

EXECUTIVE SUMMARY

VIETNAM ECONOMIC GROWTH DIAGNOSTICS



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Overview

For thirty years since initiation of the “*Doi Moi*” (reform) policy, Vietnam’s socio-economic development has seen remarkable achievements. The economy constantly grows at a high level in the world and has transformed Vietnam from one of the poorest to a lower middle-income country. However, for the last ten years, there has been a slow-down in Vietnam's economic growth, which is, partially, due to the global economic crisis, and largely, pertains to it no longer having much room for growth as its labor productivity is much lower than that of other countries in the region whilst the economic growth mainly relies on the exploitation of natural resources, capital, foreign direct investment (**FDI**) and exports. Vietnam is in a danger of falling into the middle-income trap unless it can maintain a minimum growth rate of 7.5% per annum. This is very challenging for Vietnam's economy given the context of unpredictable developments in the world’s economy and increasing trend of strong protectionism in many countries.

The private and household sectors have proven themselves to be a dynamic and creative factor with a decisive role in job creation, investment and economic growth. Vietnam is also in need of building an independent and autonomous economy that proactively integrates with the world to enhance its national position in the international arena; maintain political stability, national security and social order and safety. Thus, the Document of the XII National Party Congress has identified a direction for socio-economic development for the 2016-2020 period which is "to provide all favorable conditions for Vietnam’s businesses, particularly private-owned enterprises, to strongly develop and provide an impetus to enhancing competitiveness and autonomy of the economy".

In April 2016, the Government conveyed a message to **build a growth-enabling Government with integrity and strong actions in service of the people and businesses; and to exert focused efforts to create a favorable and secured environment for people and enterprises to invest in business and production activities, and thus to become a driver for the national economic growth.**

Towards this goal, the Government of Vietnam (**GoV**) has been exerting tremendous efforts to implement multiple economic reforms such as revision of the Enterprise Law and the Investment Law, elimination of “baby” licenses, radical reform of State-owned enterprises (**SOEs**) to shift from the extensive growth model to a more intensive one driven by internal strengths and led by productivity. Recognizing the role of the private sector as a key driver for growth is one of the noteworthy reforms. The GoV has been enacting multiple reforms and launching new initiatives to improve the investment environment and strive for having one million businesses set up by 2020.

