Provincial Extralegal Investment Incentives in the Context of Decentralisation in Viet Nam: Mutually Beneficial or a Race to the Bottom?

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Foreword

Foreign direct investment has played a vital role in Viet Nam's economic growth strategy during the reform period. Foreign investors bring much needed capital, technology, access to international markets and improved management practices to Viet Nam. Local authorities, well aware of the benefits of foreign investment to the local economy, compete with each other to attract investors to their provinces and districts. Competition is always healthy, but the question arises as to whether local authorities understand what investors need. If they do not, they may offer incentives that do not attract investment but that undermine the fiscal position of local and central government.

This UNDP Policy Dialogue Paper addresses the issue of competition for foreign direct investment in Viet Nam. It finds that many provinces offer extra-legal fiscal incentives to attract foreign companies. However, the impact of these incentives on firms' location decisions is negligible. Firms decide on where to invest on the basis of fundamental factors such as access to land and natural resources, infrastructure, the availability of skilled workers and the quality of local governance. Extra-legal tax incentives reduce government revenues but do not increase foreign investment in fence-breaking provinces.

This finding has important implications for decentralisation policy in Viet Nam. Local authorities resort to extra-legal incentives because they lack the ability or capacity to address more fundamental issues such as the development of infrastructure and the quality of education and vocational training. Therefore, the answer to extra-legal incentives lies less in enforcement of the rules than improvements to public investment and education policies at the central and local levels.

UNDP Policy Dialogue Papers contribute to key policy debates in Viet Nam through an impartial consideration of the country's development situation and potential implications for the future. Our aim is to encourage informed discussion and debate through the presentation of information and evidence collected and presented in a clear and objective manner.

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While the views expressed in the paper do not necessarily reflect the official view of UNDP, we hope that the paper's publication will stimulate further research and analysis on these important issues.



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Contents

List of Tables and Boxes ii
Executive summary 1
1. Introduction 2
2. An overview of decentralisation in Viet Nam 4
2.1. The Concept of Decentralisation 4
Political Decentralisation 4
Administrative Decentralisation 4
Fiscal Decentralisation 5
Market Decentralisation 5
2.2.Decentralisation in Viet Nam from Different Perspectives 5
Decentralisation in Viet Nam from Cultural and Historical Perspectives 5
Decentralisation in the Process of Reform 6
General Recap 7
2.3. A Brief Discussion of Fiscal Decentralisation in Viet Nam 7

3. The Decentralisation of FDI Management in Viet Nam 11
4. Provincial Fence-Breaking in Providing Incentives For FDI Projects 14
4.1.Who are the Fence-Breakers? 14
4.2.Common Fence-Breaking Practices 15
4.3.Explaining the How and Why of Fence-Breaking 16
4.4.The Dynamics of Fence-Breaking 17
4.5.Central Government Reaction and Provincial Government Compliance 18

5. Assessing The Potential Impact of Investment Incentives 19
5.1.Potential Costs and Benefits of Investment Incentives 19
5.2.Potential Impacts of Incentives on FDI Attraction 19

6. Empirical Evaluation of Incentives Effectiveness in Attracting FDI 22
6.1.Empirical Strategy 22
6.2.Description of the Data 22
6.3.Estimation Results 25

7.Concluding Remarks 28

References 29

List of Tables and Boxes

Table 1: Outcomes of State Budget Revenue and Expenditure Decentralisation (billion VND) 8
Table 2: Investment Licenses issued by People's Committees, IZs and EPZs.....12
Table 3: Investment projects licensed by provincial People's Committees 12
Table 4: Statistical summary of fence-breaking vs. non-fence-breaking provinces 14
Table 5: Timeline of fence-breaking.....17
Table 6: Estimation result (1).....26
Table 7: Estimation result (2).....26

Box 1: Revenue assignment of local governments between 1996 and 2002 9
Box 2: Revenue assignment since 2002 State Budget Law 9
Box 3: Important Milestones in the Decentralisation of FDI Management 11
Box 4: Policy Innovations or a Race to the Bottom?.....15
Box 5: The Central Government Responds….....18

Executive Summary

Between 2001 and 2005, local governments in 32 of Viet Nam's 64 provinces were reported to have violated the central government's investment policies by providing extralegal incentives to foreign investors. The remarkably widespread nature of the violations, referred to here as "investment incentive fence-breaking," has created a clash between the central and local governments, and a competition among provinces themselves in attracting foreign direct investment (FDI). This phenomenon has created a natural experiment for studying the determinants of investment location in Viet Nam. This study is the first effort to employ econometric methods (i.e., difference-in-difference techniques) to address two related questions: (i) What are the main factors significantly affecting provincial performance in terms of FDI attraction? and (ii) Did the extralegal investment incentives help provinces attract more foreign investment? The following points summarise our findings and policy recommendations:

1. Fundamental factors, namely natural resources, human capital, physical infrastructure, and quality of provincial governance, all significantly contribute to the attraction of both registered and implemented FDI.

2. As regards to the role of "hard" versus "soft" infrastructure, while hard infrastructure helps provinces attract registered FDI, it is soft infrastructure that determines the realisation of FDI.

3. After controlling for the fundamental factors, the extralegal investment incentives provided by 32 provinces not only have not helped them to attract more FDI, but have increased their fiscal burden. As a result, competition among these provinces has led to a "race to the bottom" while the objective of attracting more FDI has not been achieved.

4. Compared to the non-fence-breaking group of provinces, the fence-breaking group is poorer, less developed, and less endowed. Given that per-capita FDI, domestic investment, and official development assistance also tend to be higher in better-off provinces, this implies that the gap between the rich and poor provinces continues to widen.

5. Several factors have contributed to the recent massive fence-breaking. Accelerated fiscal decentralisation since 1996 has forced provincial governments to assume more expenditure responsibility while some traditional sources of revenue have deteriorated. In addition, the growing number of job seekers created by the baby boom after 1975 and the recent trend toward urbanization have presented challenges for local governments. All these factors help explain the temptation of provincial government to provide generous incentives to attract more investment in the hope of addressing both budget and job creation problems. That this fence-breaking could not have happened without the accompanied decentralisation of FDI administration. In a sense, the official decentralisation had helped make the de facto decentralisation happen.

6. The phenomenal prevalence of fence-breaking shows the determined (indeed desperate) efforts of poorer provinces to attract FDI to facilitate economic growth.To help these provinces, it is recommended that the central government support these provinces by financing infrastructure, investing in human capital, and insuring against exogenous risks. Moreover, to be efficient, centrally funded infrastructure projects should take a regional approach and should not be used as a means to reward or grant favours to individual provinces.

7. The disadvantaged provinces should be proactive in helping themselves by building up their human capital, improving the quality of provincial governance, creating a good investment environment, and facilitating the development of the private sector.

8. The fact that almost half of the country exercised some form of fence-breaking seriously questions the validity of the FDI regulation framework up to 2005 and the nature of decentralisation. Therefore, instead of simply punishing the violating provinces, the government should carefully consider the underlying reasons that motivate provinces to fence-break. It may be the case that the problem does not have anything to do with the act of fence-breaking, but with the fence itself. Moreover, a good understanding of positive (or negative) aspects of fence-breaking activities may help identify effective (or ineffective) policies that can be encouraged (or discouraged) in other provinces.

9. As a final note, a province is labeled as a fence-breaker if it is listed in Decision No. 1387 dated December 29, 2005 of the Prime Minister. "Fence-breaking" as used in this study, therefore, does not necessarily have a negative connotation. After all, the widespread fence-breaking at the dawn of Doi Moi in the 1980s produced a number of remarkably successful policy innovations. Moreover, when a province is referred to as a non fence-breaker, it only means that the province has not been found to issue officially extralegal regulations; it is of course possible that violations have been committed but have not been discovered.

1. Introduction

Recently, local governments in 32 of the 64 provinces in Viet Nam's were reported to have violated the central government's investment policies by providing extralegal incentives to investors, especially within industrial zones. This phenomenal prevalence of violations, referred to here as "investment incentive fence-breaking" (or just "fence-breaking") has created a clash between central and local governments as well as competition among provinces themselves.[1] While the central government considers the extra investment incentives a clear violation of the law, provincial governments argue that those incentives are necessary to attract more investment, which is a prerequisite for job creation and economic growth.

The competition between provinces in attracting investment has created a natural experiment for studying the determinants of investment location in Viet Nam. The main objective of this paper is to evaluate the impact of the provision of extralegal investment incentives on the level of investment received by provinces. Specifically, this study seeks to address the following questions: Did extralegal investment incentives help provinces attract more investment? What other factors significantly affect provincial performance in terms of FDI attraction? To answer these questions, we also examine the role of soft versus hard infrastructure and of education and training on locational decision of FDI projects.

Several factors have contributed to the recent proliferation of fence-breaking. Accelerated fiscal decentralisation since 1996 has forced provincial governments to assume more expenditure responsibility. The sub-national governments' share of total expenditures has steadily increased from 26 percent in 1992 to 43 percent in 1998 to 48 percent in 2002 (Pham Lan Huong, 2006). This fiscal decentralisation put increasing pressure on provinces, especially poor ones, to raise revenue. Traditionally, poorer provinces have depended for most of their revenue on state-owned enterprises (SOEs) and subsidies from the central government, while richer provinces are able to raise tax revenue from FDI projects, private firms, and real estate transactions. Parallel to this accelerated decentralisation, the equitisation of SOEs has also been pushed forward, meaning that many provinces are now less able to rely on state enterprises and subsidies for revenue. In addition, the growing number of job seekers created by the post-1975 baby boom and the recent trend toward urbanisation are challenges for the local government. All of these factors help explain the temptation of provincial government to provide generous incentives to attract more investors in order to address both their budget and job creation pressures. In a later section we will argue, however, that this fence-breaking could not have happened without the accompanying decentralisation of FDI administration. In a sense, government-mandated decentralisation has helped create the conditions for de facto decentralisation (i.e. fence breaking) to occur.

The rest of the paper is organised as follows. The second section provides an overview of decentralisation in Viet Nam. It begins with a discussion of different forms of decentralisation, and then examines decentralisation in Viet Nam from the economic, political, and cultural perspectives. This section argues that formal (or official) decentralisation is a recent phenomenon in the history of Viet Nam. In fact, for much of its history, political and economic administration in Viet Nam has featured a very high level of de jure concentration, paralleled by a certain degree of de facto decentralisation.

The third section describes the dynamics of decentralisation in FDI management in Viet Nam since the first Law on Foreign Investment was promulgated in 1987. It also provides the rationale for the existence of a popular form of lawful fence-breaking, which is the breaking up of larger projects into smaller pieces to circumvent the cumbersome FDI management system.

