

OVERVIEW

Vietnam 2035

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Toward Prosperity, Creativity, Equity, and Democracy

The World Bank

Ministry of Planning and Investment of Vietnam

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1818 H Street NW, Washington DC 20433
Telephone: 202-473-1000; Internet: www.worldbank.org

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“The State shall guarantee and promote the People’s right to mastery; to recognize, respect, protect, and guarantee human rights and citizens’ rights; and to pursue the goal of a prosperous people and a strong, democratic, equitable, and civilized country, in which all people enjoy an abundant, free, and happy life and are given conditions for their comprehensive development.”

—Article 3 of the 2013 Constitution of the
Socialist Republic of Vietnam

Contents

<i>Foreword</i>	xi
<i>Preface and Acknowledgments</i>	xiii
<i>Abbreviations</i>	xix
<i>Executive Summary</i>	xxi
Overview	
Introduction	1
A Record of Strong and Equitable Growth, with Emerging Concerns	2
Opportunities and Risks	7
Aspirations for 2035	13
Pillar 1 Economic Prosperity with Environmental Sustainability	
Vietnam’s Long-Term Growth in a Global Perspective	17
Trends in Productivity Growth—A Cause for Concern	19
A Reform Agenda to Reignite Productivity Growth	22
Pillar 2 Equity and Social Inclusion	
The Unfinished Agenda: Ensuring Equality of Opportunity	44
The Emerging Agenda for the Rising Middle Class and the Aging Population	50
Pillar 3 A Capable and Accountable State	
Why Institutional Quality Matters for Growth and Development	61
How Vietnam Performs on Institutional Quality	62
Institutional Constraints to Vietnam’s Development	64
The Way Forward for the State	70
Notes	80
References	82

Contents of the Full Report

Overview

Chapter 1 Review of Thirty Years of Reforms—and Aspirations for 2035

Chapter 2 Enabling Economic Modernization and Private Sector Development

Chapter 3 Moving toward an innovation-led economy

Chapter 4 Managing urbanization for greater economic efficiency

Chapter 5 Achieving sustainable and climate-resilient growth

Chapter 6 Promoting equity and social inclusion

Chapter 7 Building modern institutions for an effective state

Foreword

After 30 years of economic reforms since the launch of *Đổi Mới* in 1986, Vietnam has recorded significant and historic achievements. From a poor, war-ravaged, centrally planned economy, which was closed off from much of the outside world, Vietnam has become a middle-income country with a dynamic market economy that is deeply integrated into the global economy. Vietnam's economic growth has not only been rapid, but also stable and inclusive, translating into strong welfare gains for the vast majority of the population. This is an impressive record of success—one that the Vietnamese people take justifiable pride in, while appreciating the support of the international community.

But 30 years of success from reforms raises expectations for the future. The country's ambitions are aptly captured in the Vietnamese constitution, which sets the goal of “a prosperous people and a strong, democratic, equitable, and civilized country.” There is a firm aspiration that by 2035, Vietnam will

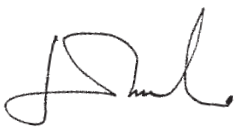
be a modern and industrialized nation moving toward becoming a prosperous, creative, equitable, and democratic society.

Motivated by these aspirations, in July 2014, the Government of Vietnam and the World Bank Group jointly initiated the *Vietnam 2035* report.

The report recognizes six key transformations that will help Vietnam achieve its goals for 2035: (1) to enable economic modernization with a competitive private sector firmly in the lead; (2) to improve the country's technological and innovative capacity; (3) to reshape urban policies and investments for more dynamic cities and urban centers; (4) to chart an environmentally sustainable development path with increasing adaptation and resilience to changing climate patterns; (5) to promote equality and inclusion among marginalized groups for the development of a harmonious middle-class society; and (6) to establish a modern rule of law state and a democratic society.

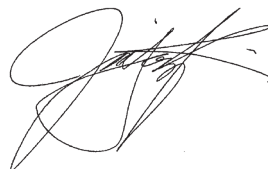
Vietnam 2035 structures these transformations and the reform agenda around three key pillars: balancing economic prosperity with environmental sustainability; promoting equity and social inclusion; and enhancing the capacity and accountability of the state.

We are delighted by the close partnership between the experts of Vietnam and the World Bank Group, and other international scholars that has characterized the preparation of the



Nguyễn Tấn Dũng
Prime Minister
The Socialist Republic of Vietnam

report, *Vietnam 2035: Toward Prosperity, Creativity, Equity, and Democracy*. We hope that the Government of Vietnam, the World Bank Group, and other development partners will continue the effective collaboration in incorporating the report's relevant recommendations in the Socio-Economic Development Plan 2016–20 and the Socio-Economic Development Strategy 2021–30, as well as in the oversight and evaluation of the implementation process.



Jim Yong Kim
President
The World Bank Group

Preface and Acknowledgments

The report, *Vietnam 2035: Toward Prosperity, Creativity, Equity, and Democracy*, is a joint initiative of the Government of Vietnam and the World Bank formally forged between Prime Minister Nguyen Tan Dung and President Jim Yong Kim in July 2014.

The report was written by a Vietnamese–World Bank team under the supervision and guidance of Deputy Prime Minister Vu Duc Dam; Minister of Planning and Investment Bui Quang Vinh; Axel van Trotsenburg, World Bank Vice President for East Asia and Pacific; Victoria Kwakwa, Country Director for Vietnam; and Sudhir Shetty, World Bank Chief Economist for East Asia and Pacific. Gratitude for insightful advice is extended to members of the Steering Committee for the Vietnam 2035 Report: Prof. Nguyen Xuan Thang (President, Vietnam Academy of Social Sciences), Nguyen VanTung (Vice Chairman of the Office of Government), Nguyen Ngoc Bao (Vice Chairman, Economic Commission of the Central Committee of the Communist Party of Vietnam), Bui

Thanh Son (Vice Minister of Foreign Affairs), Truong Chi Trung (Vice Minister of Finance), Nguyen Toan Thang (Deputy Governor), and Prof. Bui Tat Thang (President, Development Strategy Institute).

The Ministry of Planning and Investment was assigned by the Government of Vietnam to coordinate the line ministries, agencies, and research institutes, and to collaborate with the World Bank in the preparation of the report. A joint Vietnam–World Bank coordination team was established, which was led by Dr. Cao Viet Sinh (Former Vice Minister of Planning and Investment), Victoria Kwakwa (Country Director), and Sandeep Mahajan (Lead Economist).

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velopment that included Jonathan Aspin, Joe Caponio, and Mike Crumplar. Production and publication of the English version was managed by Susan Graham and Patricia Katayama of the World Bank's Publishing and Knowledge Division, External Communications.

The Vietnam 2035 report has seven chapters and an Overview written by individual chapter teams, whose members are listed below in alphabetical order of their surnames.

Overview

Lead authors: Dr. Cao Viet Sinh (former Vice Minister of Planning and Investment), Gabriel Demombynes (Senior Economist), Victoria Kwakwa (Country Director), Sandeep Mahajan (Lead Economist), and Sudhir Shetty (Chief Economist).

Core team: Prof. Hoang The Lien (Former Vice Minister of Justice), Dr. Nguyen Quang Thai (Secretary General, Vietnam Association of Economists), Nguyen Van Vinh (Vice President, Development Strategy Institute (DSI)), Pham Chi Lan (Former Vice President of the Vietnam Chamber of Commerce and Industry), Dr. Vo Tri Thanh (Vice President, Central Institute for Economic Management (CIEM)), and Doan Hong Quang (Senior Economist).

The Overview builds on background papers and notes prepared by: Manu Bhaskaran (Centennial Asia Advisors), Claus Brand (Consultant), David Dapice (John F. Kennedy School of Government, Harvard Uni-

versity), Do Thien Anh Tuan (Lecturer, Fulbright Economics Teaching Program), Sebastian Eckardt (Senior Economist), ImpactECON, LLC, Nguyen Xuan Thanh (Director, Fulbright Economics Teaching Program), and Dr. Vu Thanh Tu Anh (Director of Research, Fulbright Economics Teaching Program).

Vietnam: 30 Years of Reform and Aspirations

Lead authors: Prof. Bui Tat Thang (President, Institute for Development Strategy), Nguyen Van Vinh (Vice President, DSI), and Dr. Vo Tri Thanh (Vice President, CIEM).

The chapter builds on background papers and notes prepared by: Dr. Nguyen Duc Thanh (Director, Vietnam Institute for Economic and Policy Research), Dr. Nguyen Quang Thai (Secretary General, Vietnam Association of Economists), and Prof. Tran Dinh Thien (Director, Vietnam Institute of Economics).

Capable research assistance was provided by: Dang Huyen Linh, Vu Thu Trang, Nguyen Dang Hung, Nguyen Thi Huong Giang, and Nguyen Thi My Hanh (DSI).

Economic Modernization and Private Sector Development

Lead authors: Mona Haddad (Practice Manager), Sandeep Mahajan (Lead Economist), Pham Chi Lan (Former Vice President of the Vietnam Chamber of Commerce and Industry), and Pham Thi Thu Hang (Secretary General, VCCI).

Core team: Doan Hong Quang (Senior Economist), Claire Honore Hollweg (Economist), Steven Jaffee (Lead Rural Development Specialist), Nguyen Van Lan (Senior Operations Officer), and Daria Taglioni (Senior Trade Economist).

The chapter builds on background papers and notes prepared by: Alwaleed Fareed Alabatani (Lead Financial Sector Specialist), Guillermo Arenas (Consultant), Reyes Aterido (Consultant), Ruth Banomyong (Consultant), Dr. Dang Kim Son (former Director of the Institute of Policy and Strategy for Agriculture and Rural Development (IPSARD)), David Dollar (Brookings Institutions), Dang Hung Vo (Consultant), Mary Hallward-Driemeier (Senior Principal Specialist), Stacey Frederick (Consultant), Gian Thanh Cong (Consultant), James Hanson (Consultant), Tanja Goodwin (Private Sector Development Specialist), Claire Honore Hollweg (Economist), Victor Kümmitz (Consultant), Dr. Le Dang Doanh (Former President, CIEM), William Mako (Consultant), Miles McKenna (Consultant), Martha Martinez Licetti (Lead Specialist), Martin Molinuevo (Consultant), Ben Shepard (Consultant), Dr. Nguyen Do Anh Tuan, (Director, IPSARD), Dr. Nguyen Dinh Cung (President, CIEM), Dr. Nguyen Thi Tue Anh (Vice President, CIEM), Georgiana Pop (Senior Economist), Timothy Sturgeon (Massachusetts Institute of Technology), Prof. Tran Van Tho (Waseda University, Japan), Vu Kim Hanh (Director, Center for Business Research and Support), Deborah Winkler (Consultant), Chunlin Zhang (Lead Private Sector Development Specialist), and Ezequiel Zylbeberg (University of Ox-

ford). Dr. Vu Thanh Tu Anh (Director of Research, Fulbright Economics Teaching Program)

Capable research assistance was provided by: Gian Thanh Cong (Consultant).

The chapter team is grateful for useful comments and advice from: Danny Leipziger (Growth Dialogue and George Washington University), Catherine Martin (Principal Strategy Officer), and Daniel Street (Operations Officer).

Science, Technology, and Innovation

Lead authors: Dr. Banh Tien Long (former Vice Minister of Education and Training), Michael Crawford (Lead Education Specialist), Dr. Le Dinh Tien, (former Vice Minister of Science and Technology), and William Maloney (Chief Economist).

The chapter builds on background papers and notes prepared by: Nicholas Bloom, Raissa Ebnerb, Kerenssa Kayc, Renata Lemosd, Raffaella Sadune, Daniela Scurf, and John Van Reeneng (World Management Survey), Hyunho Kim (Chonnam National University), Joonghae Suh (Korea Development Institute), and Deok Soon Yim (Science and Technology Policy Institute). Dr. Hyungsun Kim, Inha University, Korea; Mr. Nguyen Manh Quan, Vice President, Vietnam Institute of Science and Technology Policy; Mr. Nguyen Vo Hung, head of reform policy and technology market Department, Vietnam Institute of Science and Technology Policy; Dr. Nguyen Van Duong, Senior Expert, Ministry of Education and Training; Dr. Pham Thi Thanh Hai, lecturer, Hanoi National University; Dr. Tran Thi Ha,

former director general, Education Department, Ministry of Education and Training.

The team is grateful for comments and advice from: Prof. Dr. Hoang Van Phong, Chairman, National Council for Science and Technology, former Minister of Science and Technology and Dr. Tran Ngoc Ca, head of office, Office of Science and Technology, Vietnamese Embassy in Washington DC, USA.

Urbanization

Lead authors: Dr. Huynh The Du (Fulbright School of Public Policy), Somik Lall (Lead Urban Economist), Dr. Nguyen Do Anh Tuan (Director, IPSARD), and Madhu Raghunath (Senior Urban Specialist).

The chapter builds on background papers and notes prepared by: Luis Blancas (Senior Transport Specialist), David Bulman (Consultant), Dr. Dang Kim Khoi (IPSARD), Edward Leman (Consultant), Dr. Nguyen Anh Phong (IPSARD), and Pablo Vaggione (Consultant). Truong Thi Thu Trang, (Deputy Head of Faculty - IPSARD)

The chapter team is grateful for useful comments and advice from: Zoubida Allaoua (Senior Regional Advisor), Judy Baker (Lead Economist), Abhas Jha (Practice Manager), Danny Leipziger (Growth Dialogue and George Washington University), Paul Vallely (Senior Transport Specialist), and Anna Wellenstein (Practice Manager).

Sustainable Development

Lead authors: Diji Chandrasekharan Behr (Senior Natural Resources Econ-

omist) and Prof. Truong Quang Hoc (former Director of the Center for Research Resources and Environment, Vietnam National University).

Core team: Anjali Acharya (Senior Environmental Specialist), Prof. Bui Quang Tuan (Director, Vietnam Institute for Regional Sustainable Development), Todd Johnson (Lead Energy Specialist), and Prof. Nguyen Trung Thang (Vice Director, Institute of Strategy and Policy on Natural Resources and the Environment).

The chapter builds on background papers and notes prepared by: Tijen Arin (Senior Environmental Economist), Christophe Crepin (Sector Leader), Richard Damania (Lead Economist), Franz Gerner (Lead Energy Specialist), Sarath Guttikunda (Consultant), Steven Jaffee (Lead Rural Development Specialist), Iain Menzies (Senior Water and Sanitation Specialist), Tae Yong Jung (Yonsei University), Sung Jin Kang (Koera University), Joo Young Kwak (Yonsei University), and Truong Thi Thu Trang, Dang Kim Khoi, Kim Van Chinh, Nguyen Thi Cam Nhung, Nguyen Van Lam, and Pham Kim Dung (all IPSARD).

Capable research assistance was provided by Nguyen Phuong Nga (Consultant).

The chapter team is grateful for useful comments and advice from: Carter Brandon (Lead Economist), Christophe Crepin (Sector Leader), Richard Damania (Lead Economist), Douglas J. Graham (Senior Environmental Specialist), and Iain Shuker (Practice Manager).

Social Inclusion

Lead authors: Prof. Dang Nguyen Anh (Director, Institute of Sociology), Gabriel Demombynes (Senior Economist), and Philip O’Keefe (Lead Economist).

Core team: Michael Crawford (Lead Education Specialist), Puja Vasudeva Dutta (Senior Economist), Prof. Giang Thanh Long (Director, Institute of Public Policy), Dr. Nguyen Thang (Director, Center for Analysis and Forecast), Dr. Nguyen Thi Lan Huong (Director General, Institute of Labour, Invalids and Social Affairs), Truman Packard (Lead Economist), Achim Daniel Schmillen (Economist), and Owen Smith (Senior Economist).

Contributors: Reena Badiani-Magnusson (Senior Economist), Kari Hurt (Senior Operations Officer), and Vu Hoang Linh (Economist).

Capable research assistance was provided by: Tran Thi Ngoc Ha (Consultant).

The chapter team is grateful for useful comments and advice from Prof. Ravi Kanbur (Cornell University) and Ana Revenga (Senior Director).

Modern Institutions

Lead authors: Prof. Hoang The Lien (Former Vice Minister of Justice), Jonathan Pincus (Rajawali Foundation, Indonesia), and Charles Undeland (Senior Governance Specialist).

Core team: Soren Davidsen (Senior Public Sector Specialist), Dr. Nguyen Van Cuong (Deputy Director, Institute of Legal Science), and Tran Thi Lan Huong (Senior Public Sector Specialist).

The chapter builds on background papers and notes prepared by: Maridel

Alcaide (Consultant), Dr. Bui Nguyen Khanh, Deputy Director, Institute of State and Law), Noah Buckley (Consultant), Professor Yoon Je Cho (Consultant), Dr. Duong Thanh Mai (Former Director, Institute of Legal Science), Prof. Nguyen Nhu Phat (Director, Institute of State and Law), Prof. Pham Duy Nghia (Fulbright School of Public Policy), Dr. Thang Van Phuc (Former Vice Minister of Home Affairs), and Vu Hoang Quyen (Senior Economist). Vu Thanh Tu Anh, David Dapice, Nguyen Xuan Thanh and Do Thien Anh Tuan, Fulbright Economic Teaching Program, Vietnam

The chapter team is grateful for guidance and advice from: James Anderson (Country Manager), Robert Taliencio (Practice Manager), and Graham Teskey (Principal Technical Lead, Governance, Abt JTA).

Additional editing of the report was handled by a Vietnamese editorial team with participation of Dr. Cao Viet Sinh (former Vice Minister of Planning and Investment, team leader), Prof. Hoang The Lien (Former Vice Minister of Justice), Dr. Nguyen Quang Thai (Secretary General, Vietnam Association of Economists), Nguyen Van Vinh (Vice President, DSI), Pham Chi Lan (Former member of Prime Minister's Economic Advisory Board), Dr. Vo Tri Thanh (Vice President, CIEM), and Doan Hong Quang (Senior Economist).



Bùi Quang Vinh
Minister of Planning and Investment
The Socialist Republic of Vietnam

The administrative coordination was carried out by the Administration Office of the Vietnam 2035 Steering Committee set up at the DSI. The Committee included: Prof. Bui Tat Thang (President), Nguyen Van Vinh (Vice President), Nguyen Thi Huong Giang, Bui Thi Thuong, Dang Huyen Linh, Dinh Thi Ninh Giang, Doan Thanh Tung, Le Quang Dao, Nguyen Quoc Truong, Nguyen Thi My Hanh, Nguyen Dang Hung, Nguyen Quynh Trang, Pham Le Hau, Pham Le Hoang, Pham Minh Thao, Pham Thanh Hien, and Vu Thu Trang.

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Administration and communications activities from the World Bank side were managed by Bo Thi Hong Mai (Senior Communications Officer), Tran Kim Chi (Communications Associate), Vu Lan Huong (Communications Associate), Nguyen Hong Ngan (Communications Officer) and Vu Thi Anh Linh (Program Assistant).

It is with great pleasure that the Ministry of Planning and Investment and the World Bank Group introduce the report *Vietnam 2035: Toward Prosperity, Creativity, Equity, and Democracy* with the hope that Vietnamese leaders and policy-making agencies will find it useful.



Axel van Trotsenburg
Vice President for East Asia and Pacific
The World Bank

Abbreviations

AIIB	Asian Infrastructure Investment Bank
ALTC	aged and long-term care
ASEAN	Association of Southeast Asian Nations
CEO	chief executive officer
DIV	Deposit Insurance of Vietnam
GDP	gross domestic product
GVC	global value chain
ICT	information and communications technology
IMF	International Monetary Fund
IT	information technology
LPI	Logistics Performance Index (of the World Bank)
MOLISA	Ministry of Labour, Invalids and Social Affairs
NPL	nonperforming loan
OECD	Organisation for Economic Co-operation and Development
OOP	out-of-pocket
PPP	purchasing power parity
R&D	research and development
SBV	State Bank of Vietnam
SDG	Sustainable Development Goal (of the United Nations)
SOE	state-owned enterprise
SRB	sex ratio at birth
3D	three dimensional
TPP	Trans-Pacific Partnership
UN	United Nations
UNICEF	United Nations Childrens' Fund
VCA	Vietnam Competition Authority
WGI	Worldwide Governance Indicator

Executive Summary

The year 2015 marks 70 years since Vietnam’s Declaration of Independence, 40 years since Reunification, and just short of 30 years from the launch of *Đổi Mới*, which catapulted the nation from the ranks of the world’s poorest to one of its great development success stories. Critical ingredients of success have been visionary leaders, a sense of shared societal purpose, and a focus on the future. Starting in the late 1980s, these elements were fused with the embrace of markets and the global economy, setting the nation on the path to becoming the middle-income country that it is today. Its spectacular growth since then, one of the fastest in the world, has all but eliminated extreme deprivation and lifted tens of millions of people out of poverty.