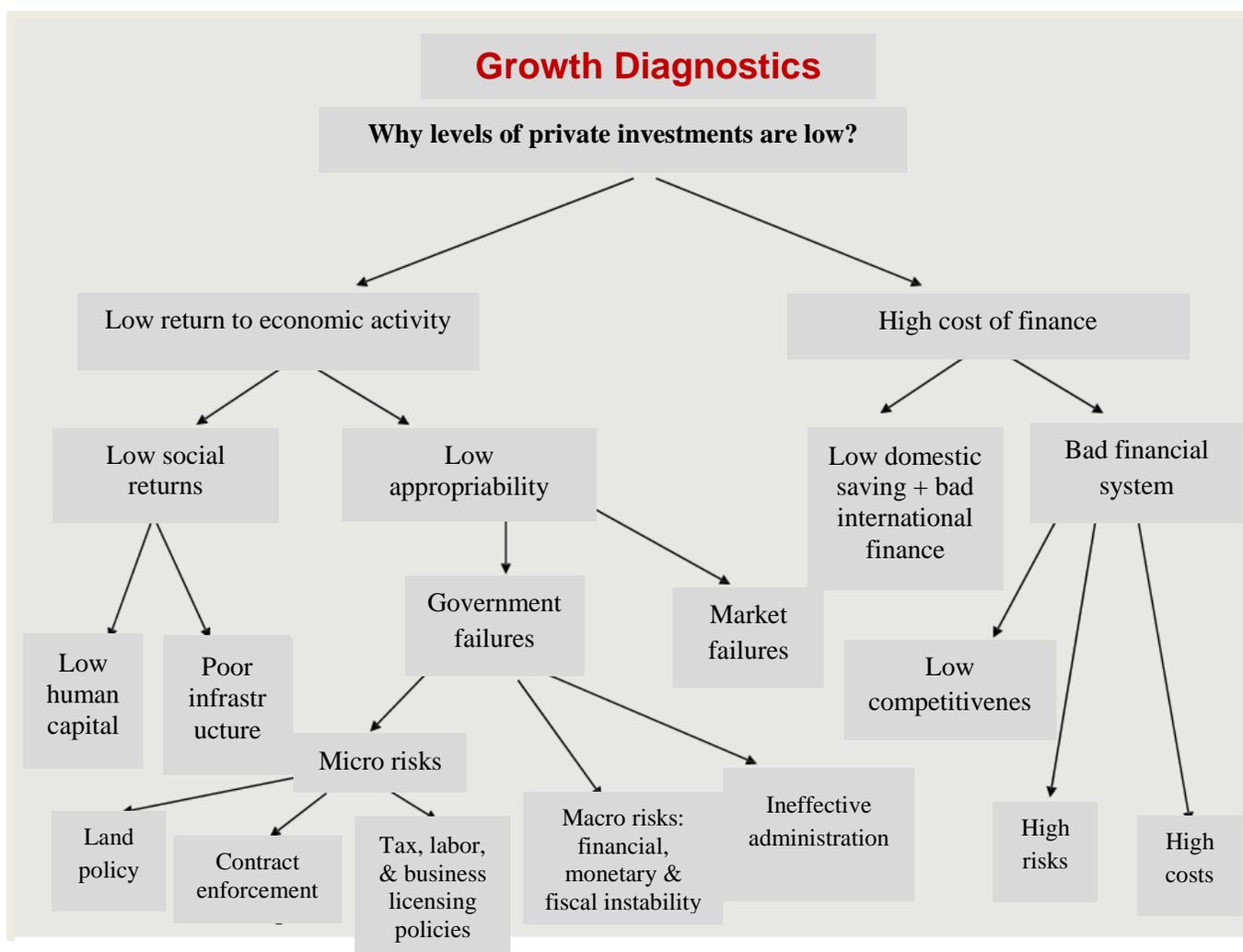
This study is aimed at identifying the “binding” constraints (in the short, medium and long run) to the private sector development and, on that basis, providing policy implications and recommendations to remove those binding constraints. The study adopts the methodology of growth diagnostics proposed in 2008 by Professor Dr. Ricardo Hausmann, Dani Rodrik and Andres Velasco, which has become popular worldwide (and known in short as **HRV methodology**). The study also contains comparative analysis across various countries, including those having geographical proximity to Vietnam, or similar production and export structure such as Indonesia, Thailand, Philippines, Malaysia, Singapore (ASEAN-5 countries); China, India; lower middle income countries; higher middle income countries; and Korea and Japan. The 2000-2015 period was selected to be the main period in terms of time because it provides more implications to make policy proposals for promoting growth, competitiveness and performance of businesses and the economy in the 2016-2020 period. The study focuses on the key factors that have great impacts on the private sector development namely access to finance, human capital, access to land, infrastructure, macro-economic risks, micro risks (tax, labor, business licensing), market failure, contract enforcement, and administrative institutions.

Methodology

Countries always face difficulties and challenges to their economic growth, they all attempt to introduce reforms and mobilize social resources in investments and development. However, the process of reforms and resource mobilization is exposed to many constraints, most notably constraints involving the government’s capability; rooms for policy change; and the availability of financial resources.

This study adopts the HRV methodology, which does not mean to remove all the constraints to growth, but focuses on the most immediate and biggest ones, or so called “binding constraints”, the unblocking of which would have a strong impact on growth. The HRV methodology applies four tests to diagnose and identify binding constraints to investments and growth of the private sector. The first test looks at the price factor (shadow price) including both formal and informal costs that an enterprise must pay to get access to relevant business and production resources (such as land and capital...). The question in the second test is whether reductions in the price (costs) of those resources should result in a rise in investment and business growth? The third test analyzes if there exist any alternative options for an enterprise to overcome or by-pass the binding constraint. And the final test aims at answering the question that if there is a binding constraint whether enterprises would shift to another field of business and production with less number of enterprises applying the constraint factor? The study diagnoses nine factors which have been perceived as constraints to economic growth in

Vietnam, by using the HRV methodology as described in the tree below.