The fourth section looks at various aspects of extralegal investment incentives employed by many provinces in Viet Nam over the past five years. It begins by providing a summary of statistics of the fence-breaking vs. the non-fence-breaking provinces. It shows that the fence-breaking group tends to be poorer, less developed, and less endowed. It then describes the most common practices of fence-breaking employed by 32 provinces. After providing an account of the motivation and dynamics of fence-breaking, this section concludes that fence breaking would not have occurred on so large a scale if it had not been preceded by accelerated fiscal and

[1] In this study, "fence-breaking" does not necessarily have a negative connotation. After all, the widespread fence-breaking at the dawn of *Doi Moi* in the 1980s produced a number of remarkably successful policy innovations. For the purposes of this study, a province is labeled as an official fence-breaker if it is listed in Decision No. 1387 dated December 29, 2005 of the Prime Minister. Moreover, when we refer to a province as non fence-breaker, it only means that the province have not been found to issue official extralegal regulations; it is of course possible that violations have been committed but have not been discovered.

FDI management decentralisation. This section ends with a discussion of the reaction of the central government to the wave of fence-breaking and the "false compliance" of fence-breaking provincial governments.

Section 5 considers the inherent costs and benefits associated with investment incentives. It also reviews the findings of both theoretical and empirical studies on the role of investment incentives in attracting FDI. Specifically, this section addresses the question: can tax incentives attract foreign investment? The main conclusion of this section is that while tax incentives can be a necessary condition for attracting FDI, they are far from sufficient.

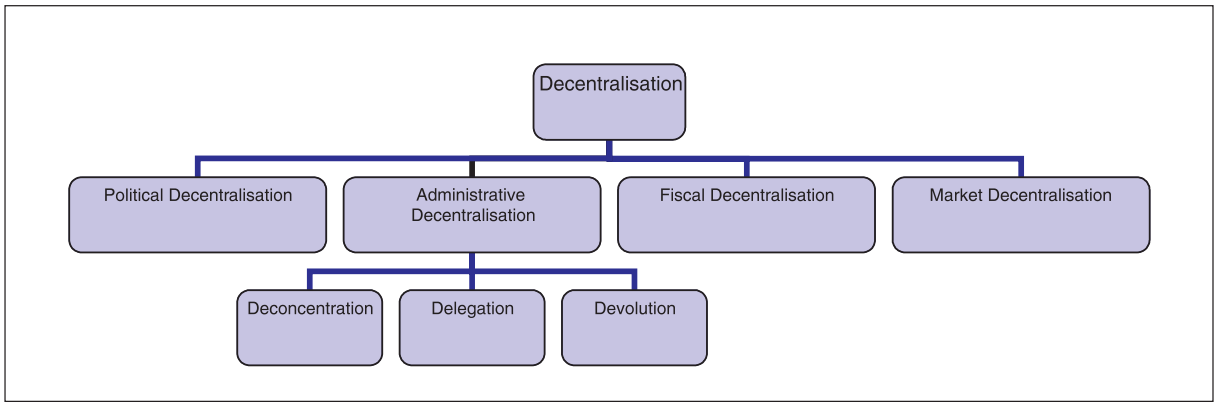
Section 6 provides an empirical evaluation of the impact of factors, including extralegal incentives, on the level of registered and implemented FDI in provinces. This section reconfirms the importance of fundamental factors such as natural resources, infrastructure, human capital, and governance to FDI attraction. It also shows that extralegal incentives have not been effective in facilitating a higher level of FDI inflows into fence-breaking provinces.[2] Section 7 concludes and discusses some caveats of the study. This section also provides directions for further research.

[2] A joint study between Viet Nam National University HCMC and Viet Nam Competitiveness Initiative in 2004 (Nguyen Thi Canh et al., 2004) finds similar results. The study reveals that when making their investment decisions, the provision of corporate income tax (CIT) incentives are much less important to domestic private firms compared to other fundamental factors, namely the provision of good infrastructure, human resources and skilled labour, access to markets, and the quality of local regulations. The study also finds that about 85 percent of firms receiving CIT incentives would definitely or probably have made the same investment decision even without the provision of tax incentives. The study's estimate of the redundancy rate of CIT incentives is nearly 83 percent while that of public subsidy ranges between 62 percent and 75 percent.

2. An Overiew of Decentralisation in Viet Nam

2.1. The concept of decentralisation

Decentralisation of state management, in its broadest sense, is a form of transfer of power and responsibility from the central level to local bodies, or the assignment of such tasks to the private sector, thereby bringing government closer to the people and creating space for flexibility in government programmes, budgeting and financing. Today, the concept of decentralisation is used to describe a variety of circumstances and phenomena in society. Although there has been a great deal of debate surrounding the concept of decentralisation, there has generally been a consensus among researchers that we must distinguish between different forms of decentralisation, as follows:



Political decentralisation

Political or democratic decentralisation aims at creating more favourable conditions for people to participate in the policymaking process at the local level. Through political decentralisation, local governments, which are elected directly, can be made more accountable to the local inhabitants.

Administrative decentralisation

Administrative decentralisation is the sharing of the power to perform public responsibilities from the centre to state agencies at various levels. As a result, through administrative decentralisation the tasks of planning, zoning, management and part of the financing of infrastructure and provision of public services will be transferred from the central level to local administrative bodies. Administrative decentralisation can be divided into three groups:

Deconcentration is a form of sharing of decision-making authority and responsibility with representative offices of central government agencies located in different regions of the country (an example in Viet Nam is the representative office of the Ministry of Planning and Investment for the Southern Region, located in Ho Chi Minh City). This is the lowest form of administrative decentralisation (some experts even argue that this is not decentralisation at all because such power transfer occurs only within the central level).

Delegation is a form of administrative decentralisation according to which the higher level central government transfers decision-making and management authority to local governments and allows local governments to undertake activities on behalf of the higher level governments.

Devolution is the highest form of administrative decentralisation. Under this form, complete authority over decision making, financing and management is transferred from the central government to independent bodies of the local government. Devolution empowers local governments to hire and fire local staff, there by making local officials accountable to elected officials, without any reference to higher levels of governments.

Fiscal decentralisation

Fiscal decentralisation is the central component of every form of decentralisation. Agencies to which authority has been decentralised can only perform their tasks independently when they have necessary resources and power to make spending decisions. Services provided by the local government can be financed by a number of sources, including (but not limited to) funding from the central government, fees paid by service users on the basis of cost recovery, co-financing from users, taxes collected by the local government in accordance with the law, and borrowing in accordance with the law.

Market decentralisation

This type of decentralisation differs from the concept of the decentralisation of state management in the economic field. Market decentralisation applies where the state transfers functions from the public sector to the private sector and responsibilities which were previously performed by state agencies are carried out by private enterprises, cooperatives, associations and non-government organisations. Market decentralisation can be divided into two groups. The first is privatisation, by which assets and responsibilities (e.g., the provision of certain products and services) are transferred from the state to private entities. The second type of market decentralisation is deregulation, which is designed to reduce administrative barriers and create the conditions for private entities to enter markets.

2.2. Decentralisation in Viet Nam from different perspectives

Decentralisation in Viet Nam from cultural and historical perspectives

It is difficult to trace formal decentralisation in the history of Viet Nam. Since Ngo Quyen regained national independence in the 10th century AD, it appears that from pre-modern times to the colonial period to the post-1945 period, the state in Viet Nam has been relatively centralised. The balance of power has always tilted in favor of the central government in almost every important dimension. At the same time, the scope of devolution has been very limited, and local government has been greatly dependent on the central government (in terms of policies, budget, and personnel). Delegation has only been adopted with some specific activities and deconcentration has been applied only to some organisations (delegations) for short periods of time, such as high mandarin(s) under the feudal time *(quan khâm sai đại thần)* or special government envoys of the government today (*đặc phái viên của Chính phủ)*. State budgets have always been highly centralised. As a result, the local level has expected support from the central budget. This situation increased the dependence of local levels on the centre and at the same time narrowed still further the capacity for local government decision making.

However, this centralised structure has always been paralleled by the Vietnamese "village culture", which has been quite influential. The village in Viet Nam possesses power and importance. The proverb "The king's laws stops at the village gate" phép vua thua lệ làng), and the observation that while Viet Nam has on occasion lost the country but has never lost the village, clearly attest to the power of village culture. Village conventions (or laws of the village - *hương ước*) were a unique feature of Viet Nam's legal system in the pre-modern period. Despite the central role of the village in Vietnamese state and society, the village has never ever been officially recognised as an administrative unit of the government apparatus. Today the village head (trưởng thôn) is not officially recognised as a civil servant (even though he/she receives allowances from the state budget); the same was true of the village chief (*lý trưởng*) before 1945. In other words, the power of the village is of an informal nature and as such can deal only with a limited set of local issues. However, as a community with a certain degree of *de facto* "autonomy", the village has substituted for the role of the state in resolving numerous social issues during the Doi Moi era, especially with respect to issues directly relating to the interests of the people such as support for the poor and education.

Decentralisation in the process of reform

From the beginning of *Doi Moi*, decentralisation was recognised by the Party and was enshrined in a Resolution of the Sixth Party Congress in 1986:

> "(We) Should restore order, discipline in social, economic management. It is the management mechanism - with a heavy nature of centralisation and red tape, that has restricted the lower levels, and at the same time reducing the efficiency of centralised management which directly caused confusion in discipline and order. Therefore, it is impossible to overcome the confusion by returning to the old mechanism, but (we) have to *implement decentralisation of management resolutely in accordance with the principle of concentrated democracy.*
>
> Decentralisation of management should ensure the policy self-ownership of all three levels: the decision making right of the central level (including functional branches of the central government) with respect to the key fields, strategic issues, ensuring balanced development of the whole economy; autonomy right of local bodies in implementing social-economic tasks in their respective localities; the autonomy right in production - distribution of economic entities, and the ownership role of collective workers. In delegation and decentralisation of management, responsibility should parallel power, and obligations should be linked to benefits."[3]

Although decentralisation has been studied in Viet Nam for some time, the theory of decentralisation, and particularly the role of the state in the economy has not been studied thoroughly. Consequently, for a very long time, decentralisation in Viet Nam has been pursued narrowly as a process of administrative decentralisation, leading to uncoordinated and incomplete decentralisation. For instance, in many fields decentralisation of decision-making responsibility has been implemented without corresponding decentralisation of responsibility for fiscal and personnel matters. This situation has had a negative impact on the decentralisation process in Viet Nam.

Decentralisation in Viet Nam usually follows a number of principles, of which two principles stand out. The first principle is "top-down decentralisation," meaning that functions that the upper level of government should not perform will be carried out by lower levels. Of course, this is a complete reversal of the popular bottom-up approach to decentralisation seen around the world, according to which only tasks that the lower level is unable to do will be carried out by the upper level. Top-down decentralisation has resulted in many circumstances in which the lower level feels unnecessarily constrained while the upper level is overloaded and unable to control things. This situation worsens the problems of moral hazard and explains why in Viet Nam the lower levels of government tend to be dependent on the upper levels.

The second key principle of decentralisation in Viet Nam is decentralisation by scale. Put differently, "keep the big, release the small" has always been a dominant characteristic of the decentralisation process in Viet Nam, especially in issues related to investment management. However, the scale of an investment does not always correspondent to the nature and impact of the investment project. The application of this principle has created significant problems for local government. In a latter section, we show that this "hold the big, release the small" pattern is also partly responsible for tempting provincial governments to fence break in order to attract more foreign investment.

