis; (ii) centralize natural resource taxes; (iii) centralize CIT; (iv) enable provinces to impose surtaxes on PIT, local businesses and excises; (v) increase autonomy over determination of user fees at local level; (vi) consider property tax in the long run.

LOCAL REVENUE ARRANGEMENTS

Levels of local revenue have increased but revenue autonomy has not.

Local authorities in Vietnam have seen increased levels of local revenue in the 2006-2011 period to match spending decentralization, but continue to have little to no autonomy over revenue policy and administration. Local authorities in Vietnam have two main sources of revenue outside of transfers from upper tiers of government: (i) revenue retained 100 percent by local authorities, which is the closest that local authorities come to “own source revenue;” and (ii) revenue that is shared with upper tiers of government, which are pooled and redistributed across the country.

Decentralized revenues as a share of GDP are relatively large in Vietnam.

Compared to other countries, decentralized revenues in Vietnam constitute relatively large shares of national GDP (9-10 percent) and general government revenue (33 percent excluding extra budgetary sources). Decentralized revenue as a share of local GDP on the whole is relatively small – less than 7 percent for half of all observations from 2006 to 2011. The reason is that central revenues constitute the bulk of general government receipts. It therefore does not necessarily reflect lower revenue effort on the part of local authorities.

The share of decentralized revenue however has fallen.

The share of decentralized revenue over total local revenue however has declined over time. This is partly because richer provinces have been making higher contributions of shared revenue to central government for the purposes of redistribution through transfers. The latter in turn have constituted a growing share of local financing.

There is however good evidence of strong revenue effort by provinces.

One concern about this trend is that provinces where sharing rates declined in subsequent Stability Periods may have disincentives to develop their economies and to the extent they affect it, to maximize revenue effort. The marginal benefit of raising more revenue for these provinces gets diminished with the decreasing tax sharing rates, which get adjusted at the beginning of each stability period with the objective of channeling those funds to the central government for redistribution and other budget objectives.

On average, provinces in Vietnam collect roughly a little over 60 percent of their revenue potential.

An analysis of revenue effort by local authorities does not suggest that this has had a significant negative impact on revenue effort by the net contributing provinces (figures 4.1-4.6). On average provinces in Vietnam collect roughly a little over 60 percent of their potential estimated revenues (figures 4.7-4.12). But performance across provinces varies a lot due to factors such as local capacity and the level of revenue decentralization as measured by share of 100 percent locally retained revenue. This, together with the needs of richer, high growth potential provinces, highlights the need to consider opportunities for more revenue autonomy.