Looking forward to 2035, which will mark 60 years since its reunification, Vietnam now aspires to modernity, industrialization, and a higher quality of life. These aspirations and the supporting policy and institutional agenda stand on three pillars: balancing economic prosperity with environmental sustainability, promoting equity

and social inclusion, and bolstering the state’s capacity and accountability. The rapid growth needed to achieve these aspirations will be sustained only if it stands on faster productivity growth and reflects the costs of environmental degradation. Productivity growth, in turn, will benefit from measures to enhance the competitiveness of domestic enterprises, scale up the benefits of urban agglomeration, and nurture a creative and innovation-led economy. Maintaining the record on equity and social inclusion will require lifting marginalized groups and delivering services to an aging and urbanizing middle-class society. And to fulfill the country’s aspirations, the institutions of governance will need to become modern, transparent, and fully rooted in the rule of law.

Balancing Economic Prosperity with Environmental Sustainability

The goalposts for Vietnam’s future economic success are set broadly and aspirationally—the 2013 constitution sets the objective of a “prosperous peo-

ple and strong country,” marking little deviation from its 1992 version. Party and government documents couch the income objectives in similarly aspirational terms, with an annual GDP per capita growth target of 7 percent (equal to around 8 percent annual growth). Growth rates in this range would produce by 2035 an upper-middle-income country on the cusp of high income—at the level of Malaysia or the Republic of Korea in the mid-2000s. But this target is extremely ambitious, far surpassing Vietnam’s past growth and with few global precedents.

The Vietnamese qualities of thrift, discipline, and hard work will have to be deployed in full measure for the country to stay close to its aspirations. The national savings rate needs to remain high while the investment rate rises slightly. Discipline and hard work can help counter the projected rapid aging of the population. But more is needed. Productivity and innovation will eventually have to become the main drivers of growth. That will require policies to tackle the stagnation in productivity and long-term investments, especially in urban infrastructure and innovation capabilities.

What explains the stagnation in productivity? Public investment is not as efficient as it needs to be because of uncoordinated and often incoherent investment decisions of a fragmented state structure. There also is little doubt that most state-owned enterprises (SOEs) are inefficient producers. So, widespread inefficiencies in state investment perpetuate the weak productivity trends across the economy. But they do not fully explain the decline in productivity growth, reasons for which

are especially worrisome. A steady erosion in the productivity growth of the domestic private sector leaves it just as inefficient as the state sector—for two reasons. First, the institutional foundations for an advanced market economy are insufficiently developed, undermining private-property rights and competition in product markets. Second, factor markets are governed by an unclear mix of allocation by markets and by fiat. Commercialized state institutions—whereby the state is directly involved in economic activity through SOEs and indirectly through the influence of vested interests—have ensured that land and capital allocations are guided as much by arbitrary administrative decisions as by efficient market signals.

Productivity is also hurt by malfunctioning land markets in at least two other ways. First, the urbanization of land is outpacing the urbanization of people, reducing urban population density and suppressing productivity gains from urban agglomeration. Second, obstacles to consolidation of small landholdings in agriculture are depressing small-landholder profits and sector productivity.

The sustainability of Vietnam’s long-term growth is further threatened by environmental stresses. Growth in the past 25 years has imposed significant environmental costs. Rapid depletion of natural resources is a particular concern. Environmental pollution from urban and industrial wastewater leaves waterways toxic, while urban water and air pollution are beginning to pose serious health hazards, especially near Hanoi and Ho Chi Minh City, and particularly for children. Vietnam is

also one of the countries most vulnerable to climate change, with settlements and economic activity in the Mekong Delta at especially heightened risk. Exacerbating the risks is rapidly growing energy consumption, increasingly reliant on coal-powered electricity generation. In recent years Vietnam's increase in greenhouse gas emissions has been one of the world's fastest.

The reform agenda to unleash strong and sustainable economic growth will have four essential elements:

1. *Create an enabling environment for domestic enterprises.* The immediate emphasis needs to be on ensuring more competitive and productive domestic enterprises. Restructuring and equitizing SOEs will remain important, but will not be enough—fixing the nascent and weak domestic private sector commands even greater policy attention. This will involve strengthening the institutional foundations of the market economy, with emphasis on protecting property rights and enforcing competition policies. A stable, well-regulated, and inclusive financial sector and transparent and functioning land markets will also be crucial. A more capable and confident domestic private sector will deepen linkages with foreign firms, enabling the transfer of technology and know-how that are critical for higher productivity growth. More rewarding participation in global value chains will also come from a stronger services sector and more extensive transport and network connectivity across the country and with trading partners. Finally, a
2. *Spur learning and innovation.* Sustaining high growth over an extended period will depend on an aggressive agenda to spur learning and innovation. Neither enterprises nor knowledge and research institutions are currently motivated to focus adequately on this agenda. A national innovation system can improve the situation. On the demand side, it will encourage firms to seek out the best available knowledge and strengthen the technical and financial support to facilitate their learning. On the supply side, such a system will help build the skills of the workforce beyond its current proficiency in basic education, while raising the quality and relevance of research and advanced training in universities and government research institutes.
3. *Reshape urban policies and investments.* For Vietnam to succeed in its growth and economic modernization ambitions, its cities need to do more to nurture private enterprise and innovation, support the growth of industrial clusters integrated with global value chains, and attract and agglomerate talent. Playing this role credibly will involve reshaping policies and investments to amplify economic density in and around large

more market driven and commercial approach will be needed to modernize agriculture. Commitments under major international trade agreements (the Trans-Pacific Partnership in particular) offer a real opportunity to carry out many demanding and politically sensitive reforms.

metropolitan areas such as Ho Chi Minh City, Hanoi, Hai Phong, and Da Nang, as well as a network of dynamic secondary cities; reduce the distance to markets to enable specialization; and equalize access to services between migrants and urban residents. Fulfilling this agenda will require functioning land markets, coordinated urban planning, and improved connective infrastructure.

4. *Sustain the environment.* There are three core elements of the reform agenda to sustain the environment: protect the quality of natural resources (air, land, and water); build climate resilience into economic planning, sectoral policies, and infrastructure investments; and find ways to tap more clean energy sources, including through regional power trade. Such a sustainable, inclusive, and resilient growth path calls for strong policies and institutions to coordinate actions and investments, smart investments (with private participation) that internalize environmental and climate costs, and more accessible data and information for decision making and monitoring progress.

Promoting Equity and Social Inclusion

Vietnam's emphasis on equity and social inclusion has always been strong. And it is one of the few countries to achieve high growth with equity. Its record rests on a foundation established by equitable land distribution in the late 1980s, effective delivery of basic services such as health and education, and public-policy choices that

equalized fiscal transfers across provinces with different levels of development. Vietnam wants to maintain that record. Its central socioeconomic philosophy—a market economy with socialist orientation—captures the balance in its preferences for equity and market-led growth.

Past performance and societal preferences notwithstanding, sustaining the positive equity trends is not something that Vietnam can take for granted, especially as the forces of urbanization, globalization, and the rising skill intensity of production take firmer root. Looking toward 2035, Vietnam needs to pursue a dual agenda for equity and social inclusion.

The unfinished inclusion agenda is ensuring equality of opportunity. While Vietnam has taken long strides in lifting living standards since *Đổi Mới*, significant groups remain marginalized, and the gaps in opportunity for children are wide between poor and wealthy households. An ethnic minority child is four times more likely than a Kinh child to die before her first birthday. More than half the children with severe disabilities never attend school.

Such exclusion stands in stark contrast to the fortunes of those at the top: Over the last decade, the number of millionaires in Vietnam has tripled while malnutrition rates among ethnic minority children have hardly budged. Rectifying such inequities will require renewed efforts. Four elements of the equality of opportunity agenda for 2035 are key:

1. *Reduce the barriers to opportunity for ethnic minorities.* Targeted initiatives in education, nutrition, and sanitation can close the large gaps

in opportunities for ethnic minority children. An approach of experimentation and evaluation, building on new insights from behavioral economics, could develop effective interventions in these areas. Policy actions would also become more effective through greater voice for ethnic minorities.

2. *Make people with disabilities full participants in society.* Vietnam has made strong commitments to the inclusion of people with disabilities but lags severely in implementation. Following the example of other countries, it can realize these promises by regularly monitoring commitments and by creating opportunities for people with disabilities and their families to be their own advocates through social organizations.
3. *Delink the household registration system from access to public services.* At least 5 million Vietnamese lack permanent registration in their place of residence and thus have limited access to public services, including schooling, health care, and such administrative services as registering a vehicle and applying for a birth certificate. While the force of the system has waned, it remains a source of inequality of opportunity and an effective tax on migration. Phased reform of the *hộ khẩu* system would place all citizens on an equal footing.
4. *Reduce gender gaps.* More opportunities for women in public leadership roles could be created by eliminating gender discrimination in the retirement age and using affirmative

action as a short-term measure. Also critical is reducing the imbalance in the sex ratio at birth, now one of the world's highest, with 114 boys born for every 100 girls. The preference for sons would be reduced through expanding the pension system, reforming the population policy, and campaigning to highlight the value of daughters.

Two social megatrends will shape the emerging inclusion agenda unfolding in Vietnam. The first is the rise of the middle class, which will be increasingly urban and employed in the formal sector. By 2035 more than half of the Vietnamese people will be part of the global middle class (up from just over 10 percent today), with needs distinct from those of the mass of rural poor that characterized Vietnam in the past. The second is an extreme demographic shift, with the size of the elderly population climbing dramatically—making Vietnam one of the most rapidly aging countries in the world—and the working-age share of the population shrinking. Around 2035 the old-age dependency ratio—the number of people 65 years of age or older for every 100 people aged 15–64—will have risen to almost 22 (from under 10 today), while the working-age population will begin to decline in absolute terms. Four elements of the middle-class and aging population agenda are key:

1. *Expand the pension system to cover a majority of the population.* Given the challenges of rapid aging, expanding coverage to those in the informal sector will be possible only through a diversified system and a

major reform to make it financially sustainable, including raising the retirement age.

2. *Ensure that nearly all children complete upper-secondary school with job-relevant skills.* One policy priority will be ending the exam-based allocation of upper-secondary-school places and replacing it with universal secondary-school attendance. Another is to continuously improve the quality and relevance of what students learn, to help them develop the noncognitive and complex problem-solving skills they need for a competitive labor market.
3. *Establish effective representation of workers through independent unions.* Vietnam needs to move toward an industrial relations system suited to a mature market economy, where the interests of workers, employers, and the state are more properly represented in a true bargaining process, following the recent commitments in a Trans-Pacific Partnership side agreement. In addition, labor market regulations could better balance the protection of workers with the flexibility to promote a vibrant formal sector.
4. *Achieve universal health coverage with a rebalanced delivery system.* Ensuring access to good quality health services without imposing financial hardship will entail both reforming the insurance regime and shifting health care from its current focus on hospitals toward high-quality primary care at the center of an integrated system.

Bolstering the State's Capacity and Accountability

Political and institutional reforms need to keep pace with Vietnam's development. Evidence from a large number of countries indicates that state effectiveness, or the capacity of government to set objectives and attain them, is closely associated with better development outcomes. State effectiveness rests on three supporting pillars: a well-organized government with a disciplined, meritocratic bureaucracy; an adherence to market rationality in economic policy making; and mechanisms to ensure checks and balances in the government and broad public participation. All three legs of the state effectiveness tripod are necessary for satisfactory results. Reforming state structures but rejecting market discipline, or assigning a larger role to the market mechanism while insulating government decision making from the community, are unlikely to generate positive outcomes.

The relationship between state effectiveness and development outcomes is evident in Vietnam. Many early achievements emerged from the country's state capacity, which was unusually strong for its level of income. Today, the productivity stagnation and the weak environment for private-sector development are attributable to gaps in state effectiveness. Vietnam's unique history has produced state institutions that are commercialized and fragmented and face insufficient scrutiny by citizens.

State commercialization in Vietnam refers to the continued strong engagement of the state in economic activity

directly through SOEs, particularly through large state economic groups, and indirectly through very close links with an exclusive segment of the domestic private sector. Vietnam is not alone in having influential vested interests, but the degree to which relationships to the state are integral to economic success appears to be unusually high. State fragmentation refers to the lack of clear hierarchy and assignment of roles and responsibilities both within the central government and between the center and the provinces—and the inertia and inefficiencies this generates in formulating and implementing policy. Horizontal and vertical fragmentation of power has resulted in overlapping mandates with conflicting rules and decisions. The result is often gridlock or decisions that are suboptimal from society’s point of view. The absence of merit-based management of public servants exacerbates the adverse effects of commercialization and fragmentation of the Vietnamese state on the quality of public administration.

Vietnam’s legal framework provides some space for citizens to participate in governance. “Government of the people, by the people, and for the people” and “People know, people discuss, people do, and people monitor” are well known affirmations in the constitution. In practice, there is a gap between these statements and the actual space that is available for citizens to influence decisions. Citizen participation in social organizations not sponsored by the government is growing rapidly, but this does not mean a corresponding improvement in the quality of their participation. Election processes and

mechanisms for engaging citizen organizations are not robust enough to provide true citizen representation, and Vietnam lacks a system of effective checks and balances between the three branches of government. Access to information, which is key to citizens exercising their voice to hold the state accountable, is still lacking.

The result is a government that often finds it difficult to articulate coherent economic policies, that is open to extensive bargaining among state institutions and between the state and private sectors, and that is shielded from public scrutiny of policy decisions and public reaction to the consequences of economic policy.

Modernization of Vietnamese institutions will involve an overhaul of the state and its relationships to the market and society. Efforts to enhance state capacity and accountability will need to move concurrently on a three-point agenda:

1. *Develop a more rationally organized government structure with a meritocratic bureaucracy.* The government needs more rational organization, and greater coherence on roles and responsibilities among state institutions. This will involve decentralization embodying clearer functional assignments for the different levels of government, with corresponding adjustments in the intergovernmental financial framework that clarify and improve accountability and overcome inefficiencies in coordination and use of public resources. The center of government could be strengthened to improve policy coordination and

oversight of execution of policies by public agencies. A clearer allocation of powers and responsibilities is needed among central bodies to have greater effectiveness and accountability. Public-administration practices need to be reformed to ensure that merit drives the deployment of human resources by the state.

2. *Apply market rationality to economic policy making.* State-market relations will have to be characterized by a clearer division between the public and private spheres. Specifically, government agencies involved in economic regulation should not engage in business of any kind, to avoid the appearance and reality of conflicts of interest. The state's role in the economy needs to be transformed from a producer to an effective regulator and facilitator, focusing on providing a level playing field in the economy with enforcement of free and fair competition and more secure and transparent property rights, particularly around land issues. This will require the state to not only significantly reduce its SOE portfolio and strengthen corporate governance of the remaining SOEs but also to stop giving preferential treatment to SOEs and closely linked private companies. In addition, there needs to be an independent and more capable, trained, and meritocratic judiciary to enforce rules and provide the level playing field. Creating the
- space for a genuinely independent private sector will require reduced state control over business and professional organizations, including the Vietnam Chamber of Commerce and Industry. Allowing these organizations to operate as authentic representatives of independent business interests would give voice to the domestic private sector and enable these groups to do more in monitoring government policy.
3. *Strengthen state accountability.* The state can be organized in a way that provides for genuine checks and balances among the executive, legislature, and judiciary. The National Assembly could be transformed into a professional body (consisting of full-time deputies and supported by expert staff), with oversight of all the state's operations. The judiciary needs to be similarly strengthened, with emphasis on its independence from the executive and enhanced transparency in its functioning. A large and diverse set of citizen organizations could be allowed to participate in decision making and hold the state accountable. The state could provide a legal framework to promote the right of citizens to associate. It could also adopt legislation requiring public bodies to be transparent and provide mechanisms for citizens to interact effectively with the state by enhancing citizen access to accurate and timely information and by providing greater media independence.

Vietnam 2035

Toward Prosperity, Creativity, Equity, and Democracy

Introduction

Shaking off the legacy of colonization and long, brutalizing conflicts is hard—and forging an uninterrupted pathway to modernity, perhaps even harder. Only a handful of nations have succeeded at both. Their winning formula? Usually some combination of strong leadership and good governance, a sense of common purpose and future orientation, a reliance on markets to allocate resources, and active engagement with the world on trade, investment, and knowledge flows.¹ Since the launch of the *Đổi Mới* (economic renovation) reforms in the late 1980s—to move from a closed, centrally planned economy to a globally integrated, socialist-oriented market economy—Vietnam has deployed these ingredients to good effect.

To any external observer, Vietnam is a major development success story. One of the world’s poorest countries at the onset of the reforms, it has, in a single generation, leapfrogged to middle-income status, while achieving social outcomes typically seen at much higher incomes. Vietnam’s economic

growth since the early 1990s has been among the fastest in the world, and its pace of poverty reduction almost unprecedented. But the Vietnamese people, keenly aware of the big challenges left, are not yet ready to declare success. And as for countries as for people, success needs to be measured not only against ability, effort, or even the performance of peers, but also against ambition.

The Vietnamese people have always set a high bar for success. The 1992 constitution exemplified this early on by setting forth the goal for the state to build “a prosperous life for its people, a strong country, and an equitable, democratic, and civilized society, ensuring the well-being, freedom, and happiness of all citizens as well as conditions for their all-round development.” Success thus defined was both multifaceted and aspirational. There is also the strong sense that the journey may be just as important as the destination. The tenets of thrift, discipline, and hard work are cherished means to higher living standards in the Vietnamese value system, not to be diluted

or lost along the way. So are societal values of equity, compassion, filial responsibility, respect for social norms and the rule of law, and the authority of elders and teachers.

The motivations that fuel Vietnam's ambitions are both external and internal. Externally, the driving force is Vietnam's neighborhood—the world's most dynamic region. Vietnamese mind-sets are steeped in the rapid ascents of Japan and the East Asian Tigers. They not only serve as powerful examples but also stoke fears of being permanently left behind. Internally, there is pride in a rich past—justifiable for a society with one of the world's longest continuous histories and civilizations.² As recently as the early 19th century, Vietnam was a regional powerhouse, with a much larger economy than those of Thailand, Malaysia, or the Philippines.³ The drive to reclaim the country's place in the community of nations is accordingly strong.

Energized by past success but by no means content, Vietnam now aspires to modernity, industrialization, and a higher quality of life. The aspirations reflect an emphasis on clean water and clear blue skies; a healthy, secure, learned, and equitable society; and an effective state accountable for improving material welfare.

Achieving these aspirations will require bold and decisive action, both to grasp the opportunities and to manage risks. The notable opportunities are an emergent domestic middle class, proximity to a rapidly rising China, and megaregional trading agreements—particularly the Trans-Pacific Partnership (TPP), in which Vietnam is the only lower-middle-income member. The major risks are the rapid aging

of the population, the less hospitable global economy, and the threat of climate change, to which Vietnam is heavily exposed. Global technological and business innovations, powered by the information revolution, will remain disruptive—presenting more opportunities and risks, with Vietnam's net benefits depending on its responses.

The country's aspirations and the supporting policy and institutional agenda thus stand on three pillars: balancing economic prosperity with environmental sustainability, promoting equity and social inclusion, and bolstering the state's capacity and accountability. The rapid growth needed to achieve these aspirations will be sustained only if it stands on faster productivity growth and reflects the costs of environmental degradation. Productivity growth, in turn, will benefit from measures to enhance the competitiveness of domestic enterprises, scale up the benefits of urban agglomeration, and nurture a creative and innovation-led economy. Maintaining the record on equity and social inclusion will require lifting marginalized groups and delivering services to an aging and urbanizing middle-class society. And to fulfill the country's aspirations, the institutions of governance will need to become modern, transparent, and fully rooted in the rule of law.

A Record of Strong and Equitable Growth, with Emerging Concerns

Vietnam is a major development success story. Its per capita GDP growth since 1990 has been among the fastest in the world, surpassed only by China. Growth has also been remarkably stable and inclusive, which, with

major gains on human development, has contributed to impressive progress in alleviating poverty and improving nonincome dimensions of welfare. But declining productivity growth, insufficient progress in including marginalized groups in the country's development (ethnic minorities in particular), and degradation of the environment call into question the durability of the current development model. Vietnam's governance structure could also be at an inflection point. The institutions that were adequate to carry the country to its lower-middle-income level are now exposing gaps that, unless addressed with boldness and urgency, are likely to impede the journey to upper-middle-income status.

In 1986 an impoverished Vietnam, on the brink of an economic crisis, embarked on a path of economic renovation (*Đổi Mới*). It was an explicit recognition that the “fence-breaking” reforms of the previous decade—opportunistically initiated to test the limits of central planning—had shown promise and that the situation was dire enough to demand a more systematic approach. Annual inflation was running at more than 400 percent,⁴ the real economy on a downward slide and heavily dependent on foreign aid,⁵ food in short supply, the budget chronically short of resources,⁶ and the vast majority of the population in poverty.