However, it can be affirmed that the essence of the reform process in Viet Nam over the past 20 years is a process of transforming the role of the state in the economy. After two decades of reforms, to a great extent, Vietnam has successfully transformed the centrally planned economy into a decentralised market-oriented economy (see also the diagram classifying decentralisation). Indeed, many of the most remarkable achievements of Doi Moi can be attributed to this form of decentralisation. Several examples stand out. The transformation of the rural areas in Viet Nam in the late-1980s was the direct result of many achievements in

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[3] Complete Collection of Party Documents, vol. 47, p. 747. Italics added.

agricultural development, which in turn were a natural result of the state's decision to renounce its directing role and monopoly position in the production and distribution of rice. After only a few years, the country escaped from the spectre of hunger to become one of the biggest rice exporters in the world.

Another remarkable achievement of *Doi Moi* was recorded in the early 1990s when the Socialist Bloc collapsed in Europe, taking with it Viet Nam's single most important source of foreign aid. At the same time, because diplomatic normalisation with the US had not yet been achieved, the US trade embargo remained in place. Viet Nam was almost completely isolated from the outside world. Once again, the private sector came to the rescue. The Law on Private Enterprise was passed in 1990 to acknowledge private ownership and the role of the private sector in the development of Viet Nam. As a result, Viet Nam was able to stand firmly on its own feet and build up foundations for further development. Since then, the state has gradually abandoned its monopoly in manufacturing and service industries.

The passage of the Law on Enterprise in 1999 marked another significant step toward deeper market decentralisation. After the Law was enacted, a record number of private enterprises have been established thanks to the simplification of business registration procedures. The huge amount of domestic capital mobilised by these enterprises has helped Viet Nam to recover from the 1997-98 regional economic crisis and maintain a relatively high rate of growth since 2000.

A lesson can be drawn from the above-mentioned successes of market decentralisation: if the role of the state in the economy and market decentralisation had been studied carefully at the initial stages of *Doi Moi*, Viet Nam might have successfully designed a relatively clear roadmap for the transition process, thereby avoiding many inefficient investment programmes during the past twenty years.

General recap

The shape of the decentralisation process depends on the economic, political, and cultural factors of each country. Historically, Viet Nam's government apparatus has been heavily centralised. However, for centuries, the village in Viet Nam has featured deeply autonomous elements. These special features deserve more thorough research in order to design decentralisation measures suitable to the circumstances of Viet Nam.

Although the issue of decentralisation has been raised in Viet Nam for a long time, it has never been studied in a thorough and comprehensive manner. The notion of decentralisation has not been understood consistently by researchers and government policymakers.[4]

Due to the lack of research and consideration of foreign experience, many of the decentralisation recommendations of the government have taken for granted the old set of government responsibilities, without asking what responsibilities the state does not necessarily need to perform and might best be discarded. This failure to conduct a thorough examination of the optimal extent of state responsibilities has limited the decentralisation process. In addition, the implementation of decentralisation according to inappropriate principles has led to uncoordinated and incomplete decentralisation which is unsuitable to the capacity of lower level government. The lack of supervision from the higher government levels causes considerable bottlenecks and waste in the process of decentralisation.

2.3. A Brief Discussion of Fiscal Decentralisation in Viet Nam

This section discusses several aspects of fiscal decentralisation related to the decentralisation of FDI management and the provision of extralegal investment incentives in many provinces in recent years.

[4] As a result, many government bodies (including ministries and branches) have encountered a number of difficulties in the process of implementing Resolution 08/2004 of the government regarding decentralisation of projects.

Table 1: State Budget Revenue and Expenditure Decentralisation (billion VND)

	1997	1998	1999	2000	Average 1996-2000	2001	2002	2003 (est.)	2004 (plan)
1. *Revenue*	65,352	70,612	78,489	90,749	73,518	103,773	121,716	141,930	149,320
Of which: local budget revenue	19,264	20,280	19,571	22,269	19,827	25,463	30,545	38,683	44,743
Share of total state budget revenue									
Growth rate	29.5	28.7	24.9	24.5	27.1	24.5	25.1	27.3	30
-State budget revenue	4.8	8	11.2	15.6	10.2	14.4	17.3	16.6	5.2
-Local budget revenue	8.5	5.3	-3.5	13.8	8.3	14.3	20	26.6	15.7
2. *Expenditure*	70,749	74,761	84,817	103,151	80,804	119,403	135,490	177,150	187,670
Of which: local expenditure	28,039	31,808	39,040	45,082	33,503	56,043	64,573	66,254	67,184
Share of total expenditure	39.9	42.5	46.0	43.7	41.5	46.9	47.7	37.4	35.8
-including capital	7,499	9,424	14,129	14,557	10,345	20,112	24,147	20,786	20,708
Plus recurrent	20,540	22,203	24,806	30,346	23,065	36,070	39,627	45,468	43,981
Growth rate									
-State budget expenditure	10.7	5.0	17.0	13.5	10.9	19.1	14.2	19.5	5.9
-Local expenditure	19.1	13.4	22.7	15.5	17.1	24.3	15.2	2.6	1.4
3. *Ratio b/w local capital expenditure and local recurrent expenditure*	93.8	91.3	78.9	73.4	89.2	70.6	77.1	85.1	101.7
4. *Transfer from central budget*	9.964	12.290	20.510	26.601	15.345	23.553	35.278	38.040	35.048
Growth rate	35.4	23.3	66.9	29.7	31.9	-11.5	49.8	7.8	-7.9
Share in total local expenditure	35.5	38.6	52.5	59.0	42.1	42.0	54.6	57.4	52.2

Source: Government of Viet Nam et al. (2000 and 2005)

Fiscal decentralisation (or the division of financial functions and responsibilities) in Viet Nam began with the promulgation of the Budget Law of 1996. The Budget Law was amended in 1998, and subject to a major revision in 2002. These changes were meant to facilitate further fiscal decentralisation which is compatible with the changing role of the state (as reflected in the public finance system).

As can be seen from Table 1, the share of local government in total national expenditure increased from 40 percent in 1997 to 48 percent in 2002. This share fell in 2003 and 2004 due to a sharp decrease in local expenditure growth in absolute terms and relative to total expenditures. This marked a reversal of a previous trend in which the growth of local expenditure had been significantly higher than that of state expenditure for many years. Despite the decrease in the share of local expenditure, it is still much higher than during the early 1990s prior to the promulgation of the Budget Law.

The bottom line is that as a consequence of fiscal decentralisation, today local governments are supposed to assume greater responsibility for their spending. This might not be a problem for provinces with high and relatively more sustainable sources of revenue like Ha Noi, Ho Chi Minh City, or Binh Duong, but it presents a real challenge for poorer provinces with meager and non-sustainable sources of revenue despite the increasing share of central government transfers in total local expenditures.

Box 1: Revenue assignment of local governments between 1996 and 2002

The revenue sources of the provincial budget shall include:

1. The revenues to be 100 percent collected: land rent; revenues from the leasing and sale of residential properties owned by the state; registration fees; revenues from state-run lotteries; non-refundable aid donated directly by foreign organisations and individuals to the province in accordance with provisions of law; fees, charges and other revenues to be contributed to the provincial budget in accordance with the provisions of the Government; money mobilised from organisations and individuals to invest in the construction of infrastructure projects in accordance with the provisions of the Government; voluntary contributions from domestic and foreign organisations and individuals to the provincial budget; revenues from the balance of the provincial budget; supplementary allocation from the central budget; other revenues as provided for by law.

2. Revenues divided in percentage (percent) between the central budget and the provincial budget: turnover tax; profit tax, excluding profit tax of entities whose all member companies pay profit tax only to central government; income tax from high-income earners; tax on remittances of profits abroad; natural resources tax; tax on the use of budget capital.

3. Revenues divided in percentage (percent) between the provincial budgets, budgets of districts, precincts, provincial towns and cities (referred to as the districts budget) and the budgets of communes and townships: tax on the use of agricultural land; tax on the transfer of land use rights; house and land taxes; land rent.

Source: 1996 State Budget Law, Article 30

On the revenue side, the share of local budget revenue in total state revenue has been relatively stable at about 27 percent since 1996. For local governments, the stability of their revenue share, coupled with an increase in their expenditures, implies that they are facing an increasing fiscal gap. Up to three-quarters of all provinces have run budget deficits for a long time. It is estimated that, even if the central government only collected revenue from crude oil and import-export duties, and all remaining taxes were left to the local level, roughly two-thirds of the provinces would still have to rely on financial support from the central budget. This reality is an important factor driving the "begging and giving" mechanism of distributing central government resources which defines the relationship between local and centre. As can be seen clearly from Table 1, even though the growth rate of transfers from central to local government has decreased over the last decade, the transfer's share of local expenditure has risen sharply from 35.5 percent in 1997 to 52.2 percent in 2004.

Box 2: Revenue assignment since 2002 State Budget Law

The sources of local budget revenues shall include:

1. Revenues enjoyed 100 percent directed to by the local budgets:

Land and house tax; natural resource tax (excluding natural resource tax collected from oil and gas); the license tax; the land use right transfer tax; the agricultural land use tax; the land use levy; the land rent; proceeds from the lease and/or sale of state-owned houses; registration fees; revenue from construction lottery; retrieval of local budget capital at economic organisations, revenue from the local financial reserve funds, income from contributed capital of the localities; non-refundable aid of international organisations, other organisations and individuals in foreign countries, provided directly to the localities; charges, fees, revenues from non-business activities and other revenues payable into the local budgets under the provisions of the law; revenue from public land funds and other income from public properties; money mobilised from organisations and individuals according to the provisions of the law; voluntary contributions of organisations and individuals inside and outside the country; resoures carried over from local budget as provided for in Article 63 of this Law; other revenues as prescribed by law;

2. Revenues divided in percentage between the central budget and the local budgets under the provisions in Clause 2, Article 30 of this Law;

3. Additional allocations from the central budget;

4. Revenues from investment mobilisation for the construction of infrastructure projects as provided for in Clause 3, Article 8 of this Law.

Source: The Revised 2002 State Budget Law, Article 32

Several new developments brought about by the State Budget Law (2002) merit attention here. The first is that the State Budget Law gives provincial governments more budgeting power vis-à-vis both the central government and lower level local governments. The provincial government is now allowed to borrow domestically without having to seek further approval from the central government, provided that certain requirements are met. The provincial People's Council, the provincial level-legislative body, can now decide how expenditures are allocated among the three sub-national tiers of government, namely the province, district, and commune. It can also influence the revenue of other tiers of local government by determining the types of fees and contributions that these governments can collect.

As the provincial governments have been granted more budgeting power and flexibility, the line ministries are losing control over their usual allocative functions. Although sub-national governments are supposed to follow the plans put in place by the line ministries when setting their budgets, the lack of effective monitoring and coordinating mechanisms often leads to inconsistencies between ministerial plans and the actual allocation of resources at the provincial level. Addressing these inconsistencies, while at the same time continuing to allow local government greater budgetary flexibility, is a major challenge of fiscal decentralisation in Viet Nam.