Local nominal GDP growth and nominal decentralized revenue growth by region

Figure 4.1: Central Highlands

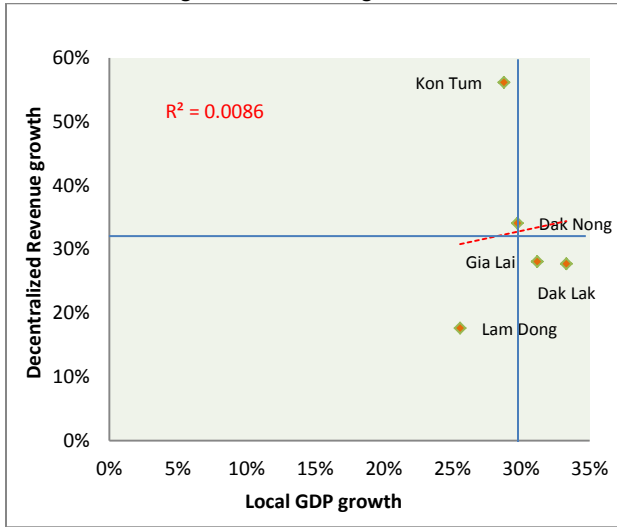


Figure 4.2: Mekong Delta

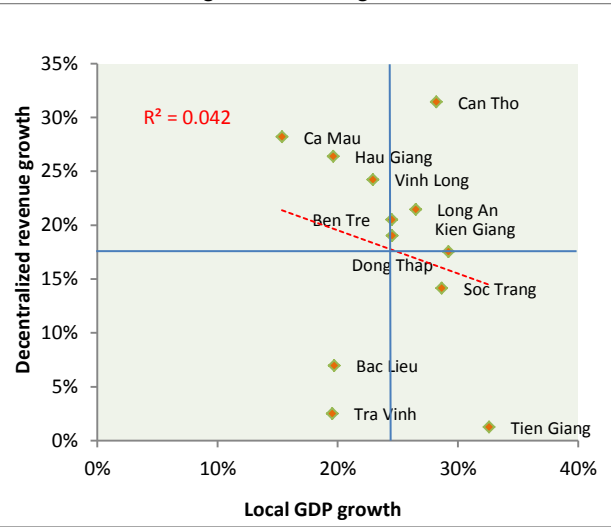


Figure 4.3: NCCC

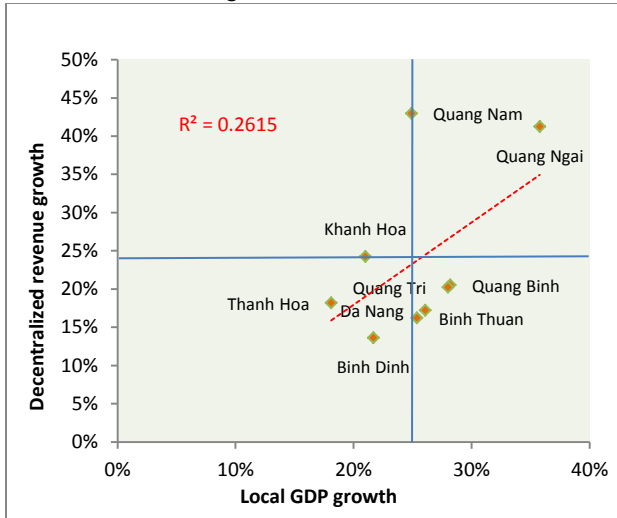


Figure 4.4: Northern Mountains

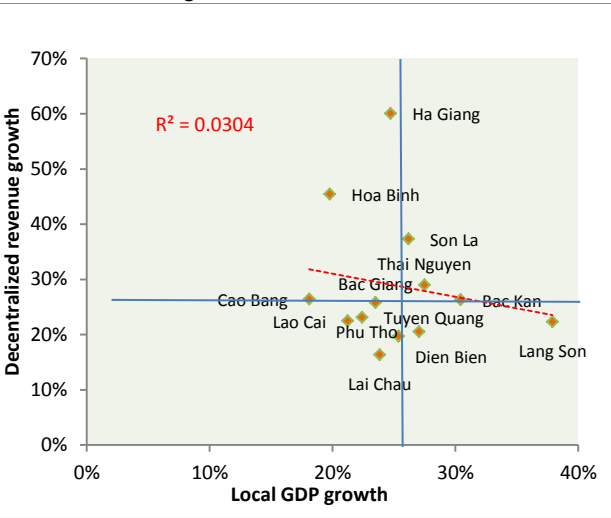


Figure 4.5: Red River Delta

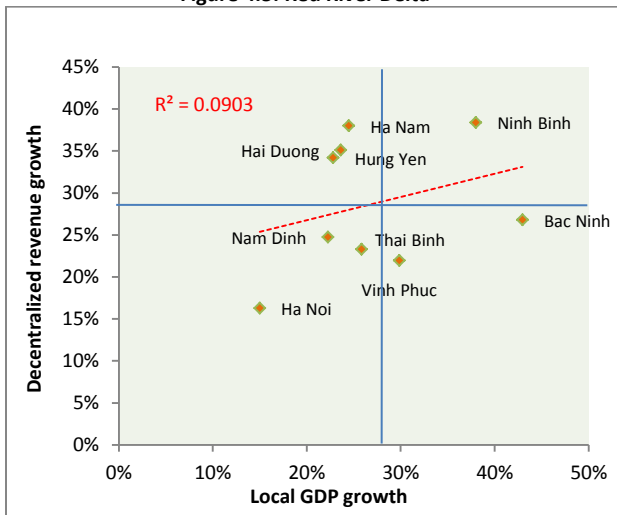
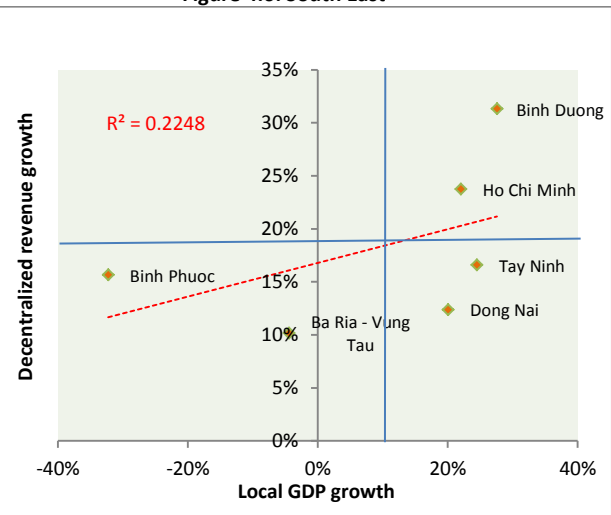


Figure 4.6: South East



Relative efficiency of local authorities in mobilization of decentralized revenue