Key findings

In the short term, three binding constraints to the private investment and growth are access to land, access to finance, and administration system

Access to land

Analysis shows that access to land currently constitutes a constraint to growth of the private sector and the economy at large. Difficulties in accessing land and being able to use land stably, long and cost reasonably have caused negative impacts on enterprise's investment and development. Therefore, a majority of private enterprises operate on a very small scale and mainly in the service sector. Very few enterprises, even including FDI ones, invest their capital in the agriculture sector although there are abundant incentives. This is because of the shortcomings with land policies, including: unstable land laws many of which are still in process of

improvement, particularly those relating to land ownerships; popularity of the subsidy and ask-give mechanisms, delays in addressing the inherently piece-meal farming practices, sluggish accumulation of farming land, and a big gap across regions. Land compensation policies as well as the compensation price for the confiscated land remain inappropriate as they are neither based on the market price nor transparent leading to the land market (particularly for agricultural and forestry land) being underdeveloped, and challenges to private enterprises in getting land for their production premises.

Thus, in the time to come, the following policies should be considered to improve access to land and to promote the private sector development include: Revision of the Law on Land to surmount shortcomings regarding land ownership, land use rights transferring mechanism, land use term, farm size limits, and rights of the State and land users; Reforms of financial policies regarding land towards being more simplified, stable, transparent, and fair; Removing the land price bucket, and application of market rules in deciding land compensation price; Development of a land information system, and promote e-transaction in the land sector; Diversification of public services related to land; and Introduction of real estate tax and income tax on transformation of the land use purposes to generate more budget revenues and at the same time better regulate the real estate market.

Access to finance

Access to credit is also a binding constraint to the private sector development. Although Vietnam's real interest rates stay at the regional average level, total cost of accessing land is still high because its enterprises must pay high financial expenses (interest rate, fee, exchange rate differences) or bear opportunity costs in getting access to capital. Cumbersome procedures, always-required mortgage for loan, and corruption practices are notable difficulties in credit transactions in Vietnam. Furthermore, compared to their counterparts in Malaysia, the Philippines and Thailand, Vietnamese enterprises must pay higher interest rates on long-term foreign currency loans.

To promote economic growth in general and of the private sector in particular, the Government needs to make break-through changes in settlement of bad debts, strongly and radically reforming administrative procedures, improving transparency and accountability of the public administration. Monetary policies should be more market driven by reducing administrative measures, improving the institutional framework, setting up a sound legal corridor, and minimizing the risks of criminalization. It is also required to speed up economic restructuring particularly rearrangement of financial institutions and SOEs; to curtail State ownership in State

owned commercial banks to call for private capital and thereby improving their financial standing and ability to supply capital to the economy including private sector. To develop, in a balanced way, the financial market particularly those for securities and corporate bonds to provide a platform for sustainable growth and to concurrently intensify accessibility to medium- and long-term credit for businesses. It is also advisable to strengthen the rules and disciplines of budget and effective management of public debts; to strongly reform operations towards improving the efficiency of policy credits and management of ODA funds and thus reducing the “crowding out” effects.

Administration System

Vietnam’s administrative apparatus is perceived to be more burdensome and costly than those of other countries in the region. The ratio of State employees and civil servants working in public sector and paid by State budget is 30.5/1,000 people, ranking highest in the region. Although salaries of State employees and civil servants are rather low, they account for a great share in the total budget expenditures and Vietnam’s GDP, which is the highest compared to that of the region and even higher than that in Korea, Japan and India. The poor-performing, bulky and less friendly administration is the result of the old-style of mindset and centrally-planning-based governance. Accountability remains low and corruption is still serious. Vietnam’s national accountability ranking remains low in the region and has seen no improvements. Vietnam’s policy making quality is also rated worst among the regional countries.