3. The Decentralisation of FDI Management in Viet Nam[5]

In 1986, Viet Nam's economy was in crisis and people faced acute hardship. In order to overcome these challenges, the Party launched three key programs: agricultural development, consumer goods production, and export promotion. Since domestic resources were severely limited, attracting foreign investment was a top priority. Therefore, the Sixth Party Congress decided to:

> "Announce the policy to encourage foreigners to invest into our country under various forms, especially with respect to high-tech industries and facilities, with an emphasis on export production. Together with promulgation of the law on foreign investment, there should be policies and measures to create favourable conditions for foreigners and overseas Vietnamese to do business in Viet Nam."[6]

On the basis of the Party Resolution, the Law on Foreign Investment was promulgated, which was the first law in Viet Nam's fledgling economic legal system. During the initial stage of implementing the Law on Foreign Investment, all foreign-invested projects were managed by the State Committee for Cooperation and Investment (SCCI). After the normalisation of diplomatic relations with the United States and the removal of the trade embargo, flows of foreign investment into Viet Nam accelerated rapidly. In this context, the decentralisation of foreign investment management emerged as an important issue, and was gradually implemented through a series of laws, decrees and decisions of the Prime Minister.

Box 3: Important Milestones in the Decentralisation of FDI Management

1997: The Prime Minister issues a decision on the decentralisation of the issuance of investment licenses to People's Committees on a pilot-basis for 16 provinces and centrally managed cities (Decision No. 386/TTg dated 7/6/1997 and Decision No. 41/1998/QD-TTg dated 20/2/1998).

1998: After more than one year of implementation, on 1/12/1998 the Prime Minister issues Decision no. 233/1998/QD-TTg authorising all provincial People's Committees to issue investment licenses and amend investment licenses for foreign-invested projects.

2000: The Law on Foreign Investment is amended. Article 55 of the amended Law on Foreign Investment and Article 115 of Decree 24/2000/ND-CP dated 31/7/2000 provide detailed implementation guidelines for the Law on Foreign Investment, expanding the authority of provincial People's Committees by granting them sole responsibility for the state management of foreign investment.

2006: The Unified Investment Law comes into effect, promoting even further FDI decentralisation.

Although the decentralisation of FDI administration has accelerated over the last two decades, there are still some constraints--particularly with respect to project scale-which continue to limit the ability of provincial governments to attract foreign investment. According to the 2002 State Budget Law, Ha Noi and Ho Chi Minh City are authorised to manage investment projects outside industrial zones (IZs) up to USD10 million, while other provinces/cities can only manage projects up to USD 5 million. IZs and export processing zones (EPZs) are entitled to license FDI projects within the zone up to USD 40 million .

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[5] This section limits itself to the discussion of FDI management decentralisation in Viet Nam up to 2005. Since the Common Investment Law became effective on July 1, 2006, the management of FDI has been nearly completely decentralised to the provincial level (with some exceptions with respect to conditional investment.)

[6] Complete Documents of the Communist Party of Viet Nam, volume 47, page 767.

Table 2: Investment Licenses Issued by People's Committees, IZs and EPZs

No.	Year	No. of projects	Registered capital (,000 USD)	Average project size (mil USD)*
1	1993(**)	7	40,293	5.7
2	1994(**)	28	203,190	7.3
3	1995(**)	39	212,272	5.4
4	1996(**)	40	310,227	7.8
5	1997	118	554,658	4.7
6	1998	206	720,040	3.5
7	1999	287	740,475	2.6
8	2000	364	1,013,865	2.8
9	2001	506	1,238,416	2.4
10	2002	763	1,641,023	2.2
11	2003	718	1,599,488	2.2
12	10 months in 2004	575	1,323,765	2.3
	Total	3,651	9,597,712	2.6

Note: (*): Including projects in IZs and EPZs at the locality
(**): The period from 1993 to 1996 shows a high average size because statistics during this period often included projects in IZs and EPZs.

Table 3: Investment projects licensed by provincial People's Committees

Region	Number of projects	Registered capital (,000 USD)	Average project size (mil USD)
1. Northeast mountainous region	115	222,086	1.9
2. Red River Delta	574	1,053,239	1.8
3. Northern Central and Coastal	147	316,691	2.1
4. Central Highlands	43	70,413	1.6
5. Southeast	1,249	1,890,119	1.5
6. Mekong Delta	65	144,388	2.2
TOTAL	**2,193**	**3,696,937**	**1.7**

As can be seen from Tables 2 and 3, the foreign-invested projects licensed by provincial governments, IZs, and EPZs are quite small, with an average investment of about USD 2-3 million. There is a good reason for this fact. Limits on decentralisation (especially with respect to project scale) not only restrict the ability of provinces to approve FDI projects, but also create many unnecessary complications for foreign investors. According to current regulations, if a project exceeds USD 5 million, the investor must personally meet with central government agencies, even if the environmental and social impact of project will not be felt outside the province and it falls within the jurisdiction of the province with respect to the Land Law. This requirement significantly increases transaction costs and discourages many investors. Faced with this situation, investors can either move elsewhere or collabourate with the provincial government to engage in legal fence-breaking, that is by either scaling down the project or breaking it into pieces and later apply for a project expansion. However, these tactics are not suitable to large projects that do not have spillover effects on other businesses in the locality. Thus the decentralisation of foreign investment has had a very limited impact.

Unlike previous decisions[7] that provided for limited decentralisation of FDI management (in terms of both scope and function), the amended Law on Foreign Investment and the accompanying Decree No. 24/2000/NĐ-CP dated July 31, 2000 provided provincial People's Committees with greater policy space; IZs were granted even more authority. For example, although decentralisation was introduced to only 16 provinces in 1998, then from July 2000, all provincial People's Committees enjoyed a much higher degree of decentralisation. Specifically, the functions of the People's Committees and the IZ management boards, previously limited to the licensing and oversight of adjustments to FDI projects, were expanded to encompass all aspects of FDI administration. For example, the provincial IZ management board now is responsible for administering all industrial and export processing zones within the province according to a "one door, on site" principle ("một cửa, tại chỗ"). The management board is in charge not only of licensing but also all other processes involved in the setting up and operation of enterprises in the zones, including land clearance, construction, and labour. Some specialised administration services such as customs, police, and taxation can also be provided on site by authorised representative offices.

In summary, since the Law on Foreign Investment came into force in January 1988, Vietnam has been relatively successful in attracting foreign investment. Over the last two decades, the central government has sought to encourage local governments, IZs, and EPZs to boost FDI flows by accelerating the decentralisation of FDI management. Viet Nam's accession to the World Trade Organization (WTO) in January 2007 should be a catalyst for increased investment by multinational corporations (MNCs). The new Unified Investment Law that came into effect on July 1, 2006, and its implementing decrees are continuing the process of decentralisation of foreign investment management.

[7] See for example, Decision No. 386 dated June 7, 1997 and Decision No. 386 dated February 20, 1998 by the Prime Minister.

4. Provincial Fence-Breaking in Providing Incentives for FDI Projects

4.1. Who are the fence-breakers?

Table 4 summarises some important statistics describing fence-breaking and non-fence-breaking groups. The fence-breaking group is clearly less-developed by various measurements such as GDP per capita, level of urbanisation, and infrastructure. Geographically, fence-breaking provinces are located far from the major markets of Ha Noi and Ho Chi Minh City. This also means that they have much less access to international markets since Ha Noi and Ho Chi Minh City are the two main gateways to international trade. Noticeably, the two groups fare similarly in terms of human capital (measured by the percentage of students in the population and by the percentage of skilled labour in the workforce.) In terms of investment attraction (both foreign and domestic) and budget performance, the non-fence-breaking group significantly outperforms the fence-breaking group. All of these factors explain why the non-fence-breakers, on average, have grown faster and enjoyed budget surpluses, while the fence-breakers have grown slower and have suffered budget deficits. Finally, due to the lack of good job opportunities, mobile workers tend to leave the fence-breaking provinces for non-fence-breaking provinces.

Table 4: Statistical summary of fence-breaking vs. non-fence-breaking provinces

Variables	Fence-breakers	Non fence-breakers
Average registered FDI 2000 - 2005 (USD per capita)	12.51	58.75
Average implemented FDI 2000 - 2004 (USD per capita)	8.62	26.47
Average domestic investment (USD per capita)	22.45	40.23
Average GDP per capita 2000 - 2005 (USD)	288.87	372.20
Average growth rate 2000 - 2005 (percent)[8]	8.99	9.37
Urbanisation in 2005 (percent)	20.27	26.02
Pupils as percentage of population 2000 - 2005 (percent)	23	22
Skilled labour as percentage of total labour in 2005 (percent)	12	12
Unemployment rate in 2000 (percent)	6.25	6.15
Non weighted PCI 2006	54.5	56.3
Communes with electricity in 2000 (percent)	85	92
Communes with motor way to the central in 2000 (percent)	84	91
Average telephone 2000 - 2005 (per 1,000 citizens)	124	177
Market proximity index	1.15	2.02
Average population 2000 - 2005 (USD millions)	1.28	1.37
Net Migration in 2000 (number of persons)	- 10,219	9,501
Average own revenue 2000 - 2003 (USD millions)	46.23	180.33
Average expenditure 2000 - 2003 (USD millions)	66.54	93.05
Average budget surplus 2000 - 2003 (USD millions)	- 20.31	87.28
Average transfers from central gov't 2000 - 03 (USD millions)	33.78	31.52

[8] Provincial GDP growth rates are calculated based on the provincial annual GDP data. As can be seen, the average rate of provincial GDP growth is about 2% higher that of the whole country, which suggests that provincial GDP data have been systematically inflated.

4.2. Common fence-breaking practices

In addition to the investment incentives permitted by the central government, the fence-breakers provide a variety of extra incentives, ranging from investment premiums and accelerated depreciation to tax holidays and reductions of land use fees. Out of 48 provinces surveyed by the Ministry of Finance (MOF), 32 provinces issued extralegal documents granting extra incentives to investment projects. Most of the incentives are related to land or taxation. With respect to land, these incentives include extended exemptions of on rent, subsidies for infrastructure, land clearing and surfacing, and preferential rents corresponding to the size of the project. As for taxation, most fence breakers had widened the list of projects subject to preferential treatment, offering corporate income tax exemptions and allowances and VAT reductions. Other measures such as credit assistance and guarantees, labour training allowances, and "one-door, one-stamp" policies are also provided by many provinces. Several provinces (e.g., Quang Ngai) have gone as far as to simultaneously violate three or four national investment incentive policies; others have provided extreme incentives such as giving land to investors virtually for free (e.g., Ha Tinh.) More concrete examples of violation are provided in Box 4.

Box 4: Policy Innovations or a Race to the Bottom?