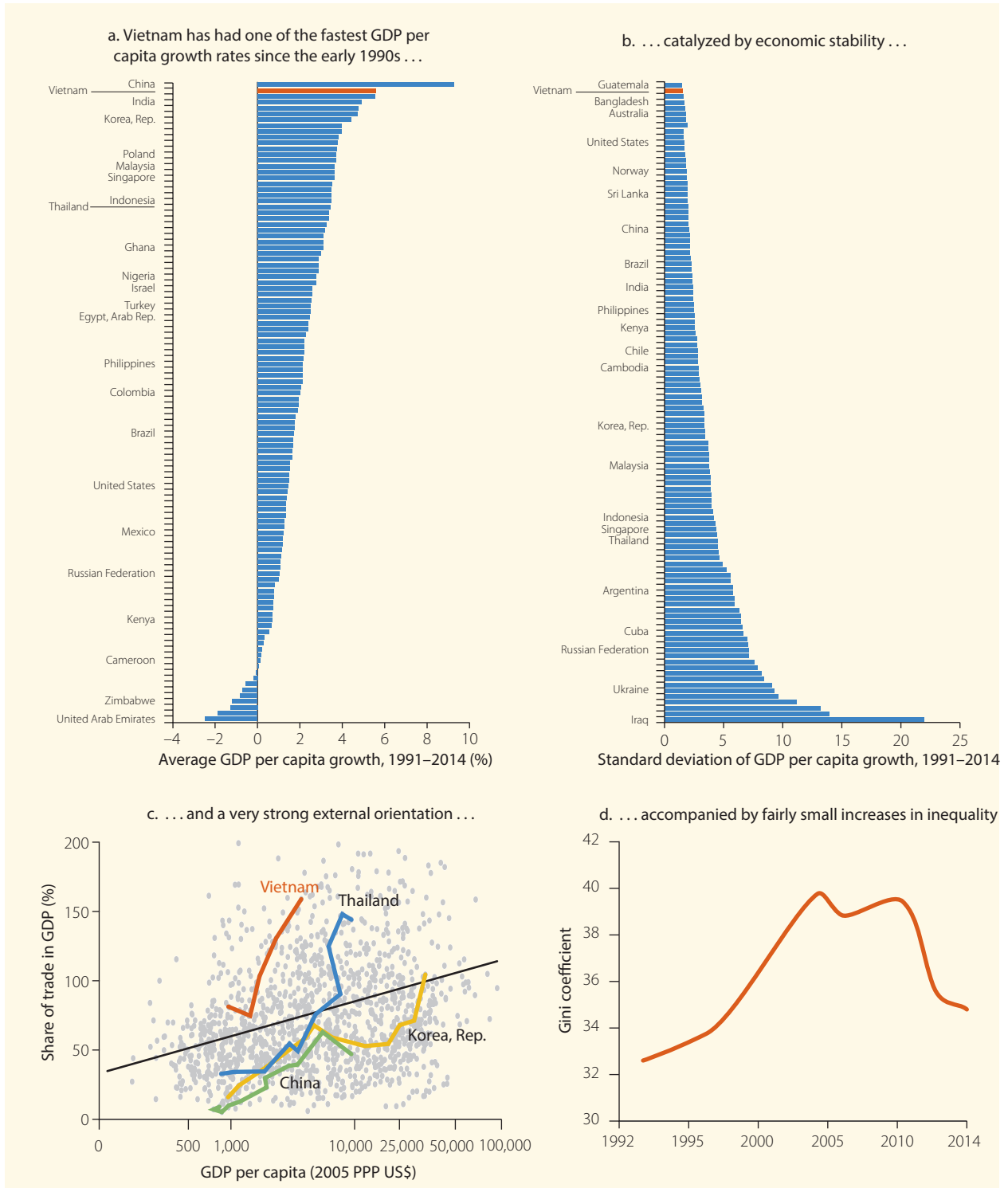
Thus *Đổi Mới* began a process of macroeconomic stabilization, unshackling the economy from state controls and gradually but steadily integrating with the global economy.⁷ More durable foundations for a market economy were built over time. And in competently managing the transition from a planned to a market-economy struc-

ture, Vietnam succeeded where many countries that had been part of the former Soviet Union have failed.

Four aspects of the approach to reforms proved most effective. First, Vietnam chose to be pragmatic and flexible, both in the sequencing and the pacing of reforms. Reforms were introduced incrementally, after extensive consensus building, and wholesale shock therapies were avoided.⁸ And if internal or global experience suggested course correction, the system proved adaptable. Second, Vietnam played to its strengths by focusing on labor-intensive production and agriculture. Third, the emphasis on building human capital was early and effective. Vietnam already had relatively high levels of literacy and life expectancy.⁹ The human-capital base was further expanded following *Đổi Mới*, enhancing the returns on the market-oriented reforms that followed. Fourth, where a domestic consensus was harder to forge, Vietnam used its commitments under external trade agreements to good strategic effect, particularly to usher in some of the more complex enterprise reforms. Each of these four aspects of the approach remains important for the next generation of reforms—a subject of this report.

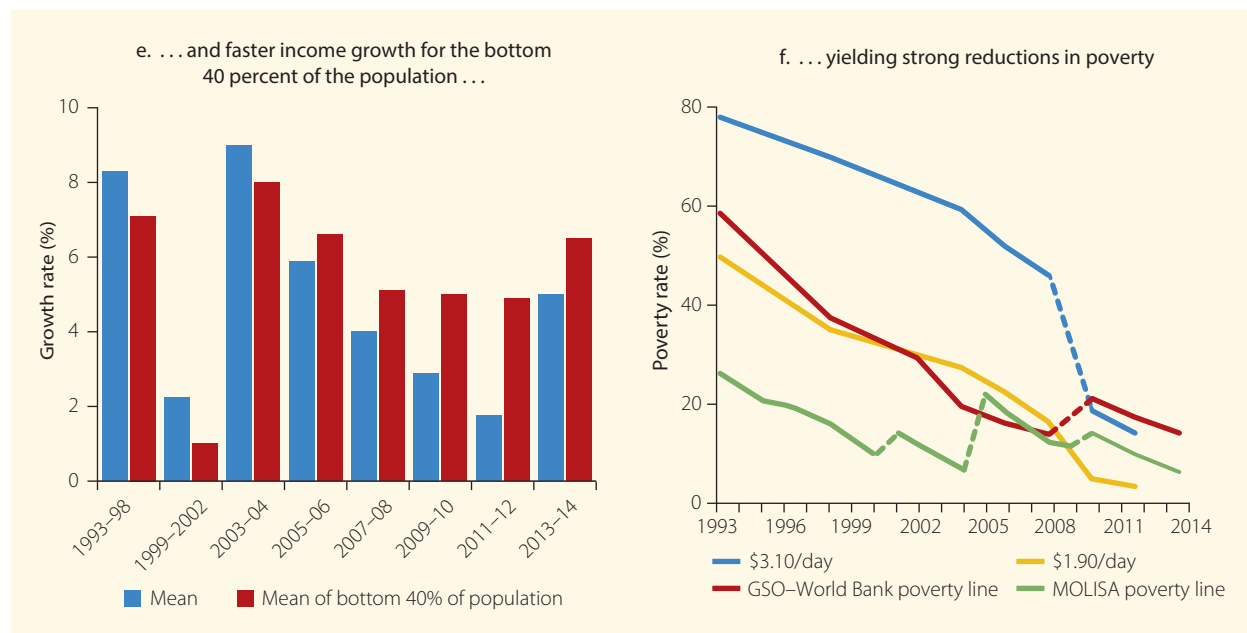
Less than three decades after the start of the *Đổi Mới* reforms, Vietnam has built up an impressive record of strong economic growth that has also been equitable and stable, as shown in figure O.1. GDP growth per capita has averaged 5.5 percent a year since 1990 (panel a), yielding a three-and-a-half-fold increase in average income. Only China performed better. Growth has benefited from its remarkable stability (panel b) and a strong external orientation of the economy. External trade

FIGURE 0.1 Rapid and inclusive growth in Vietnam has yielded shared prosperity and strong gains in poverty reduction



(figure continues next page)

FIGURE 0.1 Rapid and inclusive growth in Vietnam has yielded shared prosperity and strong gains in poverty reduction (continued)



Sources: World Bank, World Development Indicators; the General Statistics Office of Vietnam (GSO); Penn World Table 8.0; and authors' calculations.

Note: Dotted lines in panel f indicate periods when substantial changes were made to poverty lines or methodologies. MOLISA = Ministry of Labour, Invalids and Social Affairs; PPP = purchasing power parity.

has been a major driver (panel c), much of it powered by strong foreign direct investment, with the stocks standing at more than \$250 billion, sourced from a diverse group of more than 100 countries. And growth has been inclusive, as seen in a fairly small increase in the Gini coefficient (panel d) and the faster income growth of the bottom 40 percent (panel e). As a result, poverty has fallen rapidly (panel f).

Vietnam in 2015 is an unrecognizably transformed, dynamic, middle-income economy. Social outcomes have improved dramatically across the board. Using a variety of international and national poverty lines, poverty has fallen rapidly since the launch of *Đổi Mới*. The \$1.90-a-day poverty rate fell from 50 percent in the early 1990s to 3 percent today. Not only are incomes

higher, the Vietnamese population is better educated and has a higher life expectancy than most countries at a similar per capita income. In recent international tests Vietnamese students outperformed the average for countries in the Organisation for Economic Co-operation and Development (OECD), with remarkably little variation across income groups and urban-rural locations. The maternal mortality ratio has fallen below the upper-middle-income country average, while under-five mortality has fallen by half, to a rate slightly above that average. Access to basic infrastructure has also improved substantially. Electricity is now available to almost all households, up from less than half in 1993. Access to clean water and modern sanitation has risen from less than

50 percent of all households to more than 75 percent.

In some areas, however, Vietnam has fallen short. Labor productivity (output per worker) growth has been on a declining trend since the end of the 1990s, seen across most industrial subsectors, as well as in mining, finance, and real estate. In agriculture, labor productivity has grown robustly, but its level is still lower than in most of the region's middle-income countries. With almost half the workforce still engaged in agriculture, Vietnam has too many workers on its farms. Remedies include consolidating agricultural landholdings (which are too fragmented and small) and moving farmers to the more productive industry and service sectors. But it does not help that job creation in manufacturing has plateaued at a relatively low level and that services involve mostly informal activity.¹⁰

Although Vietnam has avoided the large increases in inequality in other fast-growing countries, the differences between rich and poor are still significant. While members of ethnic minorities have experienced gains in welfare since the early 1990s, they face a growing gap relative to the majority population. With 15 percent of the population, they now make up half the poor. And in recent years, progress for ethnic minorities has stalled on poverty reduction, child mortality, and nutrition. Many ethnic minority citizens remain largely disconnected from the country's larger economic success.

Growth has to a large extent come at the cost of the environment. Vietnam's greenhouse gas emissions have grown the fastest in the region, while the environmental quality of its air, land, and

water has deteriorated considerably. Water and air pollution have reached serious levels, especially near Hanoi and Ho Chi Minh City, posing major health risks. In addition, a large part of Vietnam's protective mangrove forests has been destroyed, while overfishing has seriously depleted the nearshore fisheries, posing threats to livelihoods. Removing natural forests in some upland areas has contributed to more frequent and severe flooding of lower altitude farms and human settlements. Finally, Vietnam is one of the world's most vulnerable countries to climate change, with adaptation challenges accordingly severe, especially in the Mekong Delta. With almost all large-scale hydropower potential tapped and with limited development of other renewable sources, greater reliance on coal is a growing threat to environmental sustainability and to energy security.

Last but not least, Vietnamese institutions have failed to keep up in important ways with the needs of an increasingly demanding market economy and rising aspirations of a growing middle-class society. In particular, the country's unique history has produced public-sector institutions that are commercialized and vertically and horizontally fragmented and that face insufficient scrutiny by citizens. Despite reforms, the state is still strongly engaged in economic activity—directly through state-owned enterprises (SOEs) and indirectly through very close links with an exclusive segment of the domestic private sector. State fragmentation arises from the lack of clear hierarchy and assignment of roles and responsibilities both within the central government and between the center and the provinces. The ab-

sence of a merit-based management of public servants exacerbates the gaps in public institutions. Election processes and mechanisms for engaging citizen organizations are not robust enough to provide true citizen representation, and Vietnam lacks a system of effective checks and balances between the three branches of government.

Opportunities and Risks

Global megatrends and external risks and opportunities

Vietnam's location on the eastern-most edge of the Indochinese peninsula makes it a vital link between East, Southeast, and South Asia. The physical connection to these Asian regions and the maritime connections to the rest of the world have shaped Vietnam's history and will remain crucial for its future. But geography very likely will not be destiny in the same way that it was in the past. After all, the hyperconnectivity of the modern world (which Vietnam has signed on to) overcomes many of the binds of geography. Moreover, future opportunities and risks are projected to be largely supraregional. That will require geopolitical and economic outreach well beyond the neighborhood.

Four global megatrends will be important for Vietnam to consider in the next two decades:¹¹ geopolitical, economic, technological, and climatic.

Geopolitical megatrends

The current shift in the world's economic and geopolitical axis from west to east and from north to south will define the coming decades. The rise of China is particularly significant.

The geopolitical shifts will, however, be even more complex. Other regional powers—including developed economies such as Japan and the Republic of Korea, and emerging powers such as Brazil, India, Mexico, the Russian Federation, and Turkey—are also likely to try to expand their own spheres of influence.

The emergence of a multipolar world order would give rise to multiple possibilities, among them more such collaborations as the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank of the BRICS states (Brazil, Russia, India, China, and South Africa). There could also be tensions or even conflicts among the rising powers, or among rising and existing powers.

Cooperative relations with a rising China will remain essential. Vietnam is one of the signatories to and founding members of the AIIB. Its infrastructure financing needs over the next several decades will run into tens of billions of dollars a year. With most bilateral partners reducing their presence in Vietnam, the AIIB could cover some of the emerging financing gap.

Of the geopolitical risks particularly relevant for Vietnam are maritime issues with China that go beyond just territorial concerns. The maritime waters have considerable economic and strategic value, containing a wealth of fish stocks and energy and mineral reserves. They are also critical for shipping and communications. With the Middle East in turmoil, the geopolitics of energy will also have implications for Vietnam both as a producer and exporter of crude oil and as a rapidly growing consumer of petroleum products.

In the midst of this fast-evolving world order, Vietnam will need to continue building its alliances judiciously with a clear eye on its long-term economic and political interests.

Global economic megatrends

The global economy is projected to grow at an average of 3.2 percent annually between 2015 and 2035, with continuing expansion in trade integration, urbanization, and technological advances the main drivers. The rise of China, India, and members of the Association of Southeast Asian Nations (ASEAN) matched by the (relative) decline of the United States, Europe, and Japan would be the most apparent shift in the global economic structure in coming decades.¹² China clearly is the biggest part of this story. In this report's projections, it would overtake the United States as the world's largest economy (in market prices) around 2032. It has been the world's largest exporter since 2009, and the second-largest importer of goods. It is set to become an important source of investment financing for emerging economies, particularly regionally.

Trade with China already accounts for 20 percent of Vietnam's total, up from 10 percent in 2000. The significant flow of foreign direct investment coming into Vietnam is linked, in part, to a shift in low-wage production from China. As real wages in China continue their sharp rise, many of its production bases will continue to look southward in search of lower wages—the “China+1 strategy.” Vietnam's proximity to southern China, home to many of these production networks, gives it a meaningful competitive edge. Produc-

ers can benefit from its low wages and from being part of the Chinese supply chains at the same time—a highly attractive combination. The agglomeration of a nascent electronics-industrial cluster in the north-central parts of Vietnam (around Hanoi) is an early sign of these possibilities. Moreover, with a rapidly emerging middle class, the Chinese consumer market (the world's fastest growing) will be increasingly attractive for Vietnamese producers.

Growth prospects in East Asia will also be underpinned by the ongoing shift toward multilateral (often regional) trade agreements. The ASEAN integration—starting with the ASEAN Economic Community that became a functioning trading bloc in 2016—can bring considerable economic benefits. Estimates for Vietnam range from a 1 to 3 percent cumulative increase in national income.¹³ Even so, ASEAN integration is seen in Vietnam as a stepping stone for locking in even more promising partnerships beyond the region.¹⁴ Especially noteworthy is the TPP. Also significant are the Free Trade Area of the Asia-Pacific and the Regional Comprehensive Economic Partnership, each in less advanced negotiations than the TPP.

The TPP agreement includes the world's largest and third-largest economies (the United States and Japan), with TPP countries accounting for 36 percent of world GDP and more than a quarter of all world trade. Vietnam is well positioned to benefit. According to this report's analysis, implementing the TPP could add a cumulative 8 percent to Vietnam's GDP by 2035. Others have estimated double-digit gains for Vietnam, many times larger than

for any other TPP country.¹⁵ Vietnam could also usefully leverage commitments under the TPP to lock in policy reforms that might otherwise be politically harder to carry out.

Top-down multilateral trade integration is likely to be complemented by important subregional collaborations, including that within the Greater Mekong Subregion. Dwindling and increasingly unpredictable water supplies along with a rising demand for water and energy will require greater regional cooperation for energy and water security.

New technological and business megatrends¹⁶

Technological innovations, fueled and supported by the information revolution, will disrupt production and trading patterns across the world. Advances in digital technologies ranging from three dimensional (3D) printing, programmable microcontrollers, and second-generation computer numerical control milling and routing make it easier and less expensive to manufacture customized high-quality products. Major advances in renewable energy (particularly solar) are posing a growing challenge to conventional and usually environmentally more damaging energy sources. Next-generation genome sequencing and other advances in the biomedical field are set to open a trillion-dollar industry in the next decade, enhancing and extending human life. Advanced robots are being deployed on shop floors at an exponential rate, boosting productivity and driving costs down.

The information revolution is also enabling major disruptive innovations

in business models. The Internet eradicates many of the information advantages of colocation and cost-sharing. Raw materials and other inputs to various degrees of preprocessing are available for sourcing on the Internet. Online platforms such as Alibaba.com, Etsy, and Maker's Row make it possible for manufacturers to search for customers without having to spend a lot on advertising and distribution. Crowdfunding sites such as Indiegogo and Kickstarter can aid in attracting finance.

For the most part, these trends bring upside opportunities. But some unintended consequences have to be managed. Skill-intensive and labor-efficient technology is set to eliminate the more routine middle-income vocations while complementing highly skilled and thus higher-income jobs. Already, new technologies have displaced handicraft producers in numerous industries ranging from textiles to metalworking. The progress of technology may also increase inequality in society, as those leveraging technology gain higher incomes. The gap between labor productivity and wages may also widen. Some even raise the specter of premature deindustrialization in the developing world, partly because of automation.¹⁷

Vietnam, with its well-deserved reputation as a dynamic and adaptable economy, can view these disruptive innovations with optimism (box O.1). But to maximize the benefits, long-term investments will have to upgrade the technical skill sets of the next generation, and the domestic business environment will have to be the focus. Some technologies will have associated risks that require careful management.

BOX O.1 Potential benefits and risks of new technologies

Solar energy. Solar energy is largely available year round, especially in southern and central Vietnam. The potential market for solar panels and water-heating systems is significant, but progress is slow due to high development costs. Solar panels have been installed in the Nha Trang and other urban areas along the south-central coast and in rural, mountainous, and other remote areas that are difficult to reach with grid electricity.

Social mobility, analytics, and cloud services. These services present opportunities to catch up with the developed countries, if close cooperation among scientists, enterprises, and the government is established for the long term.

Genomics and life sciences. Potential benefits come from genetically modified foods and other advances in the life sciences. Improved varieties of corn can be used as feed to fatten hogs, which should have strong commercial prospects, especially with Vietnam forecast to consume 33 kilograms of pork per person by 2020 (more than China and the European Union). Genetically improved crops could also reduce the country's feed imports, which quadrupled

between 2011 and 2014. Environmental and consumer groups are demanding more transparency on health risks and increased regulation of such products.

E-commerce. Opportunities are abundant, as foreign companies enter the market and local e-commerce firms consolidate. E-commerce sales were estimated at more than \$15 billion in 2015, driven by rapid Internet uptake and even faster adoption of smartphones. A lack of apps for purchasing online, slow online payment growth, and concerns over the security of online purchases need to be rectified, and logistics services for traceable and timely shipping of small packages upgraded. E-commerce logistics are more demanding and operationally complex than those for import-export operations—the current setup in Vietnam.