Possible policies and interventions to improve performance of the administration include: To clearly and specifically describe jobs and to fix a duration for each title; to shift the management of State employees from the civil service career system to the combination of both civil servant career and employment ones, to change the management method from the payroll-based to the one focusing on jobs and staff structure. State employees are classified into two categories including permanent State employees named in the long-term payroll, and short-term State employees who are flexibly employed under a definite term contract. To design and introduce a system of performance evaluation criteria to measure service quality of State officers, civil servants and employees in an evidence-based, objective and accurate manner, which helps ensure that their capacity and performance are properly evaluated, making basis for their later-on training, appointment, and promotion. To uphold the responsibility of the heads by empowering them to make HR-related decisions and holding them accountable for those decisions. To develop an information system to assist the evaluation and monitoring of performance and service quality of State employees and civil servants. To ensure transparency of

information, to enhance accountability, and to strictly penalize violations. To incentivize the attitude State employees and civil servants to devote and contribute by way of fundamental reforms of the salary policy including both minimum wage policy and wage scales.

In the medium term, four binding constraints to the private investment and growth are contract enforcement; micro risks (tax, labor and business licensing policies); macro-economic risks; and infrastructure system

Enforcement of contracts

Compared to several countries with a similar GDP per capita, contract enforcement in Vietnam is better. However, Vietnam still ranks low among the Asia-Pacific countries, ASEAN's top five business environment countries (Indonesia, Malaysia, Philippine, Singapore, Thailand - ASEAN 5) and two East Asian countries (India and China). In the short run, enforcement of contracts does not constitute a "binding constraint" to economic growth, but this will be the case in the medium run when Vietnam strives for higher economic growth with an improved business environment and strong national competitiveness.

To improve the enforcement of contracts in Vietnam it is necessary to improve the legal framework for contracts and dispute resolution, which remains insufficient, inconsistent with many overlaps. Particularly it falls short of the legal principles for which additional source of laws can fill in the gap in the current legal norm system when it comes to the interpretation of contracts such as practices, precedent and good faith. It is essential to have in place specific provisions on the criteria and conditions for evidence to promote proper implementation of legislations and contractual clauses on substantive and procedural matters, particularly in the civil and commercial transactions that are established electronically or verbally... other than in a traditional form.

Settlement of civil and business cases by the court takes a long time and this is what affects most public confidence in the court system. The cost of dispute settlement by the courts in Vietnam is swayed not only by protracted proceedings but also by corrupted practices. To overcome the situation, solutions to reduce time for settlement of a civil or a business/commercial case should be applied including: improving the procedures and process for filings, introducing electronic court procedures, developing a model of e-courts (automated courts), applying summary proceedings, bettering case management practice, particularly control of procedural time limits through imposing higher penalties on the judges who fail to meet the time

limits, and making public information about court proceedings and litigants concerned.

Judicial independence persists to be average as compared to other countries with similar income per capita rate and has co-relation with economic development. This needs to be improved in the coming time. Alternative Dispute Resolution (ADR) mechanism including commercial mediation and arbitration should be promoted and well facilitated to help mitigate practices of dispute resolution by the underworld or illegal means.

Late but not least, quality of judgment enforcement in Vietnam is a big concern because the number of cases and the value of enforcement properties remains very small. This has undermined the validity and effectiveness of dispute resolution for the time being. Vietnam needs to boost and improve institutional framework for bailiffs in support of judgment enforcement activities. It is advisable to consider revising regulations on debt collection to further clarify the scope of this activity. At the same time, laws should impose strict prohibitions on illegal means to enforce contract such as threat of using force or illegal and business-ethics contrary means as some enterprises or banking institutions have been using.

Tax, labor and business licensing policies

Corporate income tax (CIT) in Vietnam dropped significantly from 25% to 20% since 2016. Tax rates do not seem to be a barrier to the private sector expansion, but compared to other regional countries, the effective CIT rates [in Vietnam] remain high. Vietnam's tax regulatory authorities are seen to be a great barrier. More progress need to be made in tax payment procedures, as it now takes more time to pay tax in Vietnam (i.e. 1.5 and 8.1 times as higher as in Lao, and Singapore respectively). Improvements in the business licensing regulations help increase Vietnam's rating in the World Bank Doing Business Indicators. Relaxing regulations on business establishment has resulted in a sharp record in the number of new enterprises set up last year. Labor cost in Vietnam has been rising fast and laws protecting employment become stricter over years.