The Ministry of Finance reports that among 32 fence-breaking provinces, 18 violated budget regulations, 21 offered land incentives that go beyond the framework established by national land policy, 11 broke corporate income tax regulations; and many provinces were found to have violations in more than two areas. Most provinces offered very generous incentives with respect to land use fees and extended the exemption period for up to 10 to 20 years.

For example, it was stated in a document issued by the People's Committee of Ben Tre that "in addition to enjoying the preferential treatments allowed for by national policies, all BOT, BTO, and BT investment projects in Ben Tre will be given an extra exemption for 4 years and a 50 percent reduction of corporate income tax for the next 9 years."

Quang Nam applied a tax rate that is 3-10 percent lower than the official rate for 3 years. Ha Tinh offered land-fee exemptions for 7-13 years longer than the official policy permitted. Moreover, it allowed investors to enjoy an extra land-use fee reduction for five years or even, in some cases, forever. Phu Yen also made a bold offer to investors by allowing them to benefit from an extra land-use fee reduction of 50 percent for 8-20 years beyond the time frame set by the central government.

Nghe An offered an additional exemption from land-use fees for a period of 10 years to investment projects in Vinh and Cua Lo. An additional 20 year exemption is offered to investment projects in the province's upland region. Nghe An and Thanh Hoa also issued extralegal incentives with respect to corporate income tax.

Provinces in the South Central Coast and Central Highlands also appeared to be very competitive in granting investment incentives. For tourism projects, Binh Dinh offered full corporate income tax exemption for the first year, followed by a 50 percent reduction for the next 3-30 years. An additional land-use fee exemption will be applied to FDI projects for 3-30 years. Binh Thuan allowed investors to keep 50 percent of their corporate income tax for 2-10 years for reinvestment. Gia Lai and Kom Tum–two provinces in the Central Highlands- also offered corporate tax incentives.

The competition for FDI quickly led to an escalating race to sweeten investment incentives. For instance, once Vinh Phuc stated that "in addition to the incentives given by national regulations, investors are also provided with the following extra incentives …" neighboring Phu Tho quickly announced its intention to "ensure that [Phu Tho's] land use fees are lower than those of other provinces with similar conditions."

There has yet to be a careful estimation of the fiscal costs of these investment incentives. It is clear, however, that fence-breaking provinces have all experienced budget deficits to varying degrees, ranging from several dozen up to trillions of VND. Most of fence-breaking provinces have been running budget deficits for a long time. Some provinces, mostly in the poor Central Coast region (for example, Thanh Hoa, Nghe An, Ha Tinh, Quang Binh, Quang Nam) have received transfers from the central government amounting to up to 30-60 percent of their total annual expenditure.

Source: Ưu đãi thu hút: "Xé rào" hay linh hoạt? Wednesday, April 27, 2005
http://www.tienphongonline.com.vn/Tianyon/Index.aspx?ArticleID=7761&ChannelID=3
Thủng ngân sách vì "xé rào" ưu đãi các nhà đầu tư, Thursday, August 3, 2006.
http://www.tienphongonline.com.vn/Tianyon/Index.aspx?ArticleID=55657&ChannelID=3

4.3. Explaining the how and why of fence-breaking

Several factors have contributed to the fence-breaking observed during period 2001 to 2005 in Viet Nam. The pressing need for capital on the one hand, and the shrinking of financial resources on the other hand, have forced many provinces to search for new ways to make up the widening capital gap.[9] A higher growth rate is desirable for every province in order to raise local living standards and respond to the rising employment pressure created by the steady increase in labour force entrants every year. On the revenue side, provinces face a reduction in capital provision and subsidies from the state budget and declining state credit lines, generally because of the progressive fiscal decentralisation and the acceleration of the SOE equitization program. Provinces can no longer totally rely on central government support.

Attracting FDI is not easy, especially for those provinces which are geographically remote and poorly endowed with respect to natural resources, infrastructure and human capital etc. In addition, it is evident that the geographic distribution of foreign and domestic investment in Viet Nam has been very uneven. Provinces that attract large amounts of foreign investment are also likely to possess a more dynamic domestic private sector. A similar trend applies to ODA funds. Consequently, if the government of a poorer province wishes to grow faster to catch up with richer provinces, which is an increasingly more difficult task, it often concludes that it has no choice but to rely on innovative means to attract investment, often through tax incentives. In this context, the temptation to break the fence so as to attract more investment is understandable.

It is not a coincidence that fence-breaking with respect to investment incentives began to emerge in early 2001, becoming widespread in 2002 and 2003. Several reasons, internal and external, account for this trend. The rapid emergence of the domestic private sector, the recovery of the economy, and the return of large amounts of FDI to Viet Nam from 2000 created many opportunities for provinces to attract foreign investment projects. This stream of FDI has continued to increase over the last five years.[10] Although the level of FDI has yet to return to its peak in 1997 (right before the regional crisis), the total amount of FDI between 2000 and 2005 was about USD 17 billion, accounting for nearly 20 percent of total investment in Viet Nam during this time. Provinces saw plenty of opportunities to attract FDI, and at the same time, observed a small cohort of fortunate provinces eating a large part of this growing cake. Competition among provinces to attract FDI through the adoption of innovative policies has always been there.

Perhaps the growing temptation to fence-break (especially among the poorer provinces) and the increasing amount of FDI would not have produced such heated competition if it had not been paralleled by the progressive decentralisation of FDI administration as described in Section 3 above. Theoretically, it can be argued that the decentralisation of FDI administration has increased the level of information asymmetry between local and central government. It is this asymmetric information, combined with weak oversight of local governments by the centre, that contributed to moral hazard or fence-breaking in provinces.

In summary, the growing temptation of provinces to adopt innovative policies (albeit at the cost of breaking the law) is fueled by pressure to achieve financial self-sufficiency combined with increasing FDI inflows and much greater local authority over FDI management (but ineffective oversight of the central government). The combination of these factors created a "perfect storm" for fence-breaking. Scattered violations in 2001 became widespread in 2002 and 2003; by the end of 2004, half of the provinces in the country had joined the wave of fence-breaking in investment incentives.

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[9] The race to outdo other provinces in offering investment incentives is not the only negative consequence of competition among provinces. Many provinces have also adopted a strategy of investing heavily in infrastructure and "titanic projects" without properly taking into account the returns on these investment. For this kind of competition, see the article " The race for growth" on Tuoi Tre Online (Wednesday, July 20, 2005):

http://www.tuoitre.com.vn/Tianyon/Index.aspx?ArticleID=89562&ChannelID=87)

[10] Globalisation and the situation in the region (for example, tension between China and Japan and Taiwan, political turmoil in the south of Thailand etc.) have also contributed to the increase in FDI to Viet Nam.

4.4. The dynamics of fence-breaking

In FDI incentive literature adresses the question of the triggering mechanism for FDI incentives and their overall impact. Using a game theoreti model, Cai and Treisman (2005) study competition among countries in attracting FDI. Their model predicts that poorer countries are likely to be the first to break the law, triggering a race to the bottom and at the end well-performing countries will drive other countries out of the competition. The authors note that theoretical models often rely on the assumption that all countries have the same initial conditions with regards to physical endowment, human capital, and business environment, which may not be realistic. The paper, however, provides a good theoretical framework for the analysis of incentive competition in attracting FDI among provinces in Viet Nam.

The fence-breaking phenomenon has been described as "unhealthy competition," and has indeed negatively affected the country's investment environment. However, it can be argued that the phenomenon originated from very "healthy" motives: the urgent need to attract domestic and foreign investors to create more jobs and achieve higher rates of economic growth. This implies that poorly-endowed and backward provinces would find themselves in a disadvantageous position vis-à-vis well-endowed and richer provinces in the competition to attract FDI. Similar to the models reviewed in Cai and Treisman, all else being equal, it is more likely that the former group would initiate fence-breaking, which was indeed the case (Table 5).

As for the dynamic of fence-breaking, once a province observes its neighbours offering extra incentives to investors, the threat of being left behind creates a powerful impetus to offer incentives of its own. This mentality triggered the outbreak of an epidemic. After a while, competition for foreign investors has led to a situation in which many provinces offer maximum incentives. Some provinces even promise that they will be "flexible" in offering incentives in order to take the "leading position" over other provinces (see Box 4). The extent of fence-breaking varies from province to province depending on the "cleverness" of the local government in circumventing rules and regulations.

Table 5: Timeline of fence-breaking

Date	Provinces	Date	Provinces
1 March, 2001	**Quang Ninh**	1 January, 2003	**Quang Nam**
1 June, 2001	**Can Tho**	18 February, 2003	**Yen Bai**
1 November, 2001	**Dak Lak**	1 May, 2003	**Phu Yen**
1 November, 2001	**Nam Dinh**	6 May, 2003	**Lai Chau**
4 January, 2002	**Quang Ngai**	1 June, 2003	**Gia Lai**
1 March, 2002	**Bac Giang**	1 August, 2003	**Binh Thuan**
1 April, 2002	**Ninh Binh**	1 August, 2003	**Vinh Long**
3 April, 2002	**Thanh Hoa**	4 August, 2003	**Long An**
1 June, 2002	**Thua Thien Hue**	1 October, 2003	**Bac Lieu**
1 July, 2002	**Thai Binh**	1 November, 2003	**Ha Tinh**
1 July, 2002	**Vinh Phuc**	1 December, 2003	**Ca Mau**
1 August, 2002	**Bac Ninh**	1 May, 2004	**Khanh Hoa**
1 September, 2002	**Lam Dong**	1 June, 2004	**Ben Tre**
1 October, 2002	**Lao Cai**	1 June, 2004	**Cao Bang**
1 November, 2002	**Hoa Binh**	12 January, 2005	**Ha Tay**

4.5. Central government reaction and provincial government compliance

Box 5: The Central Government Responds…

Prime Minister Phan Van Khai signed Decision No. 1387 on December 29, 2005 ordering an immediate suspension of extralegal regulations on investment incentives issued by 32 provincial governments. Many ministries, including the Ministry of Planning and Investment (MPI), Ministry of Finance (MOF), Ministry of Justice (MOJ), Ministry of Trade (MOT), Ministry of Natural Resources and Environment (MONRE), and the Office of the Government were involved in the issuance of this Decision.

A list of extralegal regulations classified by province was attached to the Decision. The Decision also ordered the People's Committees of all 64 provinces to submit a report detailing all violations of investment incentive regulations.[11] The 32 fence-breaking provinces were furthermore ordered to report on measures they have taken to correct violations.

Although the deadline for submitting the reports was March 1, 2006, by March 14, 2006 only 14 provinces had submitted reports, and only six of these provinces acknowledged violations. The central government then, once again, ordered the remaining 50 provinces to submit the required reports no later than April 15, 2006. By August 2, 2006 22 provinces had still not yet filed their reports. Among 42 provinces that have submitted reports, some reported perfunctorily about corrective measures without even including a list of violations as required by the central government.

Source: Viet Nam News Agency, Tien Phong Online, August 3, 2006.