Figure 4.1: Central Highlands

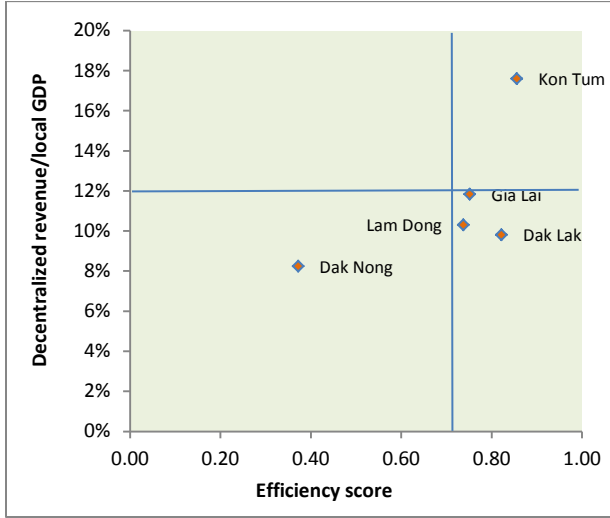


Figure 4.8: Mekong Delta

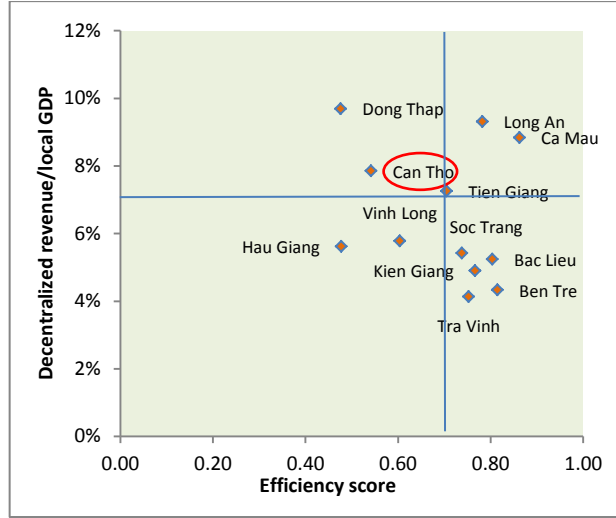


Figure 4.9: NCCC

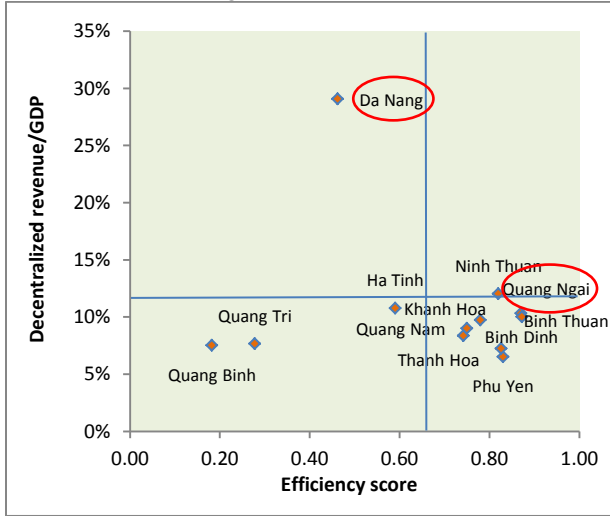


Figure 4.10: Northern Mountains

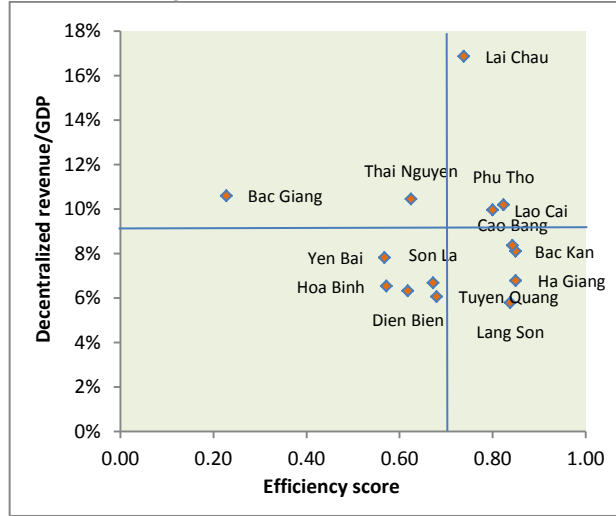


Figure 4.11: Red River Delta

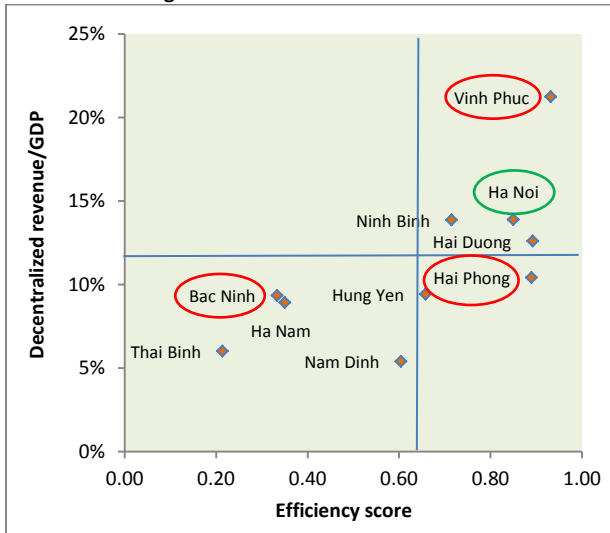
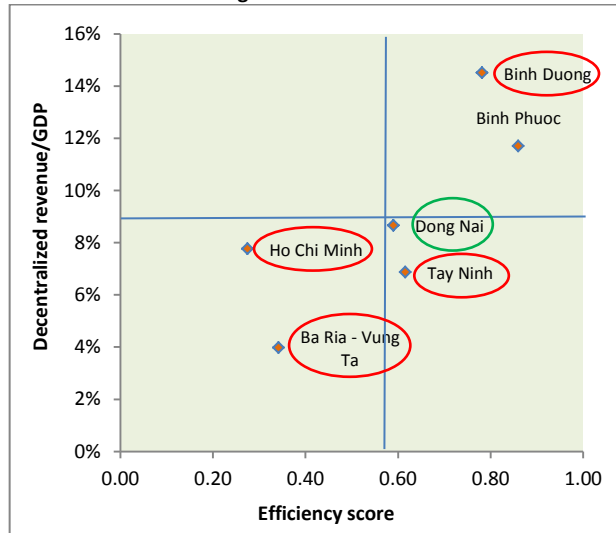


Figure 4.12: South East



The revenue sharing arrangement warrants reform including revamping the system of assigning revenue to where they are collected rather than where the tax is incurred.

Whilst the revenue sharing arrangement does not necessarily point to lower effort in collecting revenue on the part of net contributing provinces, there are a number of elements that warrant review. Shared revenues in Vietnam are split based on where revenues are actually collected rather than where the tax is incurred (the so-called “derivation principle”). This raises questions concerning the fairness of the system, especially for the Value-Added Tax (VAT) and the Corporate Income Tax (CIT). For example if an enterprise is operating in Son La province, but is headquartered in Hanoi, the enterprise’s VAT and CIT liabilities will be owed to the province of Hanoi (unless it is a firm with unified accounting, in which case CIT will be paid to the central government). The major taxes therefore end up credited primarily to the few jurisdictions where the headquarters of the enterprise are located or the place of business registration, and not necessarily where the outputs are produced or sold.