Additive manufacturing (3D printing). This technology can broaden opportunities but undermine Vietnam's traditional manufacturing. As it advances, manufacturing will likely turn small scale, widely distributed, and customizable, prompting investors from developed economies to relocate production back home.

Global climate change

Climate change is among the most consequential global issues. Greenhouse gas emissions are on a path to a 3.5–4.0 degrees Celsius (°C) warmer planet by the end of the century. Climatic conditions, heat, and other weather extremes considered highly unusual or unprecedented today could become the new normal. The impact of global climate change is already being felt, with the number of category 4 and 5 storms having risen sharply over the past 35 years. The Arctic Sea's ice has shrunk to its lowest on record, and global sea levels have risen about 10–20 centime-

ters (cm) in the past century, with an accelerating rate of shrinking. Rising sea levels increase the risk of storm surges and the fluctuations in precipitation.

Vietnam has been ranked among the five countries likely to be most affected by climate change. A high proportion of its population and economic assets are in coastal lowlands and deltas. Temperature increases in Vietnam have averaged about 0.26°C per decade since 1971,¹⁸ twice the global average.¹⁹ On current trends, annual average temperatures will (depending on the location) be 0.6–1.2°C higher by 2040 relative to 1980–99.²⁰ The pre-

dictions show intensified heat and cold waves, and 28–33 centimeter increases in sea level around Vietnam’s shores.²¹ Seasonal variability in precipitation is also projected to increase, with the wet season getting wetter and the dry season drier. Extreme rainfall and flooding would also become more likely, particularly in the northern region, including Hanoi, with increased risk of landslides in mountainous areas. A southward shift has been seen in the typhoon trajectory in the past five decades. If this continues, Ho Chi Minh City would be at greater risk of being directly hit. Coastal erosion and salinity intrusion are other unfolding risks likely to accelerate.

Agriculture, particularly rice production, is projected to be hit hard, most severely around the Mekong Delta, where much of the land area is less than 2 meters above sea level.²² Climate change could reduce annual rice production by 3–9 million tons by 2050, and highly productive areas of coffee plantations may become unsuitable for the purpose.²³ The marine ecosystems in Vietnam are also likely to be severely affected. And climate change impacts are also likely to have adverse health consequences, including water- and vector-borne diseases and diarrheal illnesses.²⁴ Flooding would compound the risks. The poor and elderly would be especially vulnerable to heat extremes, compounded by the rapid increase in Vietnam’s elderly population.

Domestic trends, risks, and opportunities

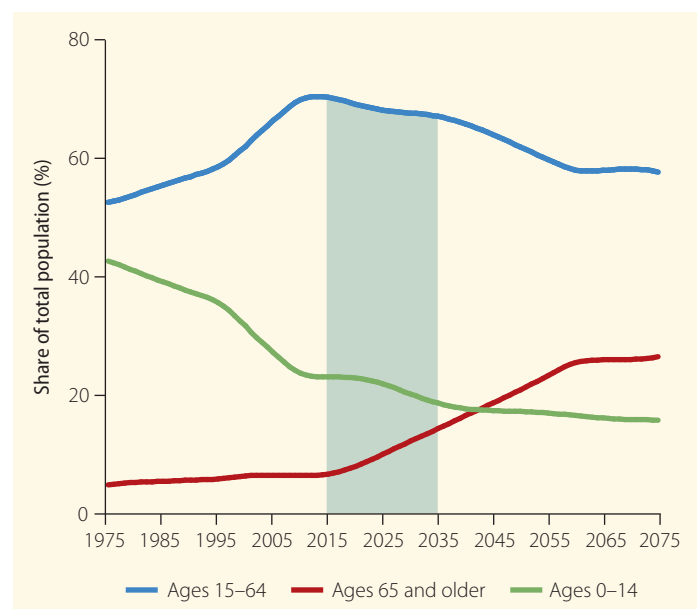
Demographic megatrends

Over the past two decades, Vietnam cashed in its “demographic dividend”—

the economic growth boost generated by a bulge in the share of the population of working age. The dividend is now nearly spent: The working-age share peaked in 2013 and is now in decline. Based on United Nations (UN) projections, the absolute number of people of working age will start to fall soon after 2035. More important, Vietnam reached a turning point in the size of its older population in 2015 and will become one of the world’s fastest-aging societies. The number of Vietnamese older than 65 years will grow from 6.3 million today to 15.5 million. The share of the population older than 65 years will rise from 6.7 percent in 2015 to 14.4 percent in 2035 (figure O.2), transforming it from a young to an aged society.

This demographic transformation has stark consequences. First, the decline in the working-age population

FIGURE O.2 The share of population over 65 will more than double between 2015 and 2035



Source: UN 2015.

will mean that a key driver of Vietnam's rapid per capita growth will diminish, making human capital deepening and other sources of productivity growth even more vital for sustaining robust growth. Second, serious fiscal challenges will be driven by the rising burden on the pension and health systems. Third, institutional arrangements for the provision of care to the old-age population will quickly become a major concern.

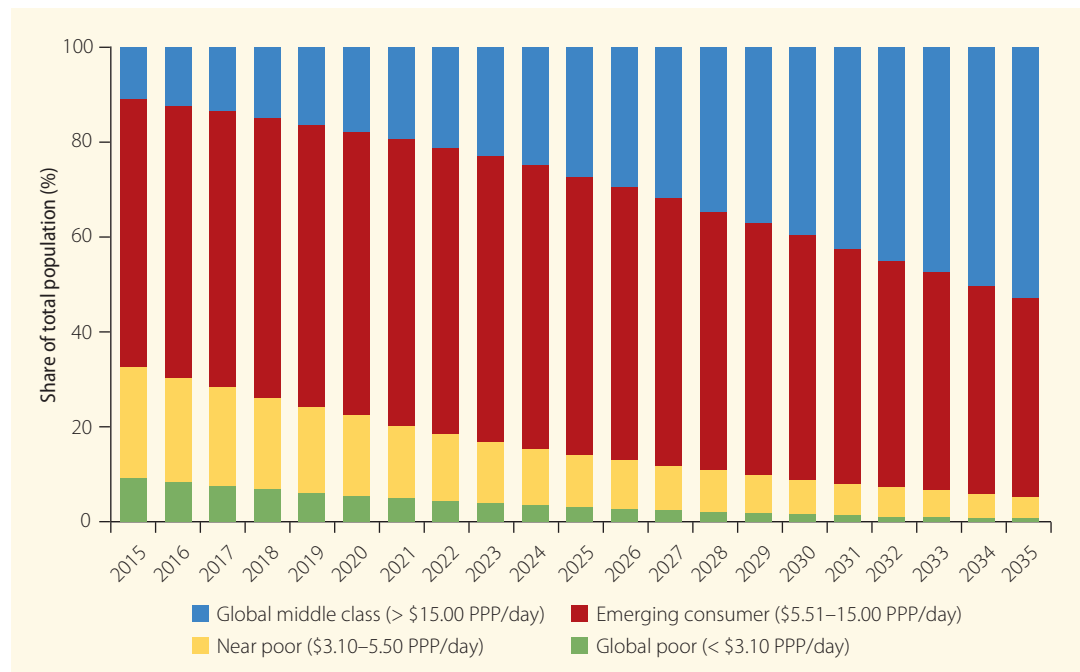
Vietnam's emerging middle class

Vietnam's rapidly emerging middle class, also increasingly more urban, will offer another significant opportunity. Vietnam is a country of 90 million people, the 14th most populous on the planet. Its \$200 billion economy is

likely to be close to the trillion dollar mark (in 2015 prices) by 2035, with more than half the population projected to join the ranks of the global middle class with consumption of \$15 a day or more in 2011 purchasing power parity (PPP) terms (figure O.3), compared with 11 percent today, giving new potency to the domestic market as a driver of growth.

In addition to being a major opportunity, a rising urban middle class will shift expectations and bring new challenges. The majority of that population will aspire to formal jobs and will want to gain high-quality skills through tertiary education. And the expansion of wage employment without well-functioning industrial relations institutions will expose the economy to the

FIGURE O.3 By 2035, more than half the Vietnamese population will enter the global middle class



Source: Vietnam Household Living Standards Survey 2014.

Note: Figures here reflect the projected distribution of per capita consumption, based on 2014 VHLSS data, assuming 4 percent annual growth in per capita consumption. PPP = purchasing power parity.

risk of substantial worker-employer conflict, evident in the large increase in strikes since 2006. The urban middle class will also demand greater political openness and more accountable government, which the existing system would struggle to meet.

Unfinished economic modernization agenda and rising political economy challenges

Perhaps the biggest and most important opportunity—necessary for all other opportunities and to mitigate risks—lies in completing the unfinished economic modernization and structural transformation agenda. Part of this relates to maximizing the gains from the ongoing structural transformations that have been a major contributor to growth since the early 2000s. With agriculture still accounting for almost half the labor force, and with significantly lower labor productivity than in the industry and services sectors, future gains from structural transformation could be substantial.

The transformation from state to private ownership of the economy is even less advanced. The state-owned enterprises and commercial banks continue to inhale too much oxygen out of the business environment, undermining economywide efficiency and crowding out the productive parts of the private sector. The state also wields too much influence in allocating land and capital, giving rise not only to opportunities for corruption by handing over arbitrary power to officials but also to heavy economywide inefficiencies. So, adjusting the role of the state to support a

competitive private sector–led market economy remains a major opportunity. And while global integration has advanced well, with Vietnam embedding itself in global value chains, the benefits are constrained by the absence of linkages with domestic firms.

Many policy actions to grasp these opportunities are well known. What has been mostly lacking is follow-up action. It may well be that the political economy of some of the needed reforms has become a binding problem. Reforms are likely to face greater resistance than in the past, from interest groups that perhaps have more to lose now than 25 years ago. And the benefits are more uncertain than they were when reforms warded off widespread economic crisis. Deploying home-grown and politically feasible solutions—a strength of the first-generation reforms—will remain important for next-generation reforms.

Aspirations for 2035

By 2035, 60 years after Reunification, Vietnam aspires to become a modern, industrialized economy—next in a succession of East Asian economies to have made the transformative journey to upper-middle or high-income status. The many achievements since the launch of the *Đổi Mới* reforms have certainly contributed to the ambitious goals. The strong record of regional peers such as the Republic of Korea, Singapore, Malaysia, China, and Taiwan, China—together with the fear of being permanently left behind in the region—has further fueled Vietnam’s ambitions. There is still an inherent desire to “catch up” with the world and

the modern institutional norms of OECD countries for living standards, the rule of law, and creativity, as reflected in the broad aspirations for 2035 (box O.2). Vietnam has also signed up to the UN's Sustainable Development Goals (SDGs), which set a

comprehensive global development agenda for the next 15 years and will give more concrete shape to some of Vietnam's key long-term goals.

The Ninth Party Congress adopted the phrase “socialist-oriented market economy” as the official way to de-

BOX O.2 Aspirations for 2035

Vietnam's aspirations may be broadly defined in the following ways:

- *A prosperous society that will be at the upper reaches of upper-middle-income status.* Its market economy will be private sector-led, competitive, and intensively integrated with the global economy. Modern industries and a knowledge-based economy, housed in an efficient and well-connected network of modern cities, will drive growth.
- *A modern, creative, and democratic society will be the driving force for future development.* The emphasis will be on creating an open and free environment that promotes learning and innovation for all citizens, who will be guaranteed equal access to development opportunities and the freedom to pursue their vocations, while fulfilling their responsibilities without compromising national and communal interests.
- *A rule-of-law state will be effective and accountable.* It will clarify the relationship between the state and the citizenry and between state and market. It will perform its basic functions effectively, including developing and enforcing legislation; managing international relations; ensuring public safety and national security; and ensuring that markets function freely while addressing market failures. It will develop strong social institutions to ensure that the power belongs to the Vietnamese citizens and protect their right of pursuing creativity. It will develop clear lines of responsibilities between the legislative, judiciary, and executive branches for adequate checks and balances on the government.
- *The National Assembly will comprise full-time deputies with the technical capacity and institutional autonomy to represent the sovereign people, exercise oversight over the executive, and pass quality legislation.* The judiciary will similarly be suitably positioned, with autonomy and strong capacity to resolve disputes in a more diverse society and economy. The executive will be well integrated horizontally and vertically, with clear functions for central and subnational authorities.
- *A civilized society will make every citizen and every political and social organization (the entire political system) equal before the law.* Underpinning this will be robust, diverse people's social organizations that can exercise fundamental rights, including the people's direct democratic rights and the rights to information and association.
- *A responsible member of the global community of nations will build global alliances and fulfill global responsibilities for peace and security while proactively seeking regional and global opportunities for economic integration.*
- *A sustainable environment will protect the quality of Vietnam's air, land, and water.* It will build climate resilience into economic planning, social policy, and infrastructure investments to reduce the most severe risks posed by climate change. It will develop diverse, clean, and secure energy sources.

scribe Vietnam's economic system in April 2001, codified in the 2013 revision of the constitution. The 2011–2020 Socio-Economic Development Strategy set forth the objective “to become a basic industrialized country with the foundation of a modern and industrial country by 2020.”

Despite broad acceptance, the precise definition of the term “modern and industrial” economy has not been announced.²⁵ While any definition would be arbitrary, this report sets forth five specific quantitative criteria for meeting that objective:

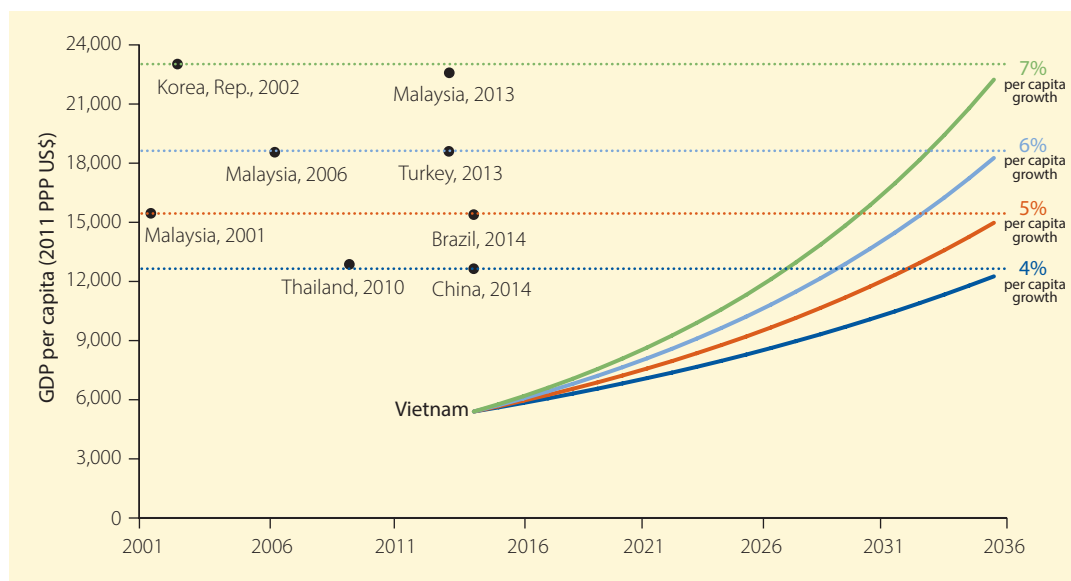
- A GDP per capita of at least \$18,000 (in 2011 PPP),
- A majority (over 50 percent) of the Vietnamese population living in urban areas.
- A share of industry and services in GDP at more than 90 percent

and in employment at more than 70 percent.

- A private-sector share in GDP of at least 80 percent.
- A score of at least 0.70 on the UN's Human Development Index.

How well is Vietnam positioned to become a modern, industrial economy by 2035? Its GDP per capita—at \$5,370 (in 2011 PPP) in 2014—would need to grow at a minimum of 6 percent a year to reach the \$18,000 mark by 2035 (figure O.4). This would be significantly higher than the average per capita growth rate of 5.5 percent between 1990 and 2014—and well above the 3.8 percent average for all middle-income countries over the same period. A lower and more feasible (but still ambitious) per capita growth rate of 5.0 percent (Vietnam's average over the last 10 years) would take its GDP per capita to just under

FIGURE O.4 Income per capita growth scenarios for Vietnam to 2035



Source: World Bank, World Development Indicators and authors' calculations.
Note: PPP = purchasing power parity.

\$15,000 by 2035 and put Vietnam on par with Brazil in 2014, well poised to reach \$18,000 by 2040. A growth path of 7 percent (Vietnam's aspirational growth target) would take per capita GDP to \$22,200, roughly the income of the Republic of Korea in 2002 or Malaysia in 2013. This higher growth rate would also enhance Vietnam's chances of catching up with Indonesia and the Philippines.

Also in 2035, at least 54 million of Vietnam's 108 million citizens would be urban residents, almost 25 million more than today. The urbanization rate, now at around 33 percent, would need to increase 2 percent a year to meet this target, matching the pace of the past 20 years. The nonagriculture sector has grown at twice the pace of the agriculture sector since 1990. This 2:1 ratio of growth rates is also projected over the next two decades, even with agriculture growing at its potential 3.0–3.5 percent. That would ensure a 90 percent share of the nonagriculture sector in the economy. The 80 percent private-sector share in GDP, if feasible, would involve a departure from the past. With the share of the public sector in GDP stuck at around 33 percent since the onset of the *Đổi Mới* reforms, this would involve a more meaningful attempt to restructure the SOEs (including equitizing bigger chunks of them) and providing a bigger stimulus to the private sector.

Thirty years of *Đổi Mới* reforms have brought many successes. Vietnamese development aspirations for 2035 are bold and significant, but the challenges and risks facing the country are also enormous. In order to achieve

the aspirations, six transformations or breakthroughs will be essential:

- Enabling economic modernization with a productive and globally competitive private sector firmly in the lead
- Building the country's technological and innovative capacity for a creative society
- Managing urbanization and other forms of spatial transformation to achieve economic efficiency
- Charting an environmentally sustainable development path with enhanced capacity for climate resilience
- Promoting equality and inclusion of the marginalized groups for the development of a harmonious middle-class society
- Building a modern, rule of law state with a democratic society and a fully established market economy

The six breakthroughs serve as the foundation for realizing the 2035 aspirations, and may be summarized in three pillars: economic prosperity, balanced with environmental sustainability considerations; equity and social inclusion; and a rule-of-law state, marked by high capacity and accountability. The rest of this report is organized around these three critical aspirations for 2035. It covers both the feasibility and challenges of realizing these aspirations under current conditions and lays out a pathway for reform to enhance the prospects of meeting the 2035 goals. Details of the six breakthroughs are presented in Part II of the final report.

Pillar 1 Economic Prosperity with Environmental Sustainability

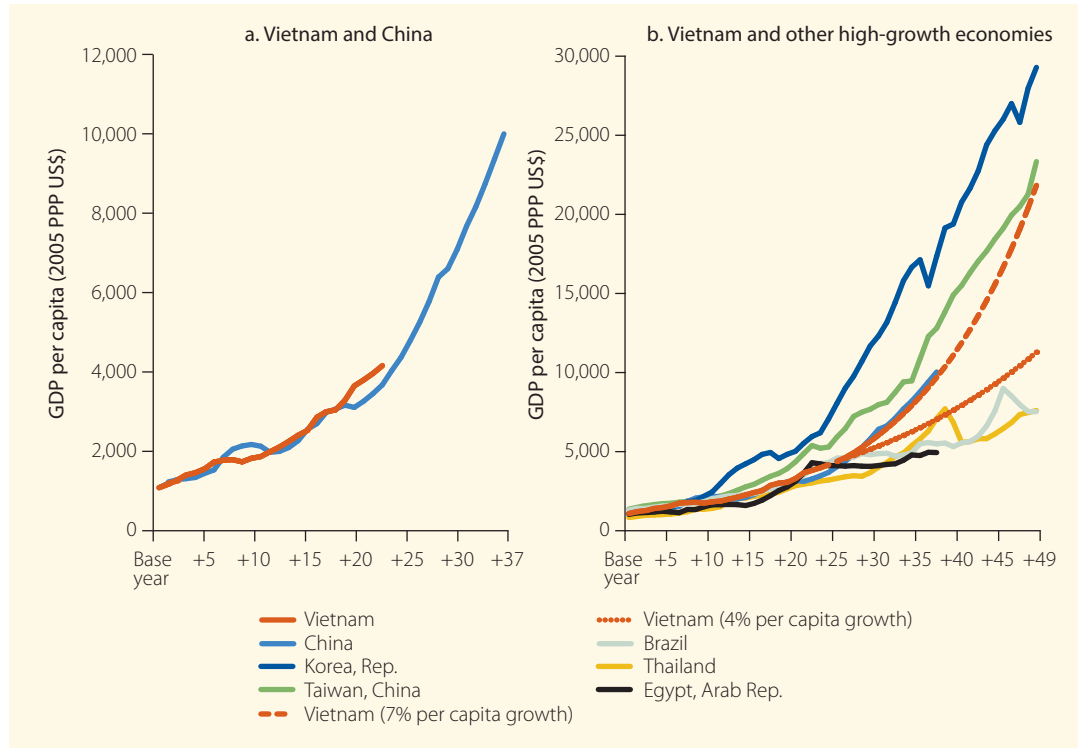
Vietnam is on a trajectory of rapid growth. Past performance has stoked ambitions of even faster growth over the next 20 years, and Vietnamese leaders are keen to see per capita growth accelerate from its average of 5.5 percent since 1990 to around 7.0 percent. This will require the ratio of gross capital formation to GDP to pick up to around 35 percent (from 31 percent currently) and stay at that level for at least a decade—and the gross national savings rate to stay at 35 percent. But, above all, productivity growth, which has been on a long-term declining trend, will require greater attention.