Policymakers express two lines of opinion with respect to the central government's efforts to deal with fence-breaking by provincial governments. The first line of opinion, which seems to be the dominant view now, holds that the central government should repeal all of the extralegal regulations and collect lost revenue stemming from extralegal incentives. By contrast, the second line of opinion recommends avoiding disturbing the investment environment and the business activities of investors by accepting the status quo, while at the same time forbidding further violations.

If the central government adopts the first solution, it may regain some of the authority and policy credibility which it lost due to its earlier failure to crack down on violations. Although the central government can reduce part of the fiscal cost by shifting it to the local governments and investors, this solution will adversely affects the investment environment not only for the provinces but also for the whole nation.

If the second solution is adopted, the central government runs the risk of damaging still further its authority and policy credibility by accepting extralegal precedents, even though it is unclear that the incentives adopted by fence-breaking provinces will in fact be conducive to economic growth.

This paper suggests a third, middle-way solution. It is certainly harmful to the central government if local governments are able to adopt extralegal regulations. But at the same time, there must be valid reasons for 32 provinces-half of the country-to engage in such flagrant violations of national laws and regulations. Put another way, logic dictates that when there is fence-breaking on so large a scale, the real problem may not lie in the act of breaking the fence, but with the fence itself! It is therefore desirable that different levels and offices of the government coordinate closely with each other and with investors to understand fully the needs of provinces and investors, and to evaluate the overall impact of common investment incentives being offered at the provincial level to consider what works and what doesn't. After this careful examination, if the central government concludes that the extralegal incentives are indeed harmful to the national interest, and are not beneficial to the provinces, then it can show its strength by banning those practices. On the other hand, if the extralegal practices prove to be beneficial, then the central government can do what it has often done in the past, namely "formalizing" popular practices via a new set of regulations.

[11] The report should be submitted simultaneously to MOF, MPI, MOJ, and the Office of the Government.

5. Assessing the Potential Impact of Investment Incentives

This section reviews the findings of both theoretical and empirical studies on the role of investment incentives in attracting FDI. Specifically, this section addresses the question: can tax incentives attract foreign investment? Before getting to the potential impact of investment incentives, we first examine their potential costs and benefits.

5.1. Potential costs and benefits of investment incentives

It is common knowledge that investment incentives are associated with costs and benefits. On the benefit side, a continuous inflow of capital is critical to achieving a high rate of economic growth, which will in turn translate into higher living standards and more job opportunities for local residents. The success of provinces such as Binh Duong, Vinh Phuc, and others attests to the significant role that FDI can play in transforming poor and under-endowed provinces in a relatively short period of time. Perhaps more importantly, FDI provides provinces with opportunities to obtain new technology and superior skills and knowledge, thereby strengthening their economic and institutional foundations and creating conditions needed for sustained high growth. It is also hoped that once FDI levels have surpassed a certain threshold, the province can enjoy positive agglomeration effects. In addition, more investment also means more pressure on local leadership to become more proactive and responsive to the needs of its constituencies (Malesky, 2005). However, Blomstrửm and Kokko (2003) note that the spillover effects to local industry created by inflows of foreign technology and management practices are not an automatic consequence of foreign investment. They also argue that the potential benefits of spillover can be realized only when local firms are well prepared and motivated to absorb foreign technologies and practices. This implies that investment incentives alone are not sufficient to take full advantage of FDI and that they need to be accompanied by proactive learning and efficient investment at the firm level.

Investment incentives also come at some cost, some of which are direct and explicit (for example, revenue forgone because of tax holidays, tax allowances, tax credits, and reduction of and exemptions to land-use fees) while others are more indirect and implicit. There has always been a fear, especially from the perspective of the central government, that competition in investment incentives will become a race to the bottom that only benefits foreign investors at the expenses of provincial and central government and the welfare of the people. In addition to the "bidding war" and its associated negative externalities, there is also the risk that discretionary power of the local officials can be abused to facilitate illicit behavior and create more uncertainty among investors, a critical concern in a developing and transitional country like Viet Nam. Another potential cost, which is less obvious, is the distortion of resource allocation due to attracting investors of the "wrong" kind with the "wrong" incentives according to the philosophy that "beggars cannot be choosers." For instance, there are always mobile investors seeking short-term opportunities and profits. A tax incentive system with generous tax allowances and credits will favor this type of investors while putting longer-term and existing projects in a disadvantageous position. Even worse, there are investors of this kind who could not otherwise survive competition without very generous preferential treatment. Moreover, complex tax incentives impose costs stemming from the need for administration and the need for a well-developed accounting system. Since investment incentives are potentially costly, it is ideal to design the investment incentives scheme specifically to meet the demands of marginal foreign investors who would not otherwise invest. Unfortunately, this is difficult to accomplish due to the inherent lack of information and implementation difficulties.

5.2. Potential impact of incentives on FDI attraction

This subsection briefly reviews the empirical assessment of the impact of investment incentives on the attraction of FDI in various countries. Although the literature on various aspects of FDI and its relationship with other economic factors such as growth, employment, and exports is quite rich, the literature on the impact of investment incentives on FDI attraction is more limited at the country level, and much more so at the local level.

In general, the importance of fundamental factors such as geographical location, physical infrastructure, human capital, and governance to FDI attraction is emphasized in most studies (Coughlin, Terza, and Arromdee (1991), Head and Ries (1996), Chen (1996), Coughlin and Segev (2000), Globerman and Shapiro (2002, 2003), Cai and Treisman (2005), Fung, Garcia-Herrero, Lin, and Siu (2005), Cleeve (2006)). However, the impact of investment incentives on FDI is more ambiguous.

Clark (2000) provides a review of empirical work, mostly drawn from the US experience, on the effectiveness of taxation on both inbound foreign direct investment (FDI) and outbound direct investment abroad (DIA). According to Clark, the sensitivity of FDI to taxation has increased over time and recent evidence supports earlier findings of significant tax effects. The same observation is made by Jacques Morisset (2003, p.1):

> "It is no coincidence that in 1985-94 foreign direct investment grew more than fivefold in tax havens in the Caribbean and South Pacific. And Ireland's tax incentives have been recognized as key in attracting international investors over the past two decades. Moreover, in recent years there has been growing evidence that tax rates and incentives influence the location decisions of companies within regional economic groupings, such as the European Union, North American Free Trade Area, and Association of Southeast Asian Nations. Similarly, in the United States incentives can play a decisive role in the final location decisions of foreign companies once the choices are narrowed down to a handful of sites with similar characteristics. *So, more accurate would be to say that tax incentives affect the decisions of some investors some of the time (italics added)."*

Moreover, Clark argues that based on current empirical results, it is recommended that countries should rely on an attractive statutory corporate income tax rate rather than special investment tax credits and deductions as a means to encourage inflows of foreign investment capital.

Head and Ries (1996) use China's "Open Door" policy as a natural experiment for studying the role of FDI incentives issued by "incentive areas," including the special economic zones (SEZs), open coastal cities (OCCs), open river delta economic zones (ODEZs), and open coastal economic zones (OCEZs). Under the Open Door policy, the Chinese central government allowed FDI projects located in the incentive areas to enjoy state and local tax reductions and exemptions. In addition to tax incentives and a good deal of discretion by local authorities in favor of foreign investors, these cities competed with each other to offer various inducements to FDI projects, including import duty reductions, reduced land-user fees, elimination of red tape, and relaxed rules on labour management.

As in our paper, because of the difficulties in measuring and separating tax incentives from other incentives, and since the cities that offered tax incentives also offered foreign firms the highest level of additional benefits, Head and Ries use a dummy variable to summarize advantages enjoyed by FDI projects located in the incentive cities. Their sample includes 931 foreign ventures located in 54 Chinese cities.[12] They found that between 1984 and 1991, the incentives granted by the central government contributed to the increase in FDI into the incentive areas. More importantly, this initial investment, together with investment by local and central governments, helped incentive cities develop a very good infrastructure and an industrial base, which are both critical conditions for attracting even more investment in the long run. Specifically, using dynamic simulations, Head and Ries show that early recipients of incentive zone status attracted 30 percent more investment than they would have had they remained an incentive-free environment.

Cleeve (2006) studies the effectiveness of fiscal incentives on FDI attraction in Sub-Saharan Africa (SSA). He finds that fiscal incentives have not worked for investment in natural resource extraction. If fiscal incentives are not helpful in this type of FDI, then they would be even less helpful in attracting more sophisticated types of FDI. However, as Cleeve points out, fiscal incentives have been unsuccessful in SSA because of various factors that work against the business environment for FDI, especially macroeconomic and political instability. In addition, Cleeve argues that if Africa is to receive more FDI inflows, its image as a high-risk investment region needs to be changed by establishing greater protection for property rights and other investment-supporting regulations.

In summary, it would be fair to say that fiscal incentives are effective in attracting some types of FDI some of the time in some places. A belief in the effectiveness of fiscal incentives explain why many national and local economic development strategies have centred on efforts to lure foreign investors with tax breaks and other incentives. On the other hand, these incentives inevitably, at least in the short run, weaken national and/or local government finances without any guarantee of gains in terms of investment and other economic and welfare measures. In general, studies of FDI location decisions show that foreign firms are more influenced by basic conditions than by special tax incentives that local authorities are able to offer (Bradbury, Kodrzycki,

[12] A key difference between Head and Ries' study and ours is that they study investment incentives as a top down policy of the central government while we study the bottom-up fence-breaking of the local governments

and Tannenwald 1997). Moreover, for incentives to be effective, they must be accompanied by other critical conditions such as macroeconomic and political stability, good governance, and good physical and human capital.

Since incentives are associated with both costs and benefits, and the impact of incentives on FDI depends on many factors, the question of the overall impact of FDI incentives is, therefore, largely an empirical one, depending on the generosity of the incentive scheme and on the existence of other fundamental factors such as human capital, governance, and infrastructure. We now turn to the task of empirically evaluating the effectiveness of fiscal incentives on FDI attraction in Vietnamese provinces.

6. Empirical Evaluation of Incentives Effectiveness in Attracting FDI

6.1. Empirical Strategy

The performance of a province in terms of attracting FDI is determined by many factors. Therefore, to evaluate the effectiveness of the extralegal incentives in attracting FDI we need to find a way to separate the impact of the incentives from other factors. Moreover, for each province, we need to compare its performance before and after the provision of incentives. There are thus two dimensions of comparison. The first is to compare the difference across two groups of provinces - fence-breakers and non-fence-breakers (difference across space). The second is to compare the difference before and after the act of fence-breaking for the fence-breakers (difference across time.)

We implement this empirical strategy by using the differences-in-differences (DD) method. One complication of our estimation is that because extralegal incentives were adopted at different times, "before" and "after" are no longer the same for each fence-breaking province and of course are not defined for non-breaking provinces. To avoid serial correlation (and therefore over-rejection in DD estimation,) and address the time difference in the issuance of incentives we adopt the strategy suggested by Bertrand, Duflo, and Mullainathan (2004) by implementing the DD estimation in two steps.