There are several options to address this including sharing VAT on a formula basis, or centralizing CIT and natural resource taxes. There is currently little interest to move to such a model because of a perception that VAT is a tax in expansion and CIT is one in contraction in their relative shares in total revenue.

Aside from this, however, increasing revenue autonomy is one of the most significant issues with the current local revenue arrangements in Vietnam. As noted in chapter 3, this is important for efficiency of spending, but also to enable richer provinces to fill their infrastructure financing deficit, as discussed in chapters 5 and 6. There are several options that Vietnam can consider to enhance local revenue autonomy.

Increasing revenue autonomy is one of the most significant policy issues with the current local revenue arrangements. Several options are proposed in the study including surcharges on existing bases or more autonomy in determining fees and charges.

This could entail for example providing local governments a closed list of selected taxes with discretion to set rates within a band. Surcharges, or piggybacking, on central taxes may provide additional subnational revenue. This involves imposing a surcharge on tax bases defined by the central government. Surcharge tax rates are frequently subject to both upper and lower limits set by the central government. Surtaxes could be imposed on Personal Income Tax (which is small now but likely to grow) or on excises for example.

More autonomy over revenue policy might also involve increasing independence over determination of user fees at subnational level. Local authorities would need to balance the revenue from fees against the cost of collecting those fees. It would also need to take into account the extent to which such fees and charges are regressive. Requiring local authorities to set the fee levels below the actual cost of service provision imposes an unfunded mandate, which can lead to poor service provision.

Over the longer-term the government can consider the full introduction of modern property taxation. Local authorities have a comparative advantage in identifying and valuing properties because they are familiar with the housing and land available there. Given the complexities of a modern property tax system however, this may take a while to introduce.

Recommendations on expenditure decentralization

	Issues	Recommendations
State Budget Law 2002	<p>Current flexibility over spending of over realized revenue leads to negative incentives to underestimate revenue in local budgets, which impacts negatively on overall credibility of the plan.</p>	<p>Eliminate provisions in the SBL 2002, which include issues such as revenue carry over and use of over-realized revenue. The latter needs to be mandated by the legislature through appropriations.</p>
	<p>Revenue sharing on a “derivation basis” leads to concentration of major revenues in selected provinces.</p>	<p>Consider two options: (i) moving to sharing VAT on a formula basis; and (ii) centralizing natural resources tax and CIT for redistribution through the transfer system.</p>
Follow up analysis	<p>Increased revenue autonomy is needed for better revenue effort and to help net contributing provinces meet their infrastructure financing needs.</p>	<p>Consider introducing a system of surtaxes (on personal income, business profits, and excises) and more autonomy over fee setting. Over long-term consider property tax.</p>

5

Intergovernmental fiscal transfers

Key issues: revenue sharing arrangements reviewed in chapter 4 are designed to address vertical imbalances arising out of the gap between local revenues and spending needs. Balancing transfers are meant to address horizontal imbalances across provinces. One issue that arises is the extent to which the transfer system is delivering more equitable resource distribution across and within provinces. Aside from revenue sharing and balancing transfers, there are also targeted transfers that face challenges on how to link national objectives with results on the ground.

Objectives: the objectives of this chapter are to assess the extent to which balancing transfers are achieving their aim to equalize resource availability not just across provinces but also across districts, and recommend opportunities for reform. Another objective of this chapter is to identify ways to reform the system of targeted transfers to more effectively deliver on their intended targets.

Key findings: revenue sharing arrangements and the system of balancing transfers in Vietnam have played a significant role in narrowing vertical and horizontal fiscal imbalances respectively. There are however growing vertical imbalances due to local authorities' increased spending responsibilities.

Trading off richer provinces' right to retain a higher share of shared revenue for growth enhancing spending to allow more redistribution is welcome though also points to potentially greater need for revenue autonomy (chapter 4) and access to debt financing (chapter 6), particularly for some of the richer provinces.

Increased spending responsibility of both provincial and district authorities are covered by increased balancing transfers. The latter at the center to provincial level are underpinned by a transparent, norms-based system. At province to district level, the publication of stability period rules and regulations have also helped to improve transparency.

The system of fiscal transfers has helped to promote greater equity in resource distribution both across and within provinces. There is evidence of fairly wide variation in per capita spending across districts. This may reflect the diversity in conditions of different districts, though it is difficult to say for sure what explains this remaining disparity.

Target transfers continue to play an important role in local spending even though its relative share has fallen over time. The lack of predictability in targeted transfers poses serious challenges. Resourcing is not closely aligned with the targets and objectives, which are quite ambitious. Complex, input-based guidance reduces flexibility and increases burden of reporting. There is a real opportunity to review the institutional arrangements for NTPs for the coming stability period aiming to simplify the system and increasing transparency, monitoring and accountability

Recommendations: (i) link stability period balancing transfers to inflation so do they do not decline in real terms; (ii) selected adjustments to allocation norms to determine spending needs; (iii) ensure greater predictability of targeted transfers to provinces and districts; (iv) simplify institutional structure for NTPS and link resourcing to performance.