The reform agenda will be demanding, given that the decline in productivity growth has been broad based. The government will need to prioritize reforms with more immediate payoffs such as strengthening the microeconomic foundations of the market economy. The reforms with medium-term impacts would support ongoing structural transformations and the deepening of global integration by developing a market-oriented and commercialized agriculture sector, strengthening Vietnam's position in global value chains, and building more resilient and credible macroeconomic institutions. Those with longer-term gestation would seek to create more robust learning and innovation structures, promote efficient urban agglomeration, and ensure environmental sustainability.

Vietnam's Long-Term Growth in a Global Perspective

“Catch-up growth”—in which latecomers benefit from investment and transfer of technology and know-how from the richer countries—has produced extraordinary episodes of economic success in East Asia and elsewhere since the end of World War II. Some economies—like Japan, the Republic of Korea, Singapore, and Taiwan, China—sustained high growth for some five decades and were propelled to high-income status. Others—like Brazil, the Arab Republic of Egypt, Indonesia, Mexico, and Thailand—showed promise for two or three decades, but then became mired in the “middle-income trap.” China's ascent, albeit incomplete, seems on a trajectory similar to the first group's—and to Vietnam's.

Having grasped the catch-up opportunities, Vietnam is strongly positioned on its long-term income trajectory relative to its global comparators. A long-term comparison with China is striking on two counts. First, growth accelerations in both countries, although 13 years apart (starting around 1977 and 1990), begin at roughly the same per capita income of around \$1,100 (2005 PPP). Second, 24 years into its growth acceleration (2014), Vietnam had kept up with China over the equivalent period (to 2001) (figure O.5, panel a).

FIGURE O.5 Keeping on course for catch-up: Vietnam and global comparators

Source: Authors' calculations based on data from Penn World Table, Version 8.0.

Note: Base years are 1951 for Taiwan, China, and for Brazil; 1958 for Thailand; 1962 for the Republic of Korea; 1969 for the Arab Republic of Egypt; 1977 for China; and 1990 for Vietnam. PPP = purchasing power parity.

The story remains broadly similar when looking at other successful economies (those with at least a three-and-a-half-fold increase in per capita income in the first 25 years of their growth accelerations) and considering a 50-year period. The starting points for the growth accelerations were close, with Thailand at \$835 (2005 PPP) at the lower end and Taiwan, China, at \$1,365 at the upper end. About a quarter century into its growth acceleration, Vietnam's position is broadly at par with those successful economies (figure O.5, panel b).

What happens from here on is even more important. At roughly 25 years

into their growth accelerations—where Vietnam is now—the economies that made it into the high-income ranks pulled ahead of the rest. The Republic of Korea and Taiwan, China maintained their growth records of the first 25 years over years 25–50, but Brazil, Egypt, and Thailand started to see growth rates fall.

Vietnam is thus seemingly at a critical juncture. Decisions at this stage matter for meeting long-term income aspirations. If the country can carry out the reforms to pull up its GDP growth to its 7 percent per capita target, it would match the trajectory of China and by 2035 stand a strong

chance of reaching the incomes of the Republic of Korea and Taiwan, China in the early 2000s. At the higher reaches of upper-middle-income status, it would be strongly positioned for the final ascent to high income. It would also have a stronger chance of catching up with or even overtaking its middle-income neighbors such as Indonesia and the Philippines. But if Vietnam's per capita growth slips to around 4 percent a year, that will be good enough only to take its average income close to that of Thailand or Brazil today, and its chances of catching up with the neighboring wealthier middle-income countries would be lower.

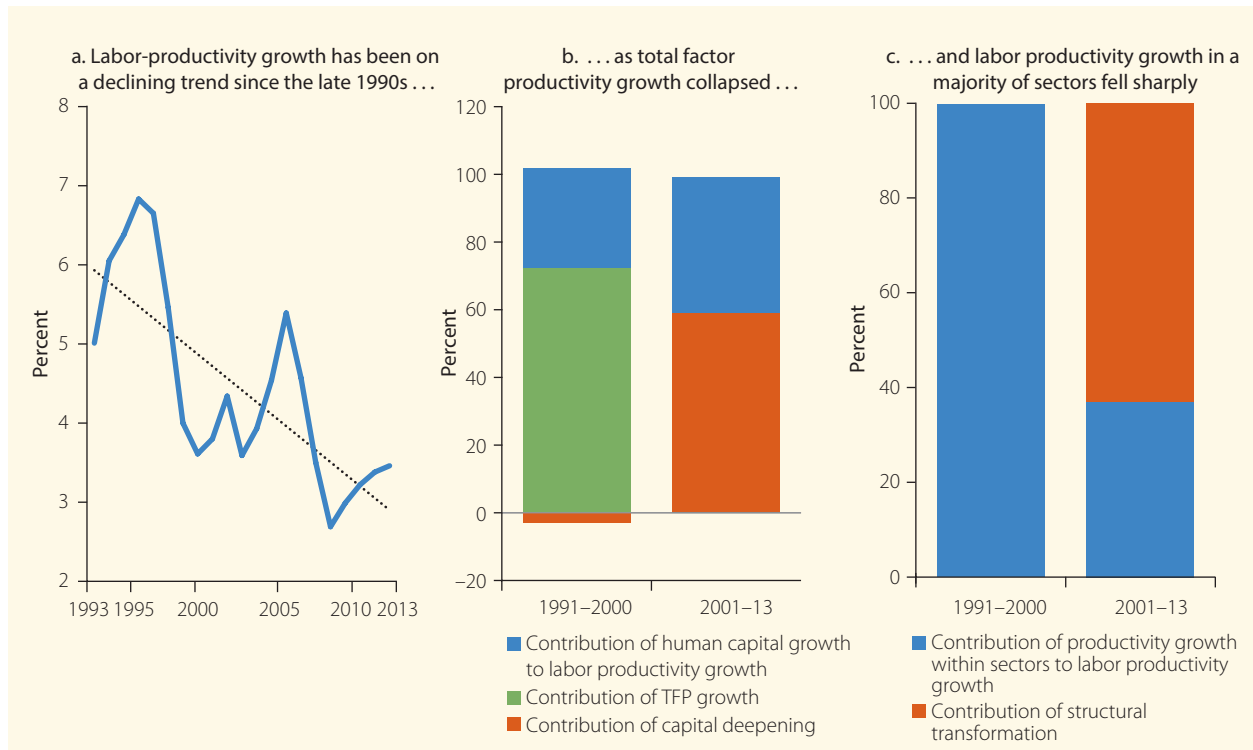
What will determine Vietnam's path? Productivity is fundamental. Economists generally agree that countries' inability to break out of the middle-income trap (whether or not they have been growing fast) is almost entirely attributable to stagnating productivity.²⁶ Summarizing the importance of productivity in development economics, Nobel Prize-winning economist Paul Krugman notes, "Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker."²⁷ Here, though, the story becomes less rosy for Vietnam.

Trends in Productivity Growth— A Cause for Concern

Behind Vietnam's impressive growth since 1990 are some worrying signs. Two stand out in comparing the 1990s with 2000–13. First, GDP growth was a full percentage point lower in the

second period (at 6.6 percent) than in the 1990s. While this slowdown was in part a reflection of the weaker environment following the 2008–09 global financial crisis, a slowdown in labor-productivity (output per worker) growth that started in the late 1990s was also a contributing factor (figure O.6, panel a). In fact, an acceleration in labor-force growth prevented an even steeper decline in GDP growth after 2000. Second, decomposition of labor-productivity growth in the two periods shows that, since the early 2000s, the contributions of capital deepening (panel b) and structural transformation from agriculture to manufacturing and services (panel c) have picked up markedly. Conversely, growth in total factor productivity, which accounted for the bulk of labor-productivity growth in the 1990s, collapsed in the post-millennium period, and labor-productivity growth fell in a majority of the sectors. Labor productivity actually declined in mining, public utilities, construction, and finance—all sectors in which SOEs have kept their dominant role.

Driven by multiple objectives (profit not high among them) and by distorted incentives, SOEs have stayed unproductive. Measures of firm-level asset (capital and land) productivity (figure O.7) and labor productivity throughout the 2000s capture their inefficiencies. Despite a long-running (albeit uneven) SOE equitization process, the public sector's presence in production and its control over factor markets remain pervasive. The state still retains a majority stake in more than 3,000 SOEs, which account for about a third of GDP (same as in 1990) and close

FIGURE O.6 Productivity growth has been trending downward

Source: Authors' calculations based on the General Statistics Office of Vietnam data.

Note: Part a displays a 3-year moving average. In part b, capital deepening is measured as the change in the ratio of capital stock to GDP.

to 40 percent of total investment. The state sector also maintains a virtual monopoly (or oligopoly) in critical sectors such as fertilizer, mining, utilities, banking, construction, and agriculture. Under growing pressure to restructure, it has at least sought to ensure that its feeble productivity does not deteriorate further.

Domestic private enterprise gives even more cause for concern. Driven by reforms to first legalize and then facilitate private enterprise, the private sector grew exponentially after the late 1980s.²⁸ But, its growing presence has been marked by worsening productivity, so much so that there is little daylight between the productivity of labor

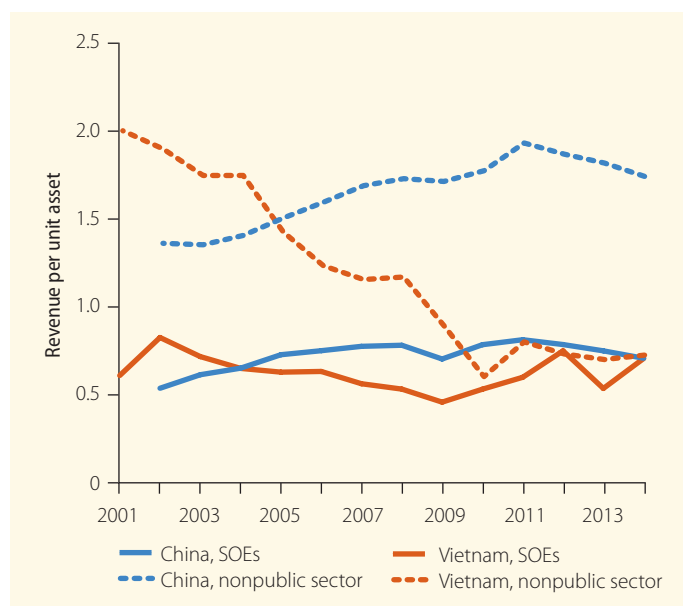
and that of assets in the domestic private and SOE sectors (see figure O.7). Vietnamese private firms, on average, were using their assets more productively than their Chinese counterparts in the early 2000s, but by 2014 their asset productivity had fallen to less than half that of their Chinese peers. Vietnamese private firms are overwhelmingly small and informal, which prevents productivity gains through specialization and economies of scale. And the relatively few large domestic private firms (especially those with more than 300 employees) tend to be even less productive than the smaller private firms (on both asset and labor productivity).

What explains these trends, and why do they differ between the two periods? The initial pickup in productivity growth in the 1990s reflected Vietnam's move toward a market-economy structure and the removal of many distortions (multiple price controls, production quotas, collectivized agriculture, trade and investment restrictions, and a ban on formal private enterprise). Most of these restrictions were lifted in the initial phases of *Đổi Mới*, with systems more friendly to the market and private sector in place by the early 1990s. These early steps gave a big boost to productivity growth across the economy.

But by the end of the 1990s the productivity gains had been exhausted and more fundamental policy and institutional constraints started to bind. Two distortions in Vietnam's nascent market economy have hurt productivity growth the most. The first is the gradual commercialization of state institutions (discussed in more detail under Pillar 3), such that the narrow commercial interests of those with connections now dominate and determine business viability. The innumerable tacit and explicit preferences handed out to firms with connections (such as all SOEs, most foreign-invested firms, and some large domestic private firms) by officials who also give inadequate attention to economic efficiency make it very difficult for many private firms to thrive, even if they are productive.

Commercialization of state institutions has produced an uneven and partial approach to market reforms, leading to two imbalances. In the first, a warm embrace of markets as the mechanism for resource allocation has coincided with a much more cautious

FIGURE 0.7 Firm-level asset productivity has declined sharply for the Vietnamese nonpublic enterprise sector



Sources: General Statistics Office of Vietnam data, National Bureau of Statistics of China enterprise data, and authors' calculations.

Note: Asset productivity is revenue per unit of assets. SOE = state-owned enterprise.

and ambiguous approach to giving up state control of production and to accepting domestic private ownership of productive assets. This has spawned an entrepreneurial business class within (or closely connected to) the state rather than outside it and permitted a continuing heavy presence of SOEs in many sectors.

In the second, the market embrace has itself been two-speed. Impressive progress in liberalizing product markets and integrating them with the global economy under international trade agreements has been accompanied by a more subdued and muddled approach to developing and liberalizing factor markets, as seen in the largely inefficient allocation of land and capital. For example, significant assets (land and capital) were accumulated in the

construction, real estate, and banking and finance sectors between 2001 and 2013, even though these sectors were among the least productive. Allocations are likely influenced by arbitrary administrative decisions and connections, at heavy economic cost—as substantiated by a considerable literature. A 2008 study finds that the allocation of bank credit is related to connections and that the most profitable private firms do not even attempt to get bank loans.²⁹ Updating the analysis to 2013, this report finds that the results hold. Provinces with a high density of SOEs provide less credit to private firms and require more time to issue land-use rights certificates than other provinces.³⁰ Easier access of SOEs to credit, land, and export quotas in the garment and textile sector has reduced the profitability and viability of private firms.³¹

Another distortion in Vietnam's market economy that has hurt productivity has been the relative neglect of building critical market institutions. The greatest weaknesses are in those responsible for protecting private-property rights and ensuring free and fair competition. These institutional shortfalls have impeded the emergence of large, competitive, private firms and further discouraged small household firms from entering the formal sector,³² even though switching from informal to formal activity can raise firms' productivity and profitability.³³

The adverse impact on the performance of domestic private firms, while unsurprising, has been substantial. With noncompetitive and state-controlled factor markets and inadequately developed formal market in-

stitutions, firms turn to informal institutions and networks and often find illegitimate means to enter the market, grow, and become more profitable.³⁴ There is no reason to believe, however, that those who are more adept at garnering political capital or exploiting connections are also necessarily better at running businesses.

A Reform Agenda to Reignite Productivity Growth

The imperative to improve productivity growth is therefore clear and strong. GDP growth since the early 2000s has been led by forces that compensated for weak and declining productivity growth but are now reaching their natural limits. Rapid labor-force growth made up for low and declining labor-productivity growth economywide. Large-scale structural transformations offset the low and declining labor-productivity growth at the sectoral level. And an acceleration in capital accumulation counterbalanced the low and declining growth in total factor productivity. In the next phase of development, each of these compensatory factors is projected to have a sharply diminished impact, exposing overall economic growth much more to the weak productivity trends. Moreover, the global context is likely to be far less hospitable than before the global financial crisis.

Vietnam's advantage is being at an early enough stage of development to reignite productivity growth without compromising its 2035 income objectives. At a similar stage of devel-

opment (the late 1970s), the Republic of Korea saw a major acceleration in its labor-productivity growth, which is encouraging since it suggests that a turnaround in such growth is possible. But it also highlights how demanding the agenda for institutional reforms is. Some of that country's reforms launched in the late 1970s and early 1980s—macroeconomic stabilization, agricultural modernization, and greater emphasis on competition and market deregulation—strongly and quite quickly helped improve productivity growth. But others—in the areas of higher education, research and development (R&D), and urbanization—operated with a significant lag, having begun many years earlier.

Reforms in Vietnam would need to be not only comprehensive (given its broad-based slide in productivity growth) but also carefully sequenced with a fixed eye on long-term growth. The agenda, accordingly, can be broken down into three broad (and overlapping) time horizons.

- *Reforms with immediate impacts.* Strengthening the microeconomic foundations of the market economy would have to be the immediate priority, with the payoffs most significant over the next five years. This should help stem the declining trend in productivity growth and, by enabling greater and more efficient participation of the private sector, provide a strong growth stimulus for the next decade or so.
- *Reforms with impacts in the medium term.* These would comprise measures that are also carried out with-

out delay, but their impact would be felt the most between years five and ten. These would aim to support the ongoing structural transformations and deepening of global integration (including the capital account) by modernizing and commercializing agriculture, strengthening Vietnam's position in global value chains, and building more resilient and credible macroeconomic institutions.

- *Reforms and investments with impacts mostly in the long term.* These could be phased in over the next two or three years, with payoffs expected only with a significant lag. They take into account the fact that the current growth model (supported by the short- to medium-term reforms) is likely to start hitting diminishing returns no later than a decade or so from now, as the economy reaches the upper-middle-income level and environmental degradation reaches its limits. The longer-term focus would be on spurring learning and innovation, promoting urban agglomeration, and ensuring environmentally sustainable development.

The impacts of the reforms are not mutually exclusive. Functioning land markets and strong microinstitutions will be just as important after a decade as they are in the next three years, although the short-term impact will be felt more acutely because of the current distortions that will get eliminated. Elements of stronger macroeconomic institutions will be needed in the next two or three years to ensure fiscal consolidation and greater efficiency of spending. The environmental agenda

can also have some immediate payoffs through more efficient pricing systems that internalize environmental costs.

Reforms with immediate impacts—strengthening the microeconomic foundations of the market economy

The immediate priorities have to be stronger microeconomic market-economy foundations. SOE reforms stay an important part of this agenda, but are no longer enough: creating better enabling conditions for the private sector, such as strengthening market institutions and liberalizing factor markets, takes precedence.

Strengthening market institutions

The evidence is compelling that well-functioning markets require well-defined rules of the game, enforced transparently and predictably. The agenda calls for strong market institutions whose role is especially important in the early phases when markets are underdeveloped and small distortions can have amplified effects. The emphasis in Vietnam will have to be on enforcing competition policies and ensuring the security of property rights. Restructuring the SOE sector and leveling the playing field for all enterprises—private or public, domestic or foreign—is an important part of this agenda (discussed under Pillar 3).

Liberalizing factor markets

Vietnam's financial sector is still relatively underdeveloped, with the banking sector saddled with deep-seated structural problems and capital mar-

kets still in their infancy. Land markets are even less developed and complete. Moreover, as noted, state influence on credit and land allocations seems excessive, leading to significant economic inefficiencies. Labor market regulations are less onerous (Pillar 2), but even those are not free of policy concerns. The *hộ khẩu* household registration system (which, among other problems, impedes rural–urban migration) is less burdensome than in earlier years but still imposes efficiency costs (Pillar 2).

Building financial markets

The financial sector has expanded rapidly since the early 1990s, but still has wide scope to take on an even bigger role. It has done a reasonably good job of mobilizing savings but fallen short in allocating credit to its most productive uses and providing an inclusive payment system. Much of the lending, especially by state-owned commercial banks, has gone to SOEs, or increasingly to private companies with connections, crowding out lending to productive segments of the domestic private sector. Financial inclusion has increased since the early 1990s, but remains an issue for less well-off Vietnamese, especially those in rural areas.

The banking sector is struggling, having taken a big hit after the global financial crisis toppled the real estate market (where the banks had heavy exposure). Banks' average return on assets has fallen steeply since the crisis (from 1.8 percent in 2007 to 0.5 percent in 2012). Their reported nonperforming loans (NPLs) have risen and are generally considered understated. And their provisions are lower than in middle-income peer countries in East

Asia. Many of the NPLs and restructured loans are related to SOEs. Moreover, cross-ownership of banks by each other and by enterprises (including SOEs) remains significant. Compliance with Basel Core Principles is improving but still low, and many banks lack Basel II's capital requirements for market and operational risks—even as the country looks to move toward Basel III. On-site inspections, particularly of the state-owned commercial banks, have been limited, and consolidated supervision of banks is lacking. Off-site monitoring also needs to be improved.