First, we estimate the following regression using the method of OLS:

$$Y_{st} = b_0 + b_1.X_{st} + b_2.Break_s + \varepsilon_{st} \quad (1)$$

in which Ys_t is the level of per capita FDI attracted to provinces in year t; X_{st} represents the relevant determinants (or control variables) of FDI attraction to province s in year t; $Break_s$ is a dummy (equal to 0 for non-breakers and 1 for breakers.) We then divide the residuals of fence-breaking provinces into two groups, one for the years before and the other for the years after the extralegal incentives were adopted. For each fence-breaking province, we calculate the average of residuals for years before and after the fence-breaking. The outcome of this process is a two-period panel of fence-breaking provinces.

Second, we estimate the impact of the incentives on FDI attraction by using an OLS regression in this two-period panel. The regression has a very simple form as follow:

$$\varepsilon_{si} = b_3 + b_4.Time_{si} + u_{si} \quad (2)$$

where $Time_{si}$ represents a dummy (equal 0 for the period before the issuance of the incentives, and 1 for the period after that).

How do we interpret the results of these regressions? Coefficient b_1 measures the impact of relevant determinants of the expected level of per capita FDI attracted to provinces. Coefficient b_2 reflects the "normal" or ex-ante difference between the two groups - breakers and non-breakers. It is worth emphasizing that b_2 does not measure the impact of fence-breaking per se, but the difference between the breakers and non-breakers as two groups (or difference in space).

Coefficient b_4 is what we are most interested in. This coefficient measures the impact of extralegal incentives on the fence-breaking provinces. In other words, it reflects the difference in FDI attraction as the result of the fence-breaking incentives as compared to the previous performance of fence-breaking provinces.

Bertrand, Duflo, and Mullainathan (2004) also noted that even when the number of provinces is small, once the t-statistic has been properly adjusted to account for the smaller number of observations, the simple aggregation continues to perform quite well. (See Donald and Lang (2000) for a discussion of inference in small-sample aggregated data set.) In other words, although residual aggregation does not perform as well as in the big sample, the over-rejection remains relatively small.

6.2. Description of the data

This section provides empirical definitions for the variables used in the regressions and their corresponding sources.

Our sample consists of all 64 provinces in Viet Nam. However, to maintain data consistency, three new provinces, namely Dak Nong, Dien Bien, and Hau Giang are integrated back into the provinces to which they belonged prior to being established, namely Dak Lak, Lai Chau, and Can Tho, respectively.[13] The dependent variable for the statistical analysis should be some measure that reflects the amount of FDI flows into provinces, properly adjusted for their difference in size. For the purposes of our study, provincial FDI per capita is chosen as the dependent variable.[14] There are two sets of data on FDI: registered and implemented. Although implemented investment reflects the true investment during a specific period of time, it can be argued that registered capital is a better measure of the investors' responses to incentives. The reason is that registration is sufficient to qualify to receive the incentives. The actual investment can then be decided depending on the business situation. In the econometric model, both measures are used to see if they produce different results.

The explanatory variables in the econometric model are time-varying characteristics of all provinces, except for three variables, namely the availability of motorways, electricity supply, and the composite provincial competitiveness index (PCI), due to the lack of time series data. The data on time-varying characteristics runs from 2000 to 2005 and comes from two main sources - the General Statistical Office (GSO) and the Ministry of Labour, Invalids, and Social Affairs (MOLISA). The period between 2000 and 2005 is chosen for several reasons. First, this period covers the entire period of investment incentive fence-breaking in Viet Nam. Second, data before 1999 is not utilized because FDI did not begin returning to Viet Nam until 2000 and we want to exclude the negative impact of the regional crisis in 1997-98. Third, the 2000 - 2005 period also coincides with the term of provincial government officials, meaning that there should be a certain degree of consistency in policy formulation and implementation throughout this period.

The independent variables are divided into five groups. A description and discussion of the explanatory variables in each group is provided below.

Education

Research on the relationship between human capital and the locational choice of FDI strongly suggests that countries with higher average levels of education are likely to attract more foreign investment. It is reasonable to expect that similar findings can be established for smaller units of analysis such as provinces in Viet Nam.

A popular measure of education in the literature is the number of school-years received by citizens who are 15 years old or older. Unfortunately, these data for Viet Nam are not yet available. In this study, the average level of education in a province is measured by the number of students and the number of schools (primary and secondary) for every 1,000 citizens. We are aware that these measurements are imperfect. In using them, we have made many implicit assumptions, some of which are weak. For instance, we assume that the quality of students is identical across all provinces, and the size and quality of schools in every province are the same and so on.

Wages

Wage rates directly affect the production costs of firms. Relatively low wage rates have helped Viet Nam become more attractive, especially for labour-intensive FDI projects. Biswas (2002) found that wage rates negatively affect the level of FDI attracted by countries. Zhang (2001) found a similar result for China between 1987-1998. Chen (1996) however found that after controlling for productivity, the locational choice of FDI projects in China did not seem to be influenced much by wage rates.

In our econometric model, wage rates are measured by the average monthly compensation of workers in each province. The data are taken from the annual comprehensive enterprise survey conducted by the GSO. Ideally, this compensation measure needs to be adjusted to take into account the relatively more important role of wages in the industrial sector to FDI projects.

[13] For instance, the statistics show the GDP per capita of Can Tho, Dak Lak, and Lai Chau increased significantly in 2004 merely because underdeveloped parts of these provinces were incorporated into the newly established provinces.

[14] For comparison, we also run a complementary regression in which provincial domestic investment per capita is used as the dependent variable. The purpose of this regression is to see whether provincial investment incentives affect the level of foreign and domestic investment differently.

Unemployment

Another labour market indicator is the unemployment rate. It can be argued that the unemployment rate reflects, to a certain degree, the potential supply of workers in each province. Other things being equal, this implies that a province with higher unemployment rates is likely to attract more FDI. Migration, however, complicates this analysis. A province with a low recorded rate of unemployment may be filled with immigrant workers from other provinces. At the same time, a province with a large pool of potential labour may not have an abundant source of labour supply. Because of the lack of data, only the unemployment rate in 2000 is used in the econometric estimation.

Structural endowments

Variables of structural endowments in this study consist of infrastructure and distance to the main markets.

Infrastructure

Infrastructure is always given a very high, if not the highest, priority in Viet Nam's provincial investment plan as a means to attract FDI. Local accessibility is a critical determinant of locational decision of FDI projects. A highly developed transportation network supported by airports, seaports, railroads, and motorways helps to increase accessibility and decrease the cost of transportation for investors. However, evidence in Viet Nam suggests that overinvestment in infrastructure may well have backfired. For instance, it is very fashionable for provinces to build deep water seaports and even airports, not because they really need them, but just because the province next door has one. As a result of this competition, Viet Nam currently has more than 100 sea ports. It is estimated that along the Central Coast, sea ports have been built every 40-50 kilometers. It is extremely difficult, if not to say impossible, to justify investment in these seaports in terms of economic efficiency.

To measure the accessibility to the main markets, both domestically and internationally, this paper uses four variables: the availability of airports, seaports, railways, and motorways. Since the area of individual provinces in Viet Nam is relative small, and to capture the regional aspect of airports, this paper use a dummy variable that sets a value of one for provinces that host airports and for its border-sharing neighbour provinces, and zero otherwise. A similar dummy is used for deep seaports that can accommodate ships of 20,000 DWT and above. The value of the railway dummy will be one for provinces through which the railway runs, and zero otherwise. For motorways, we use the percentage of communes through which a motorway passes as a measure of the provincial accessibility by roads.

Another measure of infrastructure used in this study is the availability of electricity and telephones. In the literature, power-related infrastructure is often measured by the average consumption of electricity per capita. Since we do not have these data, we use the percentage of communes connected to the national grid as a measure of the provincial electricity infrastructure. Telephones are also an important element of infrastructure. In this study, the availability of telephone in each province is measured by the average number of telephones per 1,000 provincial residents.

Proximity to Major Markets

FDI projects that seek to take advantage of big and growing markets tend to be located near well-developed cosmopolitan areas; in Viet Nam, Ha Noi and Ho Chi Minh City (HCMC). Being close to Ha Noi and HCMC brings many other benefits as well. First, it is a great way to gain access to international markets since the two cities possess or in close proximity to the busiest airports and seaports in the country. Second, it reduces the cost and complexity of domestic and international travel. Third, FDI projects located in or near Ha Noi, HCMC and neighbouring provinces, obtain positive agglomeration effects.

In this study, a provincial market-proximity index is compiled as the sum of the inverse of the distance between the province to Ha Noi and HCMC, taking into account the relative size of each market.

Fence-breaking

A province is considered a fence breaker if it is listed in Decision No. 1387 dated December 29, 2005 by the Prime Minister. There are 32 such provinces among the total of 64 provinces in Viet Nam, including Hau Giang which was separated from Can Tho at the very end of 2003.

It is important to be aware that it can sometimes be quite difficult to confirm whether or not a province is a fence breaker. The reason is that provincial governments can either break the rules formally (by issuing official decisions/documents) or informally simply by ignoring the violations of lower tier governments agencies and firms. It is very difficult to capture the latter type of violation. However, it is reasonable to believe that in provinces that had issued extralegal documents, violations had exceeded a certain level. In addition, it is required that all regulations issued by the provincial governments should be submitted toThe Ministry of Justice (MOJ) and related ministries. This implies that Decision No. 1387, which is based on input from The Ministry of Justice (MOJ), The Ministry of Finance (MOF), the Ministry of Planning and Investment (MPI), The Ministry of Trade (MOT), the Ministry of Natural Resources and Environment (MONRE,)and the Office of the Government, must at least provide reliable evidence for official violations (or non-violations) of national laws and regulations on investment. That is to say, when we refer to a province as non fence-breaker, it only means that the province has not been found to have issued official extralegal regulations. It is of course possible that violations have occurred in the province but have yet to be discovered.

It is desirable to have some measure of the extent of the violations committed by each province. Since the data on land prices and tax rates applied in each province are not readily available, we measure the extent of official violation by counting the number of documents in each province which are classified as extralegal in Decision No. 1387. It turns out, however, that the estimation of this variable is not statistically significant.

Investment Environment

The investment environment of a province critically influences the incentives, opportunities, and performance of every enterprise. Investors always seek a good investment environment, which not only creates more opportunities for them to grow, but also, and perhaps even more importantly, helps reduce their costs and uncertainty. A good investment environment has by many characteristics, for instance transparency, predictability and accountability.