INTERGOVERNMENTAL FISCAL TRANSFERS

Vietnam has developed a relatively transparent, rules-based system of intergovernmental fiscal transfers. Separate formulae are used to determine recurrent and capital spending needs of provinces (and of districts). The formulae use population, geographic location (e.g. mountainous, rural/urban) and other criteria to take account of the specific circumstances, and therefore funding needs, of different provinces. This has helped develop a highly predictable system of balancing (or unconditional) transfers.

Vietnam has a relatively transparent, rules-based system of fiscal transfers.

Revenue sharing arrangements and the system of balancing transfers in Vietnam have played a significant role in narrowing vertical and horizontal fiscal imbalances respectively. A general trend both across and within provinces, however, is growing vertical imbalances due to local authorities' increased spending responsibilities. In other words, 100 percent locally retained revenues are not keeping pace with increased spending decentralization.

Revenue sharing arrangements are helping to cover the fiscal gap, but overall spending responsibilities are growing faster. This means that horizontal imbalances (i.e. decentralized revenue/local spending) have also grown. To cover horizontal imbalances, fiscal transfers have increased over subsequent Stability Periods. This has been facilitated by a selected number of richer provinces that are contributing a growing share of their shared revenues to the central government for redistribution through balancing transfers.

The study argues that trading off richer provinces' right to retain a higher share of shared revenue for growth enhancing spending to allow more redistribution for greater equity seems like the correct policy choice in Vietnam. The evidence shows that increased spending responsibility of both provincial and district authorities are being covered by increased levels of balancing transfers. The latter at the center to provincial level are underpinned by a transparent, norms-based system. At province to district level, the publication of Stability Period rules and regulations by the provincial governments have also helped to improve transparency.

Richer provinces are transferring higher revenue to allow more redistribution.

The current institutional arrangements for fiscal transfers have helped to promote greater equity in resource distribution both across but also within provinces. The effectiveness of central government's redistribution policies is a matter of concern in countries where intermediate provincial authorities are granted responsibility for determining transfers to lower orders of government. However, the evidence shows that balancing transfers are helping to equalize levels of resourcing across provinces and across districts. However, there is evidence a fairly wide variation in per capita spending across districts. This may be reflecting the diversity in conditions of different districts but there is no conclusive evidence on this.

The current system has promoted more equity across and within provinces, but there is wide variation in per capita spending across districts.

The principles used in determining spending needs through use of allocation norms based on population, school going population, geographic location and other, have contributed to the above results. The study suggests that these norms could be further refined. For example, as noted in chapter 3, the government could use population density as a means to estimate spending needs. Less densely populated provinces will have higher spending needs than more densely populated provinces with equal population.

It may also be important to adjust allocation norms to take account of: (i) the level of service provision by different orders of government within the same jurisdiction (e.g. in where provincial authorities are a major supplier of services within a district, allocation norms should be adjusted down compared to other districts where provincial engagement is less); (ii) levels of private sector service provision within a jurisdiction. It is also important to take account of possible negative externalities (e.g. congestion, pressure on local capacity) created by non-residents or temporary migrants using local services. In those cases, it makes more sense for the upper tier to provide compensating transfers than adjusting the norm.

Targeted transfers should become more predictable and shift towards a performance-based framework.

Targeted transfers continue to play an important role in local spending even though its relative share has fallen over time. The lack of predictability in targeted transfers poses serious challenges for both provincial and district authorities. It impedes on planning, budgeting, and delivery of NTP targets. The level of resourcing however is not closely aligned with the targets and objectives, which are quite ambitious. Complex, input-based guidance on NTP implementation reduces flexibility and increases burden of reporting. There is a real opportunity to review the institutional arrangements for NTPs for the coming Stability Period.

However, moving to more output or performance-based transfers has to be a gradual process. It is not advisable to move the whole system to performance-based one. Performance-based systems have their own challenges in terms of incentives and the quality of reporting, which impact on their effectiveness. The government may therefore consider a sequenced approach in rolling out a performance-based transfer system. The new system could for example target first those provinces that have higher capacity, with poorer provinces still receiving transfers on the basis of socio-economic characteristics or inputs. As the new system gets tested and piloted, it could be gradually expanded and tailored (e.g. in terms of performance measures) to poorer provinces. In the meantime, for the latter, it is important to generate as much information as possible on what existing targeted transfers are delivering in terms of outputs and development outcomes. This will provide important inputs in the design of grants that are tailored to the specific challenges different categories of provinces.

Recommendations on expenditure decentralization

	Issues	Recommendations
State Budget Law 2002	Allocation norms to estimate spending needs and determine balancing transfers include areas that should be exclusively the central government's responsibility.	Amend Articles 31 and 33 in the SBL 2002 to clarify the exclusive responsibilities for central government, thereby eliminating the need for norms in these areas.
Stability Period regulations 2002	Maintaining balancing transfers for provinces and districts constant over the Stability Period does not take account of rising costs.	Index balancing transfers to the rate of inflation in the formula for the next Stability Period.
	Allocation norms for central and provincial authorities do not adjust for the level of service provision by different orders of government within the same jurisdiction, which could penalize areas where upper tiers are not providing any services.	Services for a particular function within a jurisdiction should be provided exclusively by one order of government, even if higher orders of government play a role in regulation or provision of subsidies
	Allocation norms do not adjust for different levels of private sector service provision within a jurisdiction	Adjust norms down for provinces with significant private sector provision. In case this leads to lower access, upper orders of government should address through targeted transfers or social protection schemes.
	Allocation norms do not compensate for negative externalities (e.g. congestion, pressure on local capacity) created by non-residents or temporary migrants using local services	Compensated affected provinces and districts through upper order transfers or direct provision of services, not through higher allocation norms.
	Use of allocation norms based on physical assets or the share of recurrent spending leads to distorted incentives	Ministry of Finance can issue guidance on the appropriate use of allocation norms to determine spending estimates.
	Lack of predictability in targeted transfers puts pressure on local budgets and creates unfunded mandates.	Institute more discipline and predictability in target transfers from center to province and province to districts.
	Different funding sources for NTPs add transaction costs due to differing financial management and procurement procedures.	Explore greater use of country systems by Development Partners supporting NTPs.
National Assembly regulations	NTP targets are not adequately linked to level of resourcing, the system does not link resources to performance, and high level targets make it difficult to meaningfully monitor NTP performance.	Move to a system of output-based conditional grants, complemented by the existing socio-economic criteria used to determine eligibility.
	Coordination across NTPs is difficult due to fragmented management and complex, input-based guidelines.	Review options to consolidate NTPs and other target programs and focus on fewer output and outcome indicators.