To promote the private sector growth in the coming time, it is necessary to improve policies that facilitate development of a labor market which is operated on a market-driven rules. It is advisable to repeal trade union fees and to reduce social insurance and health insurance premiums so that they are more reasonable, which help reduce cost burdens for enterprises, boost up the labor demand in formal sector and encourage unregistered business households to move to registered business. To enhance labor skills by introducing policies to robustly reform higher education

system, specifically by giving more autonomy to vocational education schools and universities, and allowing them to operate in accordance with the market mechanism, to develop an independent quality evaluation system, and to improve information transparency and publicity.

Macro-economic risks

Since 2012, there have been many positive changes in the macro economy. However, historical data show that macro-economic risks (such as inflation, exchange rate, external balance, and fiscal balance) would probably have negative impact on the private investments and growth. For now, these risks do not yet constitute a binding constraint, but in the medium term, they will become major obstacles unless there are improvements in the growth model, economic structure, framework and policies for macro economic management.

Vietnam's inflation rate is low but more unstable than that of other countries in the region due to the fact that monetary policies set too broad and unspecific targets and that effectiveness of monetary policies is pretty low because of weak banking and finance systems (bad debts and other system risks). Vietnam Dong is overvalued in the region and puts exchange rates under pressure to increase. Long-lasting budget deficits would expose implicit risks of macro economic instability and negatively affect the private sector development. The economic growth model is not yet improved, remains too expansive, and is of low quality; and is led by a production and export structure mainly driven by imported inputs and technologies. The macroeconomic policy framework (including monetary, exchange rates, fiscal and public debt management policies) remain inefficient, ineffective and thus there is not policy confidence.

The upcoming policies on mitigation of macro risks include to curb inflation by restructuring the economy, shifting to a growth model driven by efficiency, efficacy, productivity and competitiveness, effective macroeconomic management, and improvement of the policy effectiveness. It is essential to apply and run a flexible and balanced exchange rate policy to control psychological factors and speculation that have inherently threatened the stability of the foreign exchange market. Budget deficits and public debts need to be closely monitored otherwise they will jeopardize macroeconomic stability and adversely affect the private sector development.

Infrastructure

Over recent years, there have been improvements in Vietnam's infrastructure including electricity, telecommunications, transportation and logistics that serve imports and exports. Although, compared to that of China and Thailand, Vietnam's

infrastructure is poorer, it generally has a larger size and better quality than the infrastructure system of countries with similar level of development. Test results all show that infrastructure is not a constraint to economic growth for now, but will become a binding constraint in the medium term. Infrastructure connectivity among sea, road, air ports and railway stations is inconsistent. The transportation costs are becoming less competitive as transportation has to rely heavily on road traffic while railways and seaborne transportation are too underdeveloped. Despite improvements in transportation infrastructure, its quality is still perceived by businesses to be much poorer than that of other countries with similar development level. The costs of outsourced transport services account for a large share in the cost structure of the Vietnamese enterprises. In 2014, about 28% of an enterprise's total costs were spent on transport services. Power outages are too frequent and take most time to fix in Vietnam compared to other countries in the region. In addition, electricity prices shall increase and become a huge burden on businesses given the challenges to and inability of the State budget to maintain the price subsidy policy in the medium term. Urban infrastructure problems such as traffic congestions and environmental pollution have been getting very serious recently.

Policies need to be put in place to better infrastructure quality include improvement of performance of sea ports, improvement of consistent connectivity among waterway, road, railway and airway transportation to help reduce business cost and enhance competitiveness. The costs of outsourced transport services account for a large share in the cost structure of the Vietnamese enterprises because transportation and logistics services remain poor and thus greatly affect domestic production, distribution and the national competitiveness. Therefore, it is necessary to develop policies to promote the development of logistics services, to make public applicable fees and charges as well as ways to calculate them. Doing this will help monitor and reduce the transportation cost and make the economy more competitive.