Three items are on the agenda for the financial system over the next 20 years.

Reducing the risk of major financial crisis. Vietnam's response to potential financial crises could be accelerated if the government strengthens the National Monetary Advisory Council. The council could meet regularly, supported by a dedicated technical team to provide timely reports and drafts of notifications and instructions to banks. Information on the financial system could be improved by better off-site data and supervision from the State Bank of Vietnam (SBV). Improving the capacity for crisis management and the framework for bank resolution will improve the crisis response in the event of illiquidity or insolvency in the banking sector. This could be further strengthened by firming the resources of the Deposit Insurance of Vietnam (DIV) and legally enabling it to undertake a purchase and assumption transaction of failed banks' assets. This measure would require both a gradual shift in the DIV's funds from banks to government debt and legal changes that

permit the government to borrow from the SBV on behalf of the DIV in large crises, under well-defined conditions.

Developing a larger, more diverse, stable financial sector. This requires steadily increasing bank capital and developing the broader financial sector. The first challenge is resolving the large NPL overhang in banks. A good starting point would be confidential audits (including operational audits) by reputable international firms and strong application of prudential norms, without regulatory forbearance. For banks deemed sound and viable, NPL resolution would involve direct sales of collateral related to the NPLs and transfers of NPLs and collateral, under a more robust legal framework, to a strengthened Vietnam Asset Management Company for management, recovery, and sale. The banks deemed insolvent would be closed, merged with viable banks, or sold (either directly or through the company).

Improving future performance in the banking sector will depend on better enforcement of improved regulation and supervision of risks taken by banks (with closer attention to state-owned banks) and by other sellers of assets such as insurance and pension firms. One major improvement would be to apply macroprudential supervision and better off-site supervision. A second would be a gradual shift toward international regulatory and accounting norms. Moving toward Basel III would mean higher requirements for capital, including capital for market and operational risks, and reduced incentives for excessive risk-taking by banks (in a context where some banks are strug-

gling to meet even Basel II requirements). Third would be to gather more information on business groups, which could help reduce connected lending.

Deepening the capital markets (starting with the market for government debt) will also need changes to the legal and accounting frameworks to bring them in line with international standards. That would make foreign investment through the capital market more attractive. As in most developing countries, developing contractual savings institutions (such as insurance companies) has only begun in Vietnam, but their role will increase over the next 20 years as the economy modernizes. Generating investor interest in insurance companies will depend on improved clarity of company accounts, compliance with international accounting and reporting standards, improved corporate governance, and a strengthened Insurance Supervisory Authority.

Increasing financial inclusion. Vietnam has done fairly well in lending to individuals³⁵ relative to other lower-middle-income countries, but not as well in deposits and remittances.³⁶ Remittances in Vietnam tend to go through financial institutions, with much less use of mobile phones and money-transfer operators. Alternative uses of mobile phones would improve financial inclusion in remittances and deposits at lower cost. Although Vietnam would need major changes in regulation—for finance and telecommunications—this approach would take advantage of the country's large number of mobile phone subscriptions. A good international example is Kenya's M-Shwari, which launched in

2012, and by end-2014 had 9 million accounts, total deposits of \$45 million, and outstanding loans of nearly \$18 million—and its deposit holders can apply for short-term loans. Financial inclusion in Vietnam would also require higher-quality credit information on borrowers.

Developing land markets

Land, according to the Vietnamese constitution and law, is owned by the public and managed on its behalf by the state. Land-use rights for specified periods are issued to individuals, who are allowed under the law to transfer these rights to other individuals. The state may take back the land and annul the rights in the national interest, based on compensation according to law.

The overall legal framework for individual rights to land use is subject to the interpretation of numerous overlapping laws, and its implementation is equally riddled with a plethora of implementing regulations and overlapping mandates. This is just at the national level—provincial and municipal administrations issue their own instructions on land use and transfers.

The markets for trading land-use rights are, in effect, missing.³⁷ Functioning primary markets for land use rights are virtually absent. The role of the markets is played by state agencies, often using ill-defined administrative procedures. And the “price” for issuing land-use rights bears little resemblance to a true market-determined price.

Secondary land markets, more prevalent, operate under multiple constraints. Market mechanisms are rarely deployed in cases involving reclassification of land use from agricultural

to nonagricultural land. In such cases, land-use planning decisions by local administrations (and not demand-supply conditions or local preferences) determine the reclassified purpose of land use. Moreover, the “seller” or the individual giving up land-use rights, often a farmer, is unlikely to receive fair compensation: The benefit from the transaction is mostly captured by the local government and by the “buyer,” who often receives the land at prices below what a functioning secondary land market would have produced.

The missing land markets are problematic from several angles. For one, their absence, alongside weak property rights, fosters a patronage-based business model.³⁸ Their lack undermines efficiency in other ways, too. A land-use right holder who would like to change land use to a more rewarding economic activity will find the administrative costs high, often prohibitively so, and the processes time-consuming. The lack of land markets also creates distortions in urbanization patterns (see the later section “Using cities to power the drive to modernity”). The development of transparent and functioning land markets, therefore, is an important and urgent policy priority.

Reforms with impacts in the medium term—managing structural transformations and deepening global integration

The medium-term emphasis will have a threefold focus. First is modernizing and commercializing agriculture, which engages almost half the workforce in a country almost 70 percent rural. Second is strengthening partici-

pation in global value chains to maximize the chances of strong productivity gains, given the heavy and probably increasing reliance on external markets. And third is building more resilient and credible macroeconomic institutions, which will become more critical with the impending demographic shifts, huge spending needs in infrastructure and social sectors, and greater capital account integration with the global economy.

Modernizing and commercializing agriculture

A move to industrialize more deeply and modernize services is not incompatible with a sharp focus on agriculture. The sector is—and will remain for the foreseeable future—an important area of Vietnam’s comparative advantage, and will have to perform at its high potential to support economic modernization.

While the agricultural sector has progressed enormously since the late 1990s, emerging concerns over the quality and sustainability of its growth model require immediate policy attention. Sectoral labor productivity remains much lower than in comparator countries, despite rapid gains since the 1990s. The fragmented, smallholder-dominated character of sector with heavy state involvement contributes to this outcome. Another important factor is the dominance of rice in its use of the best land and much of the country’s irrigation capacity. Economic issues include low smallholder profitability, heavy underemployment among agricultural workers, uncertain food safety, low value addition, price-dis-

counted commodities in international markets, gaps in multimodal farm-to-market connectivity, limitations in storage and cold-chain logistics, and limited technological or institutional innovation. And some agricultural growth has come at the expense of the environment.

Agriculture is at a turning point. Major opportunities will be in domestic, regional, and international markets, yet the sector will no longer be able to compete on the basis of low-cost, labor-intensive natural-resource use. The sector will also face growing domestic competition—from cities, industry, and services—for labor, land, and water. Future growth will depend on increased efficiency and innovation.

Change is also needed in the structural patterns of production and supply-chain organization, which are highly fragmented, with limited collective action at farmer level and weak vertical coordination. This fragmentation has contributed to unnecessary transaction costs, unrealized economies of scale in certain functions, and poor incentives to produce and maintain higher-quality produce and raw materials. Similarly, change is warranted in the “state management” model—that is, in the technical and regulatory services provided by the state, in public investments and expenditures in the sector, and in the policies applied to foster farmer and agribusiness investment. Demand-driven agriculture needs flexibility. It cannot be centrally planned.

If Vietnam’s agriculture follows global patterns, it will see two transformations. The first will modernize production methods, change the pat-

terns of land use (such as less rice, more value-added crops, and more livestock), and increased collective action in organizing farm services. The second will modernize the agro-food system by processing agricultural commodities (crops, livestock, and harvested fish) into value-added food products.³⁹

Signs of these shifts are already emerging in some areas or corridors in the agro-food complex. But how efficiently these processes occur, how inclusive they are, how disruptive they are, and whether they follow a straight or convoluted path will depend heavily on public policy.

For example, the government could facilitate a more vibrant market for agricultural land and support farmer shifts from rice monocropping to mixed cropping, including livestock and aquaculture or other forms of specialization. It will want to deploy regulations, incentives, and facilitative services—combined effectively—to stimulate and monitor a “greener” agriculture and a system for food safety and consumer protection that inspires confidence. Supply chains capable of tracing the movement and physical condition of perishable products—like frozen fish from an origin in the Mekong Delta to a consumption market in Western Europe or North America—would contribute to strengthening both trade competitiveness and food safety. There will be greater demand for information and for technical and financial instruments, to better manage risks associated with agriculture. The government will need to facilitate these types of services. Improved educational and vocational training services, for instance, will quicken the adoption of

improved farm and post-harvest technologies. Creating and maintaining a favorable environment for agroindustrial and agribusiness investment and operations will also be critical for adding value to food products and rebranding them for quality and sustainability. Vietnam can draw on and adapt to many international examples of good practice.

The government has played a major and, in some areas, leading role in the past development of agriculture. Some of its functions—including land-use planner, farm manager, commodity trader, and technology supplier—will be less important or even detrimental as agriculture moves toward a more flexible, market-driven, and knowledge-based system. The government can undertake less direct investment in agriculture if it promotes private agricultural services and facilitates private investment efficiently, including through public-private partnerships. That should free resources to achieve excellence in applying environmental, phytosanitary, animal health, and food-safety regulations. The government will, though, have a continuing role in supporting farmer organizations, in maintaining rural infrastructure and other elements that influence farmer and agribusiness transaction costs, and in coordinating their activities.

Leveraging external trade opportunities

Vietnam has gained much from external trade. Deepening its participation in global value chains (GVCs) has given it a real headstart over other emerging market competitors for the

potentially even more rewarding opportunities from proposed multi- and bilateral free-trade agreements, such as the TPP. Not only is Vietnam's export basket much bigger than before, it is also much more diversified, reflecting a transition from exporting primary commodities to low- and medium-tech manufactured goods (apparel, furniture, and footwear), and then to more sophisticated products (machinery and electronics).

Growth in service exports, however, has been lackluster. Nor does the current GVC model in Vietnam fully exploit the opportunities. It relies heavily on foreign-invested firms operating final-stage assembly operations, with limited backward linkages to domestic suppliers in key manufacturing activities and little transfer of technology between foreign and local firms, which often lack the capacity to absorb higher technologies or jump to more sophisticated tasks or value chains. A striking feature of Vietnam's export-oriented manufacturing operations is the relatively high value of imported components going into final assembly—an estimated 50–60 percent for garment and footwear exports, for example. Most accessories and parts going into the export-oriented production of smartphones and tablets also come from abroad.

So, while retaining final-assembly production for large-scale job creation in manufacturing (at least in the medium term), Vietnam could simultaneously deepen the participation of domestic suppliers into the final-assembly process by developing more comprehensive networks of dependable tier-1 and tier-2 suppliers, as China has done.

This may better position it to begin moving into more sophisticated products in existing GVCs, increasing the value-added share in existing GVCs by moving into more sophisticated tasks, and shifting into new supply chains with higher value-added shares.

Reforms would first promote competitive private firms capable of establishing production linkages with foreign-invested firms. The key to moving up the value chain in each of the early industrializers in East Asia has been a vibrant domestic private sector. Eventually, as Vietnamese firms absorb know-how and become globally more competitive (through technological upgrading and scale economies), the country could aim for some of its firms to be at the head of GVCs, where returns are far higher. Apple, for instance, retains more than 45 percent of the wholesale price of a new iPhone as gross profit.⁴⁰ Samsung (Republic of Korea), Huawei (China), and Tata Group (India) are other examples.

The second policy imperative is to develop a modern service sector, a critical input for manufacturing, especially on the export side. This is one area where Vietnam lags behind its competitors. The absence of a functioning modern financial sector is a major handicap. Lack of access to early-stage financing limits the development of a dynamic entrepreneurship start-up ecosystem. Insurance, telecommunications, and transport and logistics are also lagging. This gap will be felt even more as Vietnam climbs GVCs and as the value content of its trade goods rises.

Service activities like R&D, design, and engineering should be developed as a way of upgrading participation in

GVCs (see the later section “Spurring learning and innovation”). Modern services are also a direct source of exports, growth, and job creation. If the country can upgrade its human capital base and its information and communications technology (ICT) infrastructure and connectivity, it can become a regional powerhouse in IT-enabled sectors.

Regulatory reforms will be essential to energize services. Foreign ownership restrictions in strategic services such as banking, telecommunications, media, electricity transmission and distribution, road freight, rail transport, air transport, and port operations are either prohibitive or much more onerous in costly approvals than they are in comparator countries.⁴¹ The restrictions need to be rationalized and eased, allowing market mechanisms to predictably allocate investment among domestic and foreign investors alike. Addressing gaps in dispute resolution is another priority. Foreign service firms are wary of the legal system, and often specify dispute settlement by arbitration in such jurisdictions as Singapore. Vietnam can also be more proactive in engaging partner countries to lower the barriers to service trade within ASEAN.

Finally, as Vietnam integrates more fully and profitably into GVCs, it can also boost its connectivity. Firms that participate in value chains need to move goods across borders cost-effectively and reliably, in order to keep inventory carrying costs low and comply with the strict requirements of lead firms for on-time delivery. Connectivity has three key attributes, each requiring policy attention.

TABLE O.1 Logistics Performance Index rankings

	Overall LPI	Customs	Infrastructure	International shipments	Logistics quality & competence	Tracking & tracing	Timeliness
Vietnam, 2007	53	37	60	47	56	53	65
Vietnam, 2014	48	61	44	42	49	48	56
China, 2014	25	27	26	10	32	23	31
Malaysia, 2014	28	38	23	22	35	29	36
Thailand, 2014	35	36	30	39	38	33	29

Source: The World Bank's Logistics Performance Index (LPI).

Institutional connectivity. The “software” side of things includes trade facilitation, structural and regulatory reforms, and transport and logistics facilitation. Vietnam performs relatively well on the World Bank's Logistics Performance Index (LPI), ranking 48 among 160 countries on the overall rating and the highest among the LMICs (table O.1), although still lagging regional upper-middle-income countries such as China, Malaysia, and Thailand. Its rankings have improved since 2007 across the board, except for customs procedures.⁴² Health and sanitation performance standards inspections are underperforming, below Vietnam's ASEAN peers.

Physical connectivity. A well-connected country has abundant and high-quality physical infrastructure, especially international gateways and multimodal interfaces, including ports, airports, road and rail links, as well as ICTs. It also includes energy, which is vital to the continued success of manufacturing firms, and can be traded among neighboring countries. Vietnam comes out well on the infrastructure component of the LPI ranking (44), but many transport aspects require attention.

Current modes are overloaded in and around the major economic clusters and these do not connect well to each other or to major trade gateways, reflecting lack of coordination to develop economic zones and transport corridors.⁴³ Key issues include poor road conditions (see the section “Using cities to power the drive to modernity”), grossly underdeveloped freight-rail and inland-waterway infrastructure, and supply-demand mismatches in deep-water maritime port infrastructure.⁴⁴ Although expressways require further investment, transport expenditures need to be rebalanced from road transport (the most costly form of domestic freight transport) to multimodal facilities (for handling and storing goods in high-capacity warehousing) to take advantage of more cost-effective modes such as rail and inland waterways. Rebalancing from capital to maintenance expenditures in transport is also needed.

People-to-people connectivity. The third attribute refers to ease of movement of people across borders (for service provision, education, and tourism). Vietnam has abolished caps on the number of foreign workers that foreign firms can hire, and has new procedures

for them to obtain work permits. Managers, executives, and specialists who enter the country as intra-corporate transferees are allowed to stay for an initial three years, subject to extension. But there is still wide scope to better meet global businesses' need to bring in specialist international staff.

Developing institutions for macroeconomic management

Stability of aggregate price levels, predictability of relative prices, and sound management of public resources are all critical for efficient domestic markets and long-term competitiveness. Vietnam has had episodes of high inflation, and public and publicly guaranteed debt has built up fast. The efficiency of public expenditure has also been low in several key areas,⁴⁵ while coordination between the main institutions of macroeconomic management, both at the center (Ministry of Finance, Ministry of Planning and Investment, and the SBV) and between central and provincial governments, is relatively weak. Resolving these emerging issues and meeting the anticipated needs of a more open and sophisticated economy require sustained investments in resilient, credible, and well-coordinated institutions for macroeconomic management.

Managing monetary policy

Some of Vietnam's peers pursue very different monetary policies but still follow sound principles. Chile, the Republic of Korea, South Africa, and Thailand pursue more classical inflation-targeting strategies, while Singapore maintains low and stable inflation by tightly managing its nominal effective exchange rate. Their central banks

have been assigned price stability as the primary mandate. An operationally independent decision-making body, following a transparent framework, conducts monetary policy. Decision makers are responsible to the government for fulfilling their mandate, and they use comprehensive model-based monetary and economic analysis to assess the policy stance and communicate their decisions.

The central lesson for Vietnam is that it needs to overcome the current multiplicity of objectives for the SBV.⁴⁶ To do this, the Vietnamese authorities can further develop the SBV's close management of the exchange rate or, preferably, focus on domestic inflation. Both options require a clear price stability mandate and swift development of operational and analytical capabilities of SBV staff. The SBV could assign the conduct of monetary policy to an operationally independent Monetary Policy Committee, which requires that a host of analytical and organizational aspects be resolved first, including requirements for appointing committee members, frequency of meetings, briefing requirements, structure of policy debate, and external communication. In taking monetary operations further, an operational target consistent with monetary policy will need to be chosen, and monetary instruments will need to be market oriented. Having a sound framework for managing liquidity and forecasting items on the central bank balance sheet is also crucial.

The SBV could pursue price stability to help safeguard macroeconomic stability if it had more operational independence. But central bank autonomy goes hand in hand with transparency and accountability. Stipulating regular

external reporting to political stakeholders and the public could ensure the SBV's accountability for its mandate. And to ensure that the conduct of monetary policy is unobstructed by concerns about fiscal dominance, the SBV would need to be prohibited from quasi-fiscal operations.

Vietnam thus needs to reduce the SBV's myriad objectives and strengthen its operational and research capacity. The current low-inflation global environment provides an opportunity for getting the monetary policy framework right before global monetary conditions tighten.

Strengthening budgetary institutions

The expected economic and social transformations over the next 20 years will give rise to complex fiscal challenges. Deeper global integration and further transition to a market-based economy will increase exposure to macroeconomic shocks and volatility, underscoring the importance of prudent macrofiscal management to maintain fiscal buffers to cope with shocks while ensuring a sustainable debt trajectory. Vietnam will also have to manage the transition from accessing mostly concessional external financing to relying on domestic and global capital markets to meet its fiscal financing needs. While broadening the scope of funding sources, this will intensify refinancing, interest-rate and exchange-rate risks, and expose the country more directly to the scrutiny of global capital markets and private creditors, placing additional demands on prudent fiscal management and transparency, and the country's creditworthiness more broadly.

The fiscal system will also be asked to adjust to profound social changes,

particularly to accommodate the emerging demands of an aging population and a rising, increasingly urban middle class (Pillar 2). These trends reinforce the importance of a budget process that prioritizes sound spending and aligns fiscal resources to evolving social needs. They also emphasize the more self-reliant and autonomous model of subnational and municipal finances.

As Vietnam embarks on the next phase of budgetary reforms, the interlinkage between fiscal policies and institutional arrangements will become even more important, pointing to four key reform priorities.

Maintaining fiscal discipline and rebuilding resilience to domestic or external shocks (or both). Public and publicly guaranteed debt, having increased rapidly over the past few years, now exceeds 60 percent of GDP. While the risks of acute debt distress remain manageable, fiscal buffers to handle future macroeconomic shocks are wearing thin, a matter of concern given rising vulnerabilities, including those potentially emanating from contingent liabilities associated with SOE debts (at about 50 percent of GDP).

Strengthening macrofiscal management requires three main institutional measures. First, a credible fiscal consolidation plan, institutionally anchored in a medium-term budget framework, is crucial to stabilize and then gradually reduce public debt. Second, the budget should be more comprehensive, since many fiscal and quasi-fiscal activities are not yet reflected in the core budgetary sphere.⁴⁷ Third, the government's debt-management function will have to be upgraded to enhance the coordination and consolidation of debt-

management responsibilities, which remain fragmented across functional departments in the Ministry of Finance, the Ministry of Planning and Investment, and the SBV.

Mobilizing resources for development.

A fair, transparent, and efficient tax system that minimizes distortions and generates adequate revenue for the budget is crucial. Vietnam's current revenue to GDP ratio—about 25 percent on average over the past 10 years—is commensurate with its income. But its continuing economic transformation will shift the revenue potential of different taxes, which tax policy needs to accommodate.