6

Local borrowing

Key issues: *the system of intergovernmental fiscal relations in Vietnam, as illustrated in the previous two chapters, is geared to redistributing locally collected revenues, the bulk of which are contributed by a handful of provinces that point to a growing infrastructure financing deficit. Local borrowing has accordingly emerged as an important topic in Vietnam particularly for those provinces that are not able to satisfy their capital spending needs through the existing local revenue and transfer arrangements*

Objectives: *to assess whether selected provinces could potentially borrow more to address this deficit, and highlight reforms to the existing institutional framework to enable this.*

Key findings: *borrowing by local authorities over the 2006-2011 period has remained very low (less than 3 percent of GDP). The five largest cities account for just over 40 percent of total local debt. Local authorities have several sources of debt financing including development banks (38 percent of total in 2011), state treasury (29 percent), local bonds (22 percent), central government on-lending (8 percent).*

The SBL 2002 requires local authorities to maintain total outstanding debt from these sources at below 30 percent of annual capital budgets, except for HCMC and Hanoi for whom the ceiling is 100 percent of annual capital budget (to be raised to 150 percent for HCMC from 2015). 13 provinces have already breached this ceiling in recent years, which in the first place is not a good indicator of local authorities' actual borrowing capacity.

An illustrative debt sustainability analysis of HCMC shows that under specific assumptions, the province could borrow more than the current limits prescribed in the SBL 2002 and maintain sustainable levels of debt. However, without greater access to decentralized revenue, the province would face liquidity pressures, thereby reiterating recommendations on revenue autonomy in chapter 5.

Aside from direct debt liabilities, local authorities also need to look more closely at indirect liabilities and contingent liabilities, potential sources of which include: public financial funds; local SOEs; and banking sector stress from payment arrears to local contractors.

Recommendations: *(i) restate fiscal rules related to local debt in the SBL 2002 and adopt more standard qualitative fiscal rules in the revised law; (ii) adopt specific thresholds on local debt stock and debt servicing in line with debt sustainability targets; (iii) improve transparency and reporting on public debt, including through statistical debt bulletins in more advanced provinces; (iv) transition to a two-tier local debt system with central government facilitating more market access for advanced provinces and greater ODA on-lending for less advanced provinces.*

LOCAL BORROWING

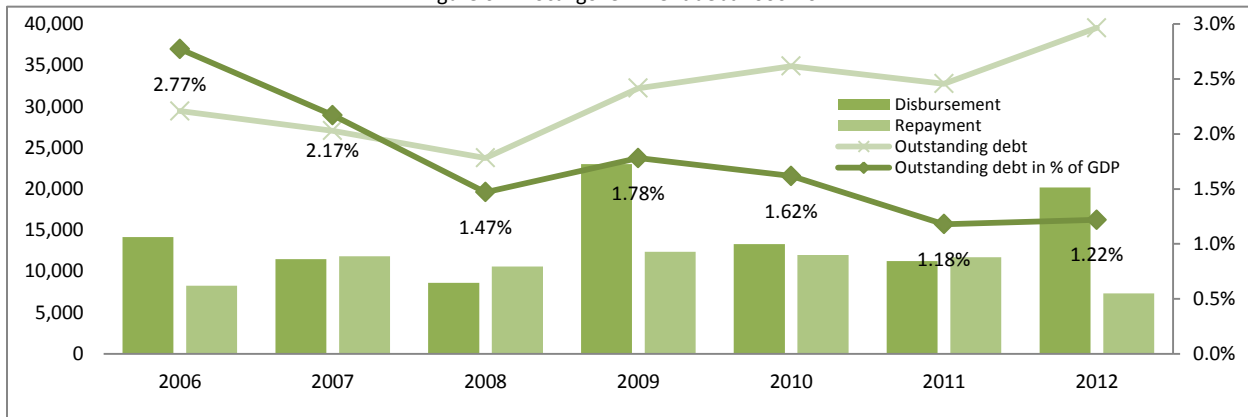
Some provinces are not able to satisfy capital spending needs through existing revenue and transfers.

The system of intergovernmental fiscal relations in Vietnam, as illustrated in the previous chapters 4 and 5, is geared to redistributing locally collected revenues, the bulk of which are contributed by a handful of provinces, which at the same time increasingly point to a growing infrastructure financing deficit. Local borrowing has accordingly emerged as an important topic in Vietnam particularly for those provinces that are not able to satisfy their capital spending needs through the existing local revenue and transfer arrangements.

Local borrowing has remained low in the 2006-2011 period.