It is also necessary to immediately develop and implement policies to address the traffic congestion situation and air pollution in major urban areas such as Hanoi and Ho Chi Minh City, otherwise this will increase the transportation cost and undermine the economic efficiency as well as quality of life which will definitely become a binding constraint to economic development in Vietnam's urban area. Beefing up investments in the railway system to ease the pressure on road and airway transportation will, in the long term, will make investments in infrastructure better perform.

In the long term, two binding constraints to the private investments and growth are human capital and market failures in innovation

Human capital

Education is one of the most important factors that affect directly labor productivity and human capital quality. Vietnam has gained great achievements in education and improvement of people's health during the past period. Compared to other countries of similar level of development, educational and health status of Vietnamese people are always higher. For now, human resources in Vietnam do not impede the private sector. However, in order to move up the global value chain targeting at the segments with higher added value, Vietnam's current human resources remain unsatisfactory as its quality remains low as compared to the world's average. A major problem with Vietnam's human capital involves a high rate of agricultural workers and unskilled labor as compared to other countries with similar economic rating. Therefore, in the years to come, shifting labor from agriculture to the industries with higher labor productivity (i.e. industrial and service sectors) would become a challenge, and thus, the quality of human capital in the long term will expose a binding constraint to the development of the economy in general and of the private sector in particular.

Vietnam's education quality remains inadequate. Primary and lower secondary students have to absorb a rather huge amount of knowledge while attention is not paid to physical education and soft skills development. A new schooling model has been piloted in some universities in Vietnam (e.g. GPE-VNEN Project, Global Partnership for Education – Viet Nam Escuela Nueva) and had positive impact. This needs to be scaled up. There still remain shortcomings with the education quality at college and tertiary levels. A linkage between training theory and practice as vocational orientation, or field visits to businesses and plants receive no attention. To contribute to improving tertiary education quality and reduce the rate of students doing work outside their majors, it is required to develop and make public a universities ranking system based on various criteria concerning employment rate and average salary of new graduates to stir competition among universities and thereby improve human resource quality. In addition, vocational education system needs also to be adjusted to be more adaptive to the labor market. State-run vocational facilities need to be privatized for better efficiency.

Market failures in innovation

The level of innovation in Vietnam ranks lowest among ten East Asian countries. Innovations in Vietnam are subject to constraints because more than 95% of its businesses are small-sized and micro-sized, scientific research organizations

operate inefficiently, and there is a lack of links between universities, academia and business network. Capacity to apply new technologies in Vietnam is also rated lowest in the region due to lack of connectivity between the private and FDI sectors which, in turn, leads to poor technology transfers via FDI. Protection of intellectual property rights in Vietnam is of the lowest level in South East Asia. Also, poor and ineffective IPR enforcement in Vietnam do not incentivize companies to invest in R&D. The monopoly situation and lack of competition due to ineffective antitrust policies also discourage businesses from innovation. Test results and evidence show that market failures put a barrier to the innovation activities of businesses in Vietnam for the time being, and will become a binding constraint to growth in the long run.

It is necessary to build a robustly competitive environment inside the country by improving both quantity and quality of domestic suppliers, development of industrial clusters, enhanced participation in the value chain, loosening the State's upper-hand in the economic sectors with active participation of the private sector, relief of the market dominance of large enterprises, and improved enforcement of the policy against monopoly.

To develop a financial policy that stimulates innovation and creative activities in order to encourage businesses to invest more in R&D and renovation of technologies (National Technology Innovation Fund, tax holiday for imported advanced technologies, exemptions of personal income tax for high-tech workers...). To improve the quality of research institutions, and to focus on the development of high-tech human resources for the spearhead industries. To set up an "innovation system" (for cooperation purpose) through enhanced linkages between businesses – research institutions - universities, to introduce policies to promote collaboration between domestic producers and FDI enterprises to create spillover effects of technologies and intensify IPR protection.