For example, trade-related revenue (about 10 percent of total revenue) will decline sharply due to commitments under free-trade agreements. In contrast, the revenue potential of personal income tax is expected to rise as wage employment formalizes. Efficient land and property taxes could become a more important revenue source, especially locally, and strengthen incentives for more efficient land use. Tax-policy reforms need to be accompanied by further modernization of the tax administration, based on risk-based compliance management and modern technologies (including e-filing). Environmental taxes should play an increasing role, not only from a fiscal perspective but also to encourage energy efficiency by reflecting the costs of externalities from natural-resource use.

Improving strategic allocations of resources and service delivery. The fiscal system will need to cope with aging-related expenditures in the pension

and health systems. And demands of a growing urban population will require smart investments in urban transport, solid waste management, water and sanitation, and health and education. The focus will have to be on adjusting the composition of spending and enhancing its allocative and operational efficiency, by instituting a clearly articulated fiscal strategy underpinned by a robust, multiyear budget framework, as envisioned in the Budget Code amendments adopted in 2015. Incorporating performance information and regular spending reviews in budgetary decision making could also inform allocation decisions and help in strategically realigning public spending.

Reforms of intergovernmental fiscal relations should continue to empower local authorities to respond to local needs, financially and administratively, while strengthening accountability mechanisms and performance incentives. Measures could include clarifying expenditure responsibilities, expanding revenue autonomy, and putting in place a prudent framework for municipal borrowing while strengthening interjurisdictional coordination across provinces.

Enhancing information management.

A final priority relates to developing robust monitoring and evaluation systems, for fiscal policy to be guided by evidence-based decision making. This is the direction taken by most rising middle-income economies, especially in Latin America. Vietnam has invested heavily in its public financial management system and capabilities, strengthening basic transaction-related controls and capturing data more effi-

ciently. Yet fragmented organizational responsibilities hamper full use of these systems for timely and comprehensive reporting and the disclosure of key fiscal information. Beyond technological changes, organizational and process changes may be required to ensure that financial and nonfinancial data are shared, processed, analyzed, and used well in decision making.

Reforms and investments with impacts in the long term—developing an innovation-driven, urban-based, and environmentally sustainable economy

Structural transformation is unlikely to be as rewarding after Vietnam reaches upper-middle-income status (around the end of the 2020s at its current pace). The returns from adapting imported technology and know-how will diminish. And the exploitative use of natural resources will certainly reach its limits. These checks require policy makers to make critical choices in three areas with longer-term gestations—developing an innovation-driven economy that is housed in modern, efficient, and competitive urban structures and is environmentally sustainable.

Spurring learning and innovation to sustain rapid long-run growth

Developing an innovation-driven economy will demand an unambiguous commitment to cultivating and upgrading a dynamic private sector. It will also demand far-reaching reforms in the education and training systems for generating higher-order human capital. And more generally, it will de-

mand a competitive societal climate that values openness to new ideas and stimulates risk taking and technology upgrading. All three were critical to the rapid growth of Japan, the Republic of Korea, and Singapore—examples that Vietnam holds up for its own growth ambitions.

Vietnam's national innovation system is weak and contributes little to output or growth. Still missing is a critical mass of dynamic and innovative firms that provides the demand side for innovation. Moreover, firms' capacity to adopt and carry out new research is underdeveloped. Also largely absent are longer-term strategic views on firm and product upgrading and the human resources necessary for innovation. These needs reflect the lack of competition in product markets and the low capabilities of firm managers.⁴⁸

On the supply side, research institutes and universities provide too little research, and what is produced is mostly deficient in quality and relevance. Too few domestic knowledge institutions produce human capital with truly world-class skills and knowledge. The research and graduate (PhD) training systems are separate, so the virtuous circle where good research in universities also produces high-quality PhD holders barely functions in Vietnam. Government funding for R&D is spread thinly across more than 600 small government research institutes that produce very little valuable output. The allocations, small and fragmented as they are, are abstractly linked to meeting high-level socioeconomic goals in long-term government planning documents. It is seldom clear what government-funded R&D's con-

crete contribution to these goals is supposed to be, and it is nearly impossible to measure success (or lack thereof). There are few linkages between universities or think tanks and the private sector. And the separate systems for research institutes and research universities creates duplication, inefficiencies, and dispersion of scarce resources.

Impressive gains in access to higher education have been made but a long agenda remains. Tertiary education fails to meet demand for high-quality degree programs. Public universities are hampered by a lack of de facto autonomy, which impedes setting or changing curricula without external approval, raising adequate revenue, or developing full-time, high-quality faculty. Faculty salaries (tightly regulated for public institutions) are inadequate, limiting the talent that universities can draw on and obliging staff to take multiple teaching jobs, often at different institutions. Private universities have more freedom to set their curricula and tuition levels, but cannot expand enrollments to match student demand.

A more consistent partnership between the government and the private sector is needed, as is greater ambition in reforming the university and research system. If improvements begin now, the system can be strong as the need for it grows. Today, few firms are fundamentally held back by the lack of indigenous R&D capacity, but as firms become more knowledge-intensive, they will be.

Placing enterprises at the center of innovation

SOEs are sheltered from competitive pressures by government support,

which applies minimal pressure on them to innovate and remain dynamic, so the SOE restructuring agenda in Pillar 3 is relevant here. Foreign-invested firms have the option of outsourcing their R&D production to countries with more developed science and technology systems. But spillovers within Vietnam from R&D carried out in such firms are weak, hampered by the generally low level of absorptive capacity of Vietnamese firms and concerns about security of intellectual property rights. The response requires improving the firms' absorptive capacity and securing intellectual property rights. Domestic private enterprises are either too small to need innovation or are so preoccupied by the business environment that the paucity of innovation capacity is not holding them back. (The reform agenda to tackle this challenge was seen earlier in the response to the obstacles faced by the domestic private sector.)

Improving enterprise capacity for technological learning

The emphasis here will be on helping firms improve their capacity for "technological learning," to know how to use processes and technologies for production that are in use elsewhere but new to Vietnam. This gradual process gives an advantage to the fastest-learning firms and readies them to seek frontier knowledge, new to the world. A broad system of firm extension paired with private-sector organizations, such as chambers of commerce and banks (as in Japan and Singapore), can help identify high-potential, high-growth firms that may merit further support. As firms become more sophisticated, they need higher-order and more tailored

knowledge from universities and government research institutes. They also need a market-driven system of venture capital/private equity to finance high-risk and high-return innovation activities.

Ensuring relevant skills and knowledge

Raising the quantity, quality, and relevance of research, knowledge production, and advanced training of human capital—while creating and deepening connections to global knowledge networks—requires the government’s research institutes, and especially its higher education institutions, to achieve a new dynamism in teaching and research. The reform path includes many of the same elements that other countries have successfully used:

- Investing more in producing research, knowledge, and advanced human capital
- Evaluating the quality and relevance of all research outputs and related activities
- Rewarding the best and most productive researchers through merit-based allocation and awarding them enough resources
- Balancing the promotion of basic research and thematic research on national priorities
- Uniting the research and university-based graduate education systems and building strong domestic graduate education through strong PhD programs
- Accessing the global knowledge frontier through international linkages

Continuously improving the quality and relevance of skills

Improving the quality and relevance of skills in the labor force calls for greater responsiveness and dynamism in tertiary education—in four areas. First, the average workers should raise their skills by completing more and better education in a wider range of economically useful disciplines, entering firms as lifelong learners to stay current with the leaders in their sectors and industries. Second, students would see an expanding range of choices of high-quality, relevant degree programs, as externally determined enrollment quotas would disappear when a greater range of providers compete to give potential students the best programs at the best prices. Third, private universities and colleges would proliferate as tuition caps are lifted and those institutions that best meet the needs of students are allowed to easily expand. As part of this, financial aid would become routinely available to qualified but needy students so expansion does not harm equity. And fourth, information systems would provide aspiring students with essential facts about each university or college, such as the employment success of graduates, their salaries on graduation by degree program, and faculty qualifications.

Using cities to power the drive to modernity and industrialization

By enabling agglomeration economies, cities enhance productivity and spur innovation and economic diversification. Rising population and economic densities enable savings in transport and communication costs, lead to fre-

quent interactions, enable finer specialization and knowledge spillovers, and heighten competition in product and labor markets. Cities create viable markets for specialized business services, freeing firms to focus on their core competencies and take creative ideas to commercial scale. Cities are also instrumental in matching skills with job opportunities, and density allows for an integrated “thick” labor market. Just as many Indian children who grew up to become software engineers lined up to move to Bangalore, a flourishing Ho Chi Minh City can help Vietnamese children find the firm that wants them—and will pay for their skill set.

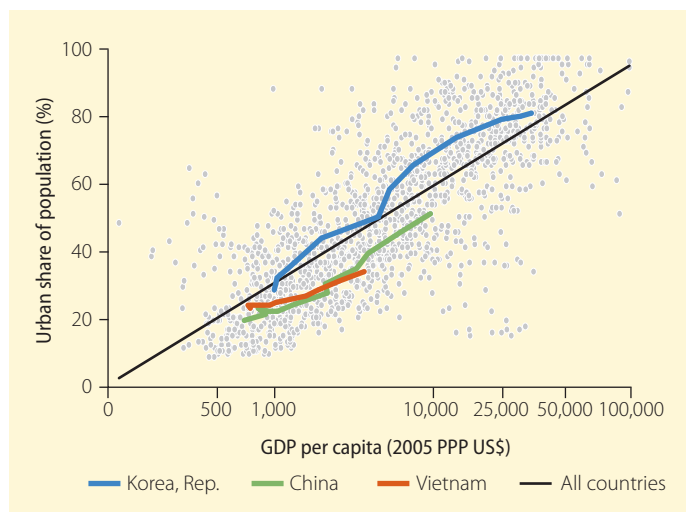
Evidence from today’s developed countries and rapidly emerging economies substantiates the tight link between economic development and urbanization fairly conclusively (figure O.8). No country in the industrial age has sustained economic development

without rapid urbanization. International evidence suggests that doubling a city’s population raises its productivity by 5 percent.

Over the past three decades, Vietnam has undergone an extensive urban transformation that has driven its structural transformation and economic development. In 1986, Vietnam had fewer than 13 million urban residents; it now has 30 million of them, and urban areas contribute over half of national GDP. Alongside rising economic density, the country also has an impressive record in keeping rural–urban and regional disparities in check through central transfers aimed at poorer areas that has allowed for the expansion of basic services and infrastructure. Even within cities, slums and urban segregation appear less of a challenge than in many other developing economies.

As Vietnam embarks on an even more ambitious growth trajectory, cities should be prepared to play a greater role in nurturing a burgeoning domestic private sector, supporting the growth of firm clusters that integrate into GVCs, and providing the logistics support and managerial capabilities to enhance productivity and accelerate growth. Policies and investments can be reshaped so that *economic density* is amplified around large metropolitan areas as well as secondary cities with demonstrated potential; *economic distance* to large markets is reduced to enable specialization; and *social division* in access to services between migrants and urban residents is dissipated to encourage human-capital development for social inclusion and greater agglomeration economies.

FIGURE O.8 Urbanization in Vietnam appears to be on a path as strong as in the Republic of Korea and in China



Sources: Authors’ calculations based on the the World Bank’s World Development Indicators database and Penn World Table, Version 8.0.
Note: PPP = purchasing power parity.

Reshaping policies is important as there are signals that the current urbanization model is constraining economic transformation. The main signal is the land conversion–based urban development model, with industrial zones developed ahead of demand and a proliferation of small, fragmented urban expansions that are not well connected to transport networks and service delivery nodes. The area of land for industrial zones increased by around 77,000 hectares from 2000 to 2010, with major fiscal implications as zones need to be serviced with roads and infrastructure. This could still be a worthwhile use of public resources if the economic returns were there. But this is not yet the case, with an average occupancy rate in industrial zones of less than 50 percent. Small, fragmented development of urban industrial and residential land poses an even bigger problem: 70 percent of the land occupied by industry in Ho Chi Minh City is in areas outside formally approved industrial zones, damping economic density. Urban areas need to be developed at scale.

The second signal is the limited connectivity between cities and markets as well as unreliable supply chains and high logistics costs. Logistics costs account for 21 percent of GDP—against an estimated 19 percent in China and 15 percent in Thailand—primarily driven by unreliable supply chains. At the greater metropolitan level, bottlenecks hamper economic efficiency and diminish their attractiveness to prospective homeowners and businesses. It takes nearly two hours to travel from the central business district of Ho Chi Minh City to the center of Binh Duong

New City even at off-peak hours, a distance of only 40 kilometers. Weak regional connections add to the economic distance, with Vietnam’s provinces and cities more like independent oases rather than parts of an integrated marketplace.

The third signal that Vietnam’s spatial transformation is being thwarted relates to social division, where migrants to urban areas have considerably lower access to urban services and lower wages (see Pillar 2). Without *hộ khẩu*, migrants face numerous difficulties in applying for a job, trying to get a loan, registering a business (or motorbike), buying or renting a house, and signing up for medical insurance.

Two main sets of policies could be addressed for Vietnamese cities to better enable economic growth: upgrading institutions and expanding connective infrastructure.

Upgrading institutions

Enable land markets. Land markets need to emerge and flourish. Reforming land institutions, like strengthening land registration and bringing in market land valuation, is a priority to reduce excess and fragmented urban land conversion. Increasing the transparency of land pricing by establishing mechanisms to regularly publicize land values obtained in auctions and individual land sales is a good start. These efforts could be tied to local-government fiscal reforms that promote broader use of land and property taxes as an alternative to land-conversion fees.

Enhance coordination. Local governments are rewarded for business expansion within their boundaries,

undermining potential clustered development or economies of scale in infrastructure investment. The city classification system encourages local infrastructure development and fragments urban development. Institutions need to be strengthened for integrated urban planning—within and across sectors and at the corridor, metropolitan, and regional levels.⁴⁹ Urbanization is at a critical juncture, and its proper management requires a “whole-of-government” approach. The mandates within line ministries need to be reviewed and aligned with international best practices.

Strengthen urban planning capabilities. There is an urgent need to strengthen capabilities in urban planning departments to integrate socioeconomic realities in developing physical plans. Master plans and other physical plans could be linked to the budget process; if plans can be supported by key investments, their credibility will rise. Coordination mechanisms that can align provincial and city plans are essential, because the socioeconomic development plans, urban master plans, and sector infrastructure plans are prepared by different departments often running on different schedules and using inconsistent data and projections for planning. The timing of planning could be synchronized and the number of plans within a territorial space cut heavily (ideally to two or three). Vietnam also needs a professional cadre of urban planners who can plan and manage cities. A greater emphasis on this discipline is required in university education and in the talent that ministries and provinces hire.

Expanding connective infrastructure

Mainstream integrated transport and logistics planning. The government could push to mainstream integrated planning for transport and logistics across modes, geographic areas, and public-sector functions. One primary reason for transport modes to be misaligned on supply and demand and relative to each other is that they are planned individually, largely decentralized and fragmented.

Improve road quality and logistics. Congestion in major urban areas has led to bans on trucks operating within city limits. The limited capacity of bridges and roads and the overall condition of transport infrastructure increase costs. Road access to big ports—Hai Phong and Cai Mep-Thi Vai being the priority—could be rebuilt, and key road corridors and expressways need more investment.⁵⁰

Expand the level and quality of urban transport services. These are closely tied to refinements in urban planning.

In addition, there is a need to synchronize policies for rural and urban development; currently, these policies are developed in isolation. This is unfortunate and is leading to a growing perception that rural and urban areas are in competition—for example, for water resources—or that urban development has been predatory—for example, in inequitable land acquisition and compensation policies. It is important to see that rural-urban relations are the venue for the structural transformation of the economy. A symbiotic relationship between rural areas and a

hierarchy of urban areas will likely determine how inclusive Vietnam's future urbanization will be.

In implementing projects and supporting investments, the authorities may want to recalibrate the roles of the state and the market in managing the urbanization process. In particular, they could:

- Refocus the role of the state and improve its capabilities in areas that only the government can manage. These areas include strengthening the capacities and coordination of urban planning, augmenting public finances, improving social services, and increasing investment in infrastructure to support urban plans.
- Redistribute responsibilities, powers, and resources among national, local, and metropolitan governments to ensure that issues addressed at the regional scale are not undermined by local interests.
- Relax the state's control of and involvement in activities managed more efficiently by markets, particularly land markets, where regulation has produced costly distortions. The solution is not new regulations but fewer restrictions.

Achieving environmentally sustainable development

The sustainability of Vietnam's long-term growth is threatened by the environmental problems that have built up. These hazards are expected to worsen at an increasing pace between now and 2035 as the current model of economic growth, industrialization, and urbanization further strains the

country's limited land, water, and energy resources. One of the lessons of development is that the environmental quality of water and the air is important not only for ecosystem health and the quality of life in general, but also for income growth. Four environmental challenges stand out for the last of the longer-term gestation responses.

Four environmental challenges

Deteriorating natural resources. The nation depends on natural resources much more than most other countries in the region. This is most evident in employment, with more than half the labor force depending on agriculture. In the mountainous northwest and central areas, poorly planned expansion of agriculture has eroded soil and removed biodiverse natural forests, degrading the land. The soil erosion has, in turn, contributed to more frequent and severe flooding of lower-altitude farms and human settlements. A significant portion of the protective mangrove forests has been destroyed, resulting in estimated losses of US\$34 million a year, while overfishing has seriously depleted nearshore fisheries resources, threatening the livelihoods of several hundred thousand people. Agricultural output has risen, but at the cost of increased land use and of chemical fertilizers and pesticides. Without regulatory and institutional checks, the next 20 years are likely to see greater competition over scarce arable land, more conversion of forests for agriculture, and even faster depletion of these precious natural resources.

Deteriorating environmental quality. The quality of land, water, and air has

worsened considerably. Water pollution has reached serious levels, especially near Hanoi and Ho Chi Minh City. Air quality has also declined due to growth in fossil fuel use for power generation, industrial energy, and transport. A high incidence of respiratory infections among children under age five is observed, due to poor air quality, and an estimated 4,000 premature deaths annually are related to coal-fired power generation. In urban areas, environmental pollution from urban and industrial wastewater has resulted in toxic waterways with impacts on economic production, and unknown—but likely severe—impacts on human health.

Threats from climate change. Vietnam is among the countries most vulnerable to climate change given its location, share of population in low-lying deltas, and dependence on climate-vulnerable sectors. Forecast changes in precipitation, temperatures, and sea level all point to substantial risks in high-density and economically important areas. The country's response must consider the demographics, socioeconomic context, political dimensions, and biophysical landscape when allocating resources and coordinating land and resource planning and use, in a climate-resilient approach to development.

Rapidly growing energy consumption. Energy use is growing faster than in any country in the region, led by electric power. Reflecting current trends and policies, the share of coal for power generation will rise from 32 percent in 2014 to 54 percent by 2030. Around 60 percent of coal used for

electrical generation will be imported. The intensity of energy consumption (the amount of energy used per unit of economic output) is also among the highest in the world, and inefficient energy use is one of the main reasons. The energy policies adopted over the next few years—on energy efficiency, renewables, natural gas, and coal—will largely determine the trajectory of the energy sector and of associated issues.

Making the right choices

Given the confluence of these four challenges, Vietnam is at a juncture where the right choices can help it avoid the irreversible environmental degradation and major environmental remediation costs facing some other countries. A low-carbon growth path prioritizes investments that take account of environmental costs and results in inclusive and resilient growth, and is a more sustainable and affordable long-run option. It requires strong institutions to monitor and enforce plans, policies, and regulations for sustainable natural resource and environmental management; incentives for sustainable investments (with private participation) that benefit the environment and the poor; and improved access and use of information for decision making, monitoring, and transparency and accountability.

Strong policies and institutions. Much of sustainable growth is about policies that address market failures and “get the prices right” by introducing targeted incentives such as environmental taxes, pricing environmental externalities such as carbon, creating tradable property rights, and reducing inap-

appropriate subsidies. Such growth also requires reduced resistance to change with, for example, information on the economic value of environmental services provided by natural assets.

Vietnam needs well-coordinated public institutions that can correct the market failures related to the environment, and can enforce regulations and standards. They are especially needed in the Mekong Delta, which is highly vulnerable to climate change and is institutionally complicated, with planning and implementation across several ministries and agencies with little coordination of investment decisions by provinces. Institutions also need to ensure that agricultural promotion policies do not conflict with environmental goals. For example, some locations have subsidies to expand their fish-processing capacity or boat building while making efforts to conserve fisheries.

Climate-smart investments. One move would be to accelerate the restructuring and equitization of SOEs in natural resource sectors, as well as in energy and heavy industry. This would also require enforcing standards, such as food safety and biosafety in aquaculture or improved energy efficiency (especially on the demand side). The government can establish public goods and services to enable greater private involvement in such investments. Better pricing of energy products (particularly electricity) will improve the efficiency of their

use while attracting greater private investment. Private investment could be permitted in renewables other than hydropower. It will also significantly increase the proportion of electricity produced for renewable sources through the development of hydro, wind, solar, and biomass, in conjunction with the expansion of cleaner natural gas.