Borrowing by local authorities over the 2006-2011 period has remained very low (less than 3 percent of GDP). The five largest cities account for just over 40 percent of total local debt. Local authorities have several sources of debt financing including development banks (38 percent of total in 2011), State Treasury (29 percent), local bonds (22 percent), and central government on-lending (8 percent).

Figure 6.1: Local government debt 2006-2012



Source: Ministry of Finance

Local borrowing should be part of local authorities' balance sheets.

The State Budget Law 2002 (SBL 2002) and the Public Debt Management Law 2009 (PDML 2009) stipulate the golden rule that provincial governments cannot borrow to meet recurrent expenditures. The SBL also requires local authorities to maintain balanced budgets, which means that any borrowing is treated off the balance sheet. Even though aggregate local borrowing levels have been relatively low to date, it is critical to integrate local borrowing on local authorities' balance sheets to ensure accurate fiscal reporting.

The SBL 2002 requires local authorities to maintain total outstanding debt from these sources at below 30 percent of annual capital budgets, except for HCMC and Hanoi for whom the ceiling is 100 percent of annual capital budget. Currently 13 provinces have already breached this ceiling, which in the first place is not a good indicator of local authorities' actual borrowing capacity.

An illustrative debt sustainability analysis of HCMC shows that under specific assumption, the province could potentially borrow more than the current limits in the SBL 2002, but that it could run into liquidity pressures without greater revenue autonomy.

An illustrative debt sustainability analysis of HCMC shows that under specific assumptions, the province could borrow more than the current limits prescribed in the SBL 2002 and maintain sustainable levels of debt. As illustrated in figure 6.2 below, the anticipated debt stock for HCMC remains affordable when comparing to local GDP as the indicator for repayment capacity.

However, without greater access to decentralized revenue, the province would face liquidity pressures. This is illustrated in figure 6.3, which shows that the debt service to revenue ratio could rise higher than 25 percent in some years. Therefore if HCMC wants to borrow more, it also needs more access to local revenues, which reiterates recommendations on revenue autonomy in chapter 5. It is also important to note that higher borrowing could also lead to interest payments crowding out other important spending, as these payments are likely to rise significantly.

Figure 6.21: HCMC Debt-to-GDP ratio

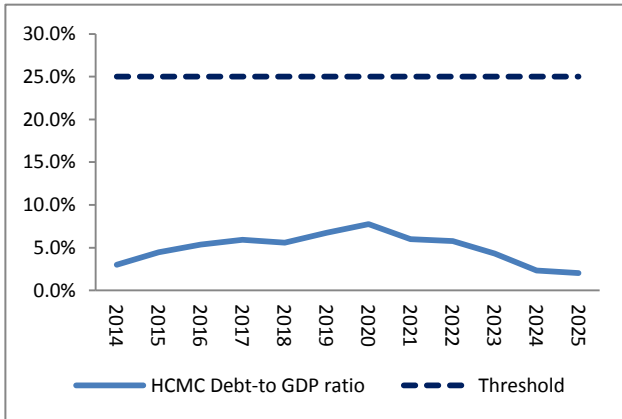


Figure 6.3: HCMC Debt service-to-revenue ratio

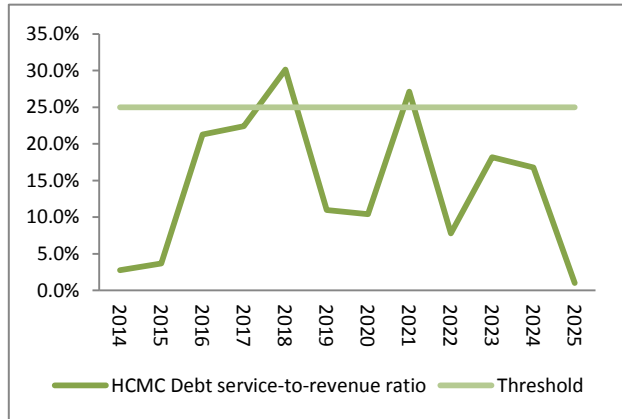


Figure 6.42: HCMC Interest payment/Recurrent Expenditure

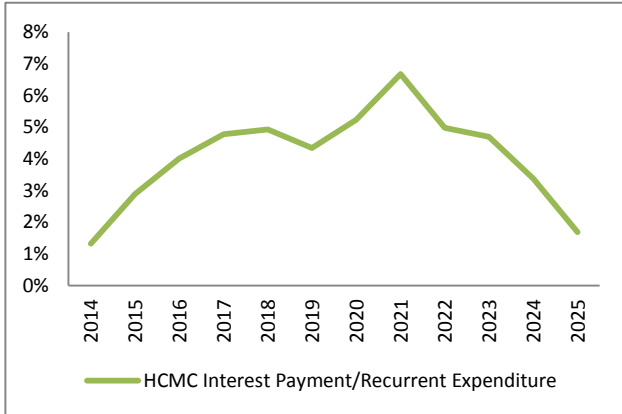
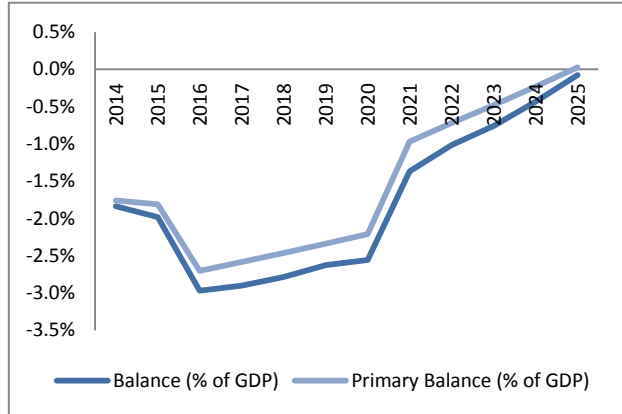


Figure 6.5: HCMC Overall and Primary Balance (% of GDP)



Source: Staff estimates

This analysis points to the need for reviewing Vietnam's current fiscal rules for local borrowing.