Our econometric analysis takes advantage of the recent provincial competitiveness index (PCI) constructed by the Viet Nam Chamber of Commerce and Industry (VCCI) and the Viet Nam Competitiveness Initiative (VNCI). The PCI has been designed to rank provinces by their regulatory environments for private sector development. The PCI in 2005 covers 9 factors of the business environment for 42 provinces, while the PCI in 2006 covers 10 factors and all 64 provinces. The 10 factors in the 2006 PCI include: entry costs (or business establishment costs), land access and security of tenure, transparency and access to information, time costs of regulatory compliance or inspections, informal charges, state-sector bias (or competition environment), pro-activity of provincial leadership, private sector development services, legal institutions, and labour training. The input for compiling these indicators came from two main sources - a perception survey of private businesses in every province and more objective data collected from statistical yearbooks, business associations, and interviews with third parties (state-owned banks and real estate firms). Since our study is concerned with the investment environment as it pertains to FDI projects, not all factors in the PCI are relevant. Therefore, only the four most relevant and relatively stable indicators, namely transparency, state-sector bias, proactivity, and legal institutions, are used to form the 10-point scale index of provincial investment environment by taking the simple average of the four indicators.

6.3. Estimation Results

Estimation results of the model are presented in Tables 6 and 7. Two measures of FDI (registered and implemented, measured in per capita basis) are used as the dependent variables in regressions (1) and (2), respectively.[15] As can be seen from Table 6, the two regressions provide quite similar qualitative results. The first noticeable result is that non-fence-breakers as a group outperform the fence-breaker group regardless of the measure of FDI used. The difference is, however, much more emphatic in regression (1), where registered FDI is used as the measure of FDI attraction, suggesting that the fence-breaking group has been less successful in converting registered FDI into implemented FDI. As has already been noticed, this reflects the difference between the two groups and has nothing to do with the impact of the fence-breaking itself (which will be reported in Table 7).

[15] Quite similar results are obtained when the level of provincial domestic investment per capita is used as the LHS variable.

Table 6: Estimation result (1)

Dependent Variable: registered FDI per capita (2000-2005) in Regression 1 and implemented FDI per capita (2000-2004) in Regression 2

Independent Variables	*Regression 1*	*Regression 2*
BREAK	-18.51 (-1.58)	**-2.18 (-0.60)**
GDP	0.41 (8.57)***	**0.016 (0.58)**
INFRASTRUCTURE2	19.76 (3.01)***	**7.45 (2.68)*** **
PROXIMITY	7.57 (3.67)**	**10.03 (6.09)*** **
URBANIZATION	-3.04 (-7.75)***	**-0.32 (-1.27)**
PUPILS	317.91 (1.68)*	**174.91 (2.22)** **
WAGE	-0.58 (-1.29)	**0.43 (2.19)** **
PCI	16.17 (2.15)**	**13.82 (4.48)*** **
CONSTANT	-228.66 (-3.41)***	**-156.14 (-5.63)*** **
N	360	**300**
R^2	0.45	**0.43**
Adjusted R^2	0.44	**0.42**
F - statistic	35.87***	**27.95*** **

** Significant at the 0.1 level, ** Significant at the 0.05 level, *** Significant at the 0.01 level*

Table 7: Estimation result (2)

Dependent Variable: Residual from Regression 1 and Residual from Regression 2

Independent Variables	**Regression 1**	**Regression 2**
Time	-35.23 (-2.91)***	-6.39 (-0.93)
Constant	15.96 (1.87)*	5.59 (1.15)
N	60	58
R^2	0.127	0.015
Adjusted R^2	0.112	-0.002
F - statistic	8.47***	0.87

** Significant at the 0.1 level, ** Significant at the 0.05 level, *** Significant at the 0.01 level*

The coefficient of GDP is positive and statistically significant as expected. It is well documented that FDI tends to be attracted to provinces with higher GDP per capita. This leads to a wider gap between rich and poor provinces and makes it even harder for poorer provinces to catch up. This effect is, however, counter-balanced to some extent by the degree of urbanization, which is significantly negatively related to per capita FDI. The main reason for this is that FDI projects are often located in rural and peripheral areas to avoid high land costs and take the advantage of (low cost) labour abundance.

The impact of labour costs (or wages) appears to be different for registered and implemented FDI. While the coefficient of wages is positive and statistically significant in regression (2), it is negative and statistically insignificant in regression (1). This may reflect the different ways in which labour costs enter the calculation of foreign investors before and after they actually invest. The negative sign of the wage coefficient in regression (1) implies that, all else being equal, investors tend to choose the investment location where they can economise on labour costs. Nevertheless, once the investment has already been implemented, the investor no longer has the luxury of selecting the location with the lowest labour cost. Moreover, the presence of FDI projects contributes to relatively scarcer labour, higher productivity, and therefore, higher wages. This explains why the coefficient of wage in regression (2) is positive.

The coefficient of proximity (to the major markets) is also positive and statistically significant. This reconfirms the critical importance of geographic location to FDI projects. It is worth emphasizing that although being close to major market like Ha Noi and Ho Chi Minh City is associated with many benefits (and a higher market potential and better infrastructure), this is far from a sufficient condition for development. Ha Tay and Bac Giang in the north, and Tay Ninh in the south are clear examples of provinces located close to urban centres that are not performing well.

The importance of physical infrastructure cannot be over-emphasized. The coefficient for infrastructure in both regressions is positive and statistically significant. Remember, though, that infrastructure measurement in this study reflects not only the province's own infrastructure, but also the physical infrastructure of neighbouring provinces that it can use without paying for such as ports and airports.[16] This result suggests that public infrastructure development should take a regional instead of individually provincial approach.

It is also very interesting to compare the role of physical (or hard) infrastructure and institutional (or soft) infrastructure in attracting registered and implemented FDI. As can be seen from Table 6, "soft" infrastructure, measured by the adapted PCI index, plays a critically important role in attracting both registered and implemented FDI. Although it is very difficult to quantify the exact contribution of hard and soft infrastructure to FDI attraction, it is safe to say that the relative role of soft and hard infrastructures to the two types of FDI is quite different. While good physical infrastructure appears to be very important to potential investment (registered FDI), its relative importance is much lower for actual investment (implemented FDI). In contrast, the relative role of soft infrastructure is more important with regards to implemented FDI as compared with registered FDI. These results suggest that while hard infrastructure is necessary to attract investors, it is the soft infrastructure that is more critical in determining the capability of turning potential (registered) capital into actual (implemented) investment. These results are consistent with a study on determinants of FDI in China by Fung, Garcia-Herrero, Iizaka, and Siu (2005). Their paper provides an even stronger conclusion, which is that after controlling for the standard determinants of FDI, soft infrastructure is consistently more important than the hard infrastructure in determining FDI amounts in China.

Last, but not least, is the role of education in attracting FDI. The coefficient for education in both regressions is positive and statistically significant. This result reconfirms the critical role of education, and more specifically, the stock of human capital, to a province's ability to attract FDI. Studies on migration and remittances also reveal a positive correlation between the quality of a province's human capital and the amount of remittances it receives. The commonly observed pattern is that skilled and professional workers from less to more developed regions and then send money back or return to invest in their home provinces. This pattern has been documented for many provinces in Viet Nam, particularly those in the central region such as Quang Nam, Quang Ngai, Nghe An, Ha Tinh.

To sum up, the estimation results presented so far are consistent with the literature on the role of fundamental factors in determining the location of FDI. Now we turn to the result regarding the impact of fence-breaking to FDI attraction. The estimation result is presented in Table 7. As discussed earlier, the coefficient of the time dummy captures the difference-in-difference outcome or the net effect of fence-breaking. The coefficient is negative and statistically significant, implying a negative impact of fence-breaking. More specifically, on average, the amount of per capita FDI received by a province after it adopted extralegal incentives decreased USD 35.23 (in terms of registered FDI) and USD 6.39 (in terms of implemented FDI) compared to its performance in the previous period. Given our analysis in Section 4, the negative impact of extralegal incentives on FDI is not a surprising result.

[16] Indeed, if the index of a province's own physical infrastructure is used instead, then its coefficient turns negative. This potentially has significant implications for regional development strategy and policy. The importance of this topic demands separate research

7. Concluding Remarks

Decentralisation and the free flow of capital are two major global trends, both of which have influenced development in Viet Nam. Accelerated decentralisation in Viet Nam over the last twenty years was a response to the failures of the planned and centralised economy and the need to unleash the potential of people, markets, and local government. During the same period, the movement of capital, and particularly FDI inflows, has contributed significantly to the country's growth and development. It was against this backdrop, that 32 provinces, most of them poor and under-endowed, became fence breakers by providing extralegal investment incentives to investors.

Our study reconfirms an important finding of the literature on investment incentives: in the absence of the fundamentals (human capital, hard and soft infrastructure) the incentives themselves are not helpful. In particular, this study has shown that after controlling for fundamental factors, the extralegal investment incentives provided by 32 provinces over the last five years not only did not help them attract more FDI but also increased their fiscal burden. As a result, competition among these provinces has indeed become a "race to the bottom" while the original objective of attracting more FDI has not been achieved.

What else can we learn from the recent phenomenon of fence-breaking? The good news is that despite their desperate situation, disadvantaged provinces in Viet Nam have not given up their efforts to compete with other provinces (and perhaps also with the rest of the world) in attracting foreign capital, which is a necessary input for growth and modernization. Nevertheless, given their lack of natural resources, human capital, and infrastructure, it is unlikely that many of these provinces will succeed in attracting meaningful amounts of FDI. The supportive role of the central government in helping these provinces to improve their basic indicators is, therefore, crucial. For instance, the central government can help by financing infrastructure, improving human capital, and insuring against exogenous risks (see also Cai and Treisman, 2005.) It is should be emphasized that to be efficient, centrally funded infrastructure projects should take a regional approach and should not be used as a means to reward or bestow favor on individual provinces.

But poorer provinces should not passively await central government assistance. After all, a good investment environment determines the success of current foreign investors, and therefore, the potential for attracting new and serious investors in the future. This study has shown that while hard infrastructure helps provinces attract registered FDI, it is soft infrastructure that determines the realization of FDI, and therefore growth and job creation. Moreover, as argued by Blomström and Kokko, the potential benefits of spillovers can be best realized when local firms are well prepared and motivated to absorb foreign technologies and skills. This implies that, by facilitating the development of the local private sector, provinces can simultaneously reach both targets of mobilizing local financial resources and human capital and preparing themselves for efficiently receiving FDI in the future.

Finally, the fact that half of the provinces in the country jumped on the fence-breaking bandwagon seriously questions the validity of the FDI regulatory framework up to 2005. Instead of simply punishing the violating provinces, the government should carefully consider the reasons and motivations for their acts of fence-breaking. After all, it may be the case that the problem does not reside in the act of breaking the fence, but in the fence itself. At the same time, if the phenomenon of massive fence-breaking is understood well, it may point to effectively innovative policy that can be applied to the whole nation.

This study is subject to several limitations, perhaps the most important of which is that because of the difficulty in obtaining, measuring, and incorporating widely varying incentive schemes into a provincial index, the question of the influence of tax and other provincial-specific incentives could not be examined. The lack of data on provincial labour productivity and implemented FDI for 2005 may also have an effect on the estimation results. Another limitation of the study is that all types and sources of FDI are lumped together. As a matter of fact, not all FDI dollars are equal: long term investment is clearly preferable to short term investment, and projects with positive spillover effects are superior to those that to exploit natural resources or take advantage of tax incentive loopholes. Addressing these limitations awaits further research.

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