The above analysis points to the need for reviewing sub-national fiscal rules in Vietnam. There are generally three types of indicators for controlling local government debt including limits on: (i) debt service, (ii) new borrowing in a fiscal year and (iii) on total outstanding debt. Borrowing limits might be regulated by combined indicators. So local governments should meet multiple criteria, e.g. limits on both debt service and debt stock. The State Budget Law might set out general principles or indicators against which to monitor local debt (e.g. debt service/local revenues, outstanding debt stock/local budget). But quantitative thresholds should be set separately in secondary regulations.

Aside from direct liabilities, local authorities also need to watch indirect and contingent liabilities.

Aside from direct debt liabilities, local authorities also need to look more closely at indirect liabilities and contingent liabilities. Cross country experience suggests that explicit contingent liabilities, especially loan guarantees, may be the most frequent type of indirect liability but implicit ones are often the most costly. The latter include bailouts of SOEs, banks and local governments. It also includes natural disasters contingent liabilities, which can significantly add to governments' balance sheet risk in as much as they imply additional leveraging and tend to be triggered in times of financial stress, with realized costs having a major impact on a country's fiscal position and debt sustainability

Recent developments suggest greater monitoring of Public Financial Funds, local SOEs, and banking sector stress.

Recent developments in Vietnam, particularly in the banking sector and SOEs underscore the importance of monitoring contingent liabilities. Rapid credit growth in 2008-2009 with insufficient due diligence, coupled with the effects of the global economic crisis, has led a build-up of Non-Performing Loans and a rapid deterioration in the balance sheets of domestic banks in Vietnam. The crisis also brought to the fore the vulnerability of SOEs and the lack of transparency around their operations and finances. MOF/MPI have estimated total SOE debt as at September 2011 to be closer to US\$20 billion, or roughly 15 percent of GDP. More specifically for local authorities in Vietnam, there are potentially three important sources of contingent liabilities: (i) Public Financial Funds; (ii) local SOEs; and (iii) banking sector stress as a result of payment arrears to capital construction projects.

Local authorities should report more systematically on its debt and other contingent liability obligations.

The successful implementation of any rules and management of fiscal risks requires transparency and reporting arrangements. Although local authorities are required to follow a large number of steps and regulations to contract debt, there is little formal requirement on reporting and disclosure of local debt. Increased transparency is important not only for the government's internal management purpose but also for private investors to take timely and adequate decisions. For the more advanced provinces, the need for transparency is particularly important. These are provinces like HCMC that plan to go increasingly to debt markets for infrastructure financing. Secondly, SOEs in these provinces are also turning increasingly to the market on account of falling budgetary subsidies. The requirement for greater transparency and disclosure should apply across all provinces, but in terms of sequencing, the more advanced provinces should already start preparing debt statistical bulletin covering its domestic and external (on-lent) debt.

The government may wish to pursue to a two-tier strategy to strengthening local debt management capacity.

The government may consider following a two-tier strategy in relation to local borrowing. The central government can target the more advanced provinces to strengthen the enabling environment for better access to debt markets. This will require appropriate capacity building support for fiscal planning and debt management, in addition to greater transparency and disclosure as mentioned above. For less advanced provinces, the central government could start with greater ODA on-lending to begin with. As capacity improves, these provinces can also gradually progress to increased access to debt markets. However, this would need to be done in a careful and sequenced manner to prevent build up of unsustainable debt as experienced in other countries.

Recommendations on expenditure decentralization

	Issues	Recommendations
State Budget Law 2002	Conflicting rules in SBL 2002, requiring provinces to maintain balanced budget while allowing them to borrow for capital spending.	Revising rules in SBL 2002 to require current account balance only, and account subnational budget deficit in the overall national budget deficit.
	Existing quantitative ceiling of subnational debt does not reflect provinces' debt sustainability, solvency or repayment capacity.	Revamping the thresholds to better monitor both debt service (e.g. debt service/local revenues) and debt stock (e.g. outstanding debt stock/local budget). Considering balancing the operational and capital budgets in the longer-run. Quantitative thresholds should be set separately in regulations and decrees.
	Concerns over "off-budget" borrowings	Including borrowings for cost-recovery projects and on-lending in the total subnational debt amount. Monitoring closely borrowings of SOEs and Local Development Investment Funds.
Strategy for strengthening debt management capacity	Missing subnational debt data in the national Public Debt Bulletin. No provincial public debt bulletins despite interest of potential investors.	Including subnational debt data in the national Public Debt Bulletin. Considering interactive way to collect subnational debt information from LGs. Encouraging frontier provinces to develop debt statistical bulletin covering both domestic and external (on-lent) debt and other fiscal information that is of interest to credit rating agencies and potential investors.
	Limited capacity in public debt management at both central and local governments.	At the central level, developing comprehensive methods for local borrowing capacity assessment, and strengthening MOF capacity. At the local level, strengthening DOFs capacity to develop medium-term fiscal plan and public debt management program, and closely monitor contingent liabilities.
	Evolving fiscal landscape and debt profile at both central and local levels.	Central government facilitating appropriate "enabling environment" to ensure smooth supply of loanable funds for the frontier provinces, while promoting ODA on-lending in net budget recipient provinces.