Information systems. Disclosure and harmonization of information must underpin effective management of natural resources and mitigation of environmental pollution and land degradation. The systems must enhance the data and information used for managing natural resources, and make the information understandable and accessible to the broader public. Vietnam could accelerate the adoption of technology in upgrading the environment-related information systems. But it must first update, scale up, and further harmonize the information platforms that already exist.

The net cost of sustainable and climate-resilient growth is usually modest in the long run. The up-front capital investments are often recouped through subsequent savings from low operating costs or new markets, and an improved skill base (if suited to the needs of the market economy). Most estimates indicate that investments to decarbonize energy systems often pay for themselves.

Pillar 2 Equity and Social Inclusion

Equity is a deeply held value of the Vietnamese people. The preamble to the Constitution of the Socialist Republic of Vietnam sets the goal of “a prosperous people and a strong, democratic, equitable, and civilized country.” And Article 50 stipulates, “The State shall create equal opportunities for citizens to enjoy social welfare.”

Vietnam’s economic growth, particularly in the 1990s, rested heavily on the equitable distribution of land-use rights in the early years of *Đổi Mới*, driving a rapid increase in agricultural production. The government channeled substantial resources from this growth to fund pro-equity spending, which helped the country avoid the spike in inequality experienced in some other fast-growing countries. But past performance is no guarantee of future results, and signs of growing inequality are emerging. Looking to 2035, Vietnam faces a dual agenda: one unfinished, for equality of opportunity, and one emerging, for a rising middle class and aging population.

Underpinning both agendas is the need for a new vision of social policy. Historically, and especially in planned economies, social sectors have been considered “nonproductive.” This view is changing. The social sectors are very much productive and becoming increasingly central to realizing the goals of knowledge-based and globally competitive upper-middle-income countries. Education contributes to productivity growth. Labor-market institutions balance productivity growth and societal welfare. Reforming the *hộ*

khẩu system can help realize the full potential of structural change from low-productivity rural employment to formal-sector urban work. An adequate social safety net allows people to take entrepreneurial risks with the confidence that they will not face destitution if their business fails. And universal health coverage ensures that people are productive students and workers, channeling otherwise high precautionary savings to more productive uses.

The Unfinished Agenda: Ensuring Equality of Opportunity

Vietnam’s move from collectivism toward a market economy has created incentives that allow talented, entrepreneurial, and hard-working individuals to flourish. But it also leads inevitably to some inequality in outcomes—the result of interaction between opportunities, effort, and luck. While inequality in outcomes is expected in a market economy, inequality of opportunity is inherently unfair and incompatible with the ideals in the constitution. Equality of opportunity prevails when social outcomes are independent of circumstances at birth. It can be understood as a “level playing field,” giving all children an equal chance at success. Despite significant social achievements, profound inequality of opportunity remains.

The discussion here focuses on inequality of opportunity for three marginalized groups: ethnic minorities, people with disabilities, and urban migrants. Members of these groups—

who collectively make up one in four Vietnamese—have faced particular challenges, despite strong government commitments to their full inclusion in society. The discussion also reviews gender equity, focusing on the imbalance in leadership positions and the sex ratio at birth.

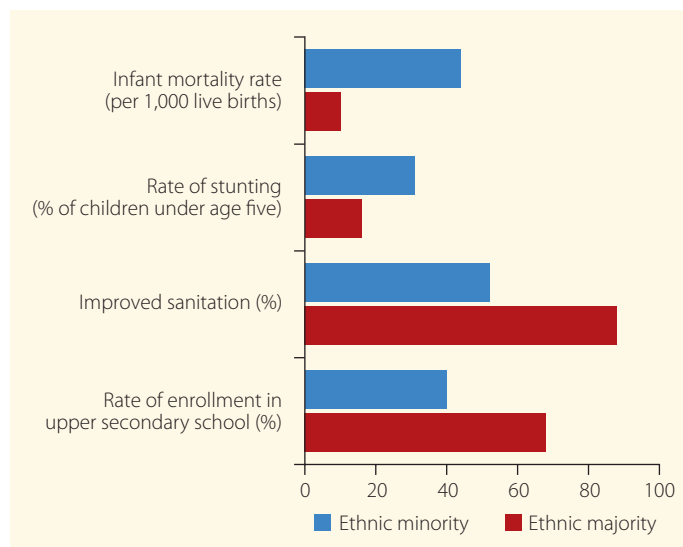
Ethnic minorities

The single greatest equity challenge is the persistent and substantial gap in socioeconomic outcomes between most members of the country's 52 ethnic minorities and other Vietnamese. This divide is driven in part by steep disadvantages in opportunities among ethnic minority children (figure O.9).

Over the long term, migration will likely be a pathway to economic integration for many ethnic minorities, which points to a need to focus on providing equality of opportunity for the next generation of ethnic-minority children, so that they will be equipped to lead prosperous lives wherever they end up in adulthood. Three interrelated circumstances generate a triangle of inequality of opportunity for ethnic-minority children: poor education, malnutrition, and low access to sanitation (figure O.10).

The higher poverty among ethnic minorities can be attributed in substantial part to low educational attainment. The modest ethnic minority enrollment at tertiary and upper-secondary levels are a consequence of many factors, including childhood malnutrition, in turn driven by poor sanitation. Completing the cycle, children who grow up in poor households with less-educated parents are much more likely to drop

FIGURE O.9 Ethnic minority children face higher inequality of opportunity



Sources: Analysis of the 2014 Vietnam Household Living Standards Survey and UNICEF's 2014 Multiple Indicator Cluster Survey.

out of school early, be malnourished, and lack adequate sanitation. In these three areas, focused policy interventions could close the opportunity gap.

Improving education access for ethnic minority children is the first policy priority, to be addressed by expanding current government initiatives: high-quality early-childhood education programs; placing teaching assistants who know the local mother language

FIGURE O.10 Triangle of unequal opportunity for ethnic minority children

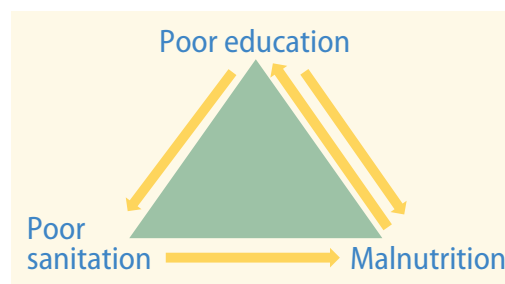
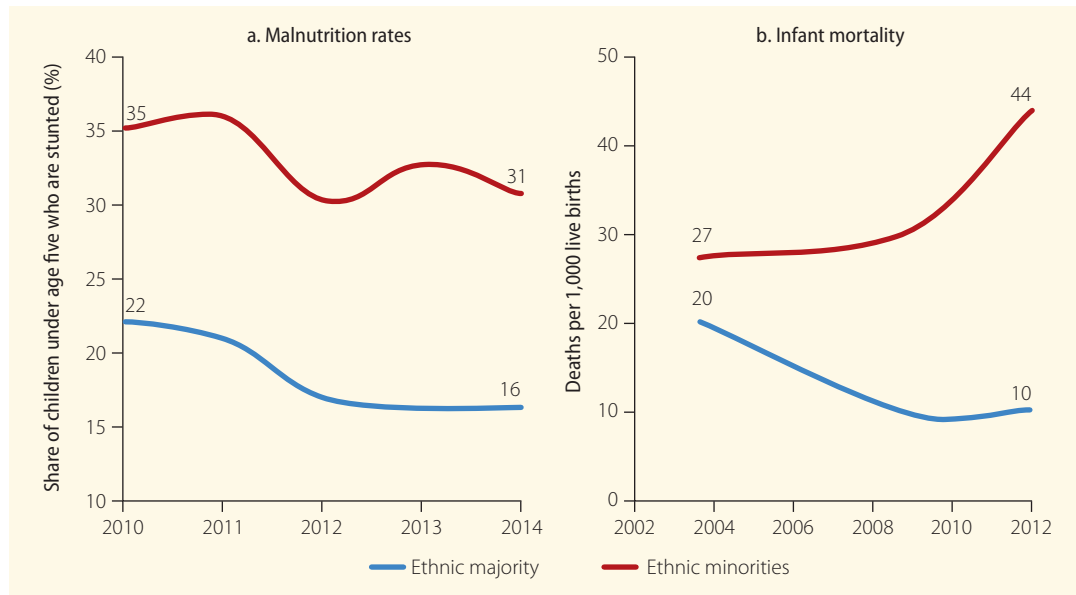


FIGURE O.11 Large gaps in child health and nutrition by ethnicity persist

Sources: Analysis of National Institute of Nutrition Surveys and UNICEF's Multiple Indicator Cluster Survey 2006, 2011, and 2014 reports.

Note: For the nutrition figures, the ethnic-majority group includes only Kinh, while in the infant-mortality figures it includes both Kinh and Hoa. Figures shown are point estimates based on household survey data. As with any survey-based estimate, they are subject to sampling error. The sampling error—and thus the confidence interval around the point estimate—is larger for ethnic minorities because their sample size is small within the survey. The MICS reports do not specify the confidence interval for point estimates.

in the first few years of primary school to ease the transition for children who do not learn Vietnamese at home; and financial support, including cash transfers to households, conditional on school attendance, to make it possible for children to attend upper-secondary school.

Improving nutrition is the second priority. A vast literature has shown that early-childhood nutrition has substantial effects on early cognitive development and readiness to learn in school. Despite existing programs, high rates of malnutrition persist among ethnic minority children (figure O.11, panel a). The National Nutrition Program in Thailand, which reduced malnutrition rates by more than 75 percent in 10 years, shows what a concerted national effort can achieve. Such a campaign in Vietnam could

include promotion of exclusive breastfeeding of infants under six months old, coupled with extension of maternity leave for women in wage employment. It could also introduce a comprehensive program to fortify basic foods with vitamin A, iron, selenium, and zinc. And it could develop new varieties of bio-fortified rice and maize and provide free nutritional supplements to women of childbearing age.

The third policy priority is sanitation. Major drivers of malnutrition are poor hygiene practices and lack of access to improved sanitation facilities. In communities without improved latrines, children are often exposed to bacteria, viruses, fungi, and parasites that cause intestinal infection. The high rates for diarrhea and parasitic infection are two leading causes of morbidity in the northern mountains, and lack

of access to sanitation is one reason for the persistently high infant mortality rates among ethnic minorities (figure O.11, panel b). And stunting rates for children below the age of five are high precisely among the ethnic minority communities most likely to lack such facilities. A targeted sanitation program, with incentives to promote community-wide behavior changes, can do much to achieve universal use of improved sanitation among ethnic minorities.

In developing education, sanitation, and nutrition programs for ethnic minority children—and programs to address ethnic minority poverty more generally—the government could benefit from experimenting, monitoring, and evaluating, since in many cases the evidence on “what works” is thin. Pilot approaches could be carefully evaluated before programs are expanded to scale. And for all three points of the triangle, initiatives could draw on promising new insights from behavioral economics. Choices about sending children to school, feeding infants, and constructing latrines are determined by a variety of factors other than cost-benefit calculations. Interventions in all three areas that seek to “nudge” behavior can be effective and cost-efficient.

Policies and programs to achieve equality of opportunity for ethnic minorities need to tackle prejudice and stereotyping and getting ethnic minority voices heard. Although the legal framework is adequate in recognizing equality of status between ethnic minorities and Kinh, prejudice against minorities is still common.⁵¹ Education can be the basic platform, focusing on appreciating and respecting the diversity of Vietnamese ethnicity and culture.

Conspicuously lacking is a strong ethnic minority presence in the Committee for Ethnic Minority Affairs, and local authorities are typically Kinh even in mainly ethnic minority areas. Vietnam can benefit from having ethnic minority social organizations take part in developing and implementing policy.

People with disabilities

Vietnam has many people with disabilities, in part a legacy of conflict. They merit particular consideration in a vision of social inclusion for several reasons. Their number is likely to increase rapidly as the old-age population expands, by one projection to more than 12 million by 2035. As Vietnam reaches upper-middle-income status, it will face the rising expectations of people with disabilities and their families for greater inclusion. And given greater resources, it could meet the promise of its commitments to inclusion. Foremost among them are the Law on Disabilities, passed in 2010, and the UN Convention on the Rights of Persons with Disabilities, which Vietnam ratified in February 2015. Protecting people with disabilities is also in the constitution.

The UN Convention’s purpose is “to promote, protect and ensure the full and equal enjoyment of all human rights and fundamental freedoms by all persons with disabilities, and to promote respect for their inherent dignity.” The Law on Disabilities guarantees the following rights to people with disabilities:

- To participate on an equal basis in social activities

- To live independently and integrate into the community
- To enjoy exemption from or reduction of certain contributions to social activities
- To be provided with health care, functional rehabilitation, education, vocational training, employment, legal assistance, access to public facilities, means of transport, information technology and cultural, sports, tourist and other services suitable to their forms and degrees of disability

Many people with disabilities around the world have been hidden from society and sometimes been segregated in residential institutions and special schools. But global policy has recently shifted toward including them in society, making them subjects of the law with clearly defined rights rather than objects of charity. This approach recognizes that disability is the result not of impairment but of the interaction between a person and his or her environment. For example, a person in a wheelchair might have difficulties finding a job not because of her condition but because of such barriers as staircases in the workplace. And a child with a disability might have difficulties going to school due to the attitudes of teachers and school officials who cannot adapt to students with particular needs.

On paper, Vietnam's policies for people with disabilities are highly inclusive. But there are substantial shortcomings in implementing a broad agenda. More than half the children with severe disabilities never pass through the doors of a schoolroom. Getting them into schools is crucial to provide them with

basic opportunities to participate in society and to engender attitudes of inclusion among others.

One simple step would be to regularly monitor policy implementation. A mechanism for this is, in fact, one of the government's commitments under the UN Convention on the Rights of Persons with Disabilities.

Another step would be to create space for social organizations for people with disabilities. In other countries, such people and their families have advocated for themselves through their own organizations. Such campaigns have guided governments on policy implementation and ensured that they follow through on commitments.

Urban migrants and the *hộ khẩu* system

Urban migrants are a third group lacking equality of opportunity, due to the *hộ khẩu* system. More than 5 million Vietnamese do not have permanent registration where they live, 2.7 million of them in Ho Chi Minh City. Although the registration system has less force than it once did, it perpetuates inequality of opportunity. Citizens in major urban centers without permanent registration face difficulties in access to services for health, schooling, social protection, and utilities as well as challenges in employment and social connections. Applicants for permanent registration face steep hurdles, including large unofficial payments to local officials, such that some people live in major cities as temporary residents for several years.

The broad objective of policy reform could be to further loosen the link be-

tween service access and permanent registration status. One option is to make it easier to obtain permanent registration. Many countries have some form of local registration for service access, and in most of them, obtaining local residence requires some proof of residence, such as a property title or lease. What distinguishes Vietnam's *hộ khẩu* is that permanent registration is possible only after two or three years of residence, and both the payment and document requirements are heavy. Costs and inequities would be greatly reduced if these requirements were lightened. A second option is to eliminate differences in service access between those with temporary and permanent registration. A third, suitable for the long term, is to replace *hộ khẩu* with a national identification card, with details held in a unified national database.

Gender equity

Vietnam has made impressive achievements in gender equity. Differences in school enrollment and attainment by gender are minimal, and the gender wage gap is modest by global standards. In two areas, however, sharp differences still exist—in leadership and in the sex ratio at birth.

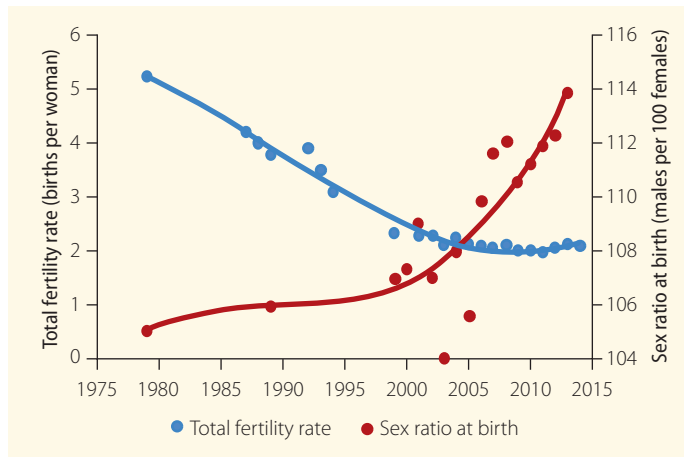
First, in business and particularly in government and political spheres, the leadership is overwhelmingly male. In the last decade and a half, the share of women in the National Assembly has been declining and is now at 24 percent (as of 2015). Few chairs of National Assembly committees are female. The civil service has a large share of women, but their representation in

leadership positions is low, mostly at lower levels. There is a target that all ministries should have at least one female vice-minister, but the system for that is yet to be developed. Women's representation also remains low in key bodies of the Communist Party: the Politburo, the Central Committee, and the Secretariat. Women constitute only 18 percent of party leadership in communes, 14 percent in districts, and 11 percent in provinces.

Measures to boost women's leadership could focus on equalizing retirement ages in the labor code, using affirmative action as a short-term measure to ensure qualified women are fast-tracked to management positions, adopting a long-term program to identify potential women leaders early in their public career, and addressing gender stereotypes that limit women's career choices. This demands a long-term approach to update the education system and to promote healthier views of masculinity and gender roles in the media, and perhaps social media.

The second area of difference is the sex ratio at birth (SRB)—the number of male births per 100 female births. The much higher number of boys than girls born because of sex-selective abortion is gender discrimination and a threat to gender equity. The ratio was in the normal range of 105–106 in 1979 and 1989 (figure O.12). Since around 2005 it has risen rapidly, reaching nearly 114 in 2013, placing Vietnam—with India and China—among the countries with the highest SRBs. This imbalance will see a large number of surplus men starting in about 20 years, which may increase antisocial behavior, violence, and human trafficking.

FIGURE O.12 Total fertility rate has fallen over time, and the sex ratio at birth has increased sharply since 2005



Sources: 1989, 1999, and 2009: Population and Housing Census; other years: Population Change and Family Planning Surveys.

The high SRB is a result of a combination of factors, including the high value placed by Vietnamese families on having sons, and the ready availability of ultrasound technology allowing sex identification. Families prefer sons in part because they traditionally have the roles of carrying on the family line and worshipping their ancestors. Another driver of the preference for sons is that they traditionally have the main responsibility for taking care of parents in old age. The population policy discouraging couples from having more than two children is a contributing factor. What would happen if that policy were loosened? Although the impact is highly uncertain, the slight increase in the total fertility rate in 2012–2014—possibly the result of a perceived policy shift—suggests that full elimination may well result in modestly higher fertility. The broader economic dynamics of fertility are probably more important determining

factors: in a more prosperous country, the high opportunity cost of time and the wish to invest more in each child have reduced the desired family size.

It is likely that easing the two-child policy will help reduce the sex ratio at birth but not bring it down fully to normal levels. Government legislation to prohibit sex identification of fetuses to reduce sex-selective abortions has not proved effective. The imbalance in the SRB probably will change substantially only as parent preferences evolve. The government may be able to speed this evolution with, for example, public campaigns to emphasize the value of daughters, or by providing sufficient old-age support to lessen parents' concerns about not having a male offspring to support them in their later years.

The Emerging Agenda for the Rising Middle Class and the Aging Population

The second element of Vietnam's social-inclusion vision for 2035 is the emerging agenda of supporting the growing middle class to manage risks and pursue opportunities in a market economy. The country will also face a rapidly aging population, creating new challenges of elderly financial protection, health care provision, and long-term care.

Social policy should respond to the needs of an increasingly urban but also aging middle class whose needs are very different from those of the mass of rural poor that characterized Vietnam in the past. By 2035 Vietnam will be overwhelmingly a middle-class society, and the focus of social policy will have shifted from moving out of chronic

poverty to helping the middle class achieve rising prosperity and manage the risks that could set back social and economic progress. While poverty will have been all but eliminated, in the middle-class society of 2035 there will still be a substantial group of poor and a larger population vulnerable to falling back into poverty. The growing share of elderly are likely to be at particular risk.

By 2035 more than half of Vietnam's population will be members of the "global middle class" (\$15 or more per day consumption in 2011 PPP), with new expectations and challenges. They will expect that the state will provide a minimum standard of services, financial protection, and conditions for decent work, including affordable health care, quality education to at least senior-secondary completion (and often beyond), old-age financial protection and care services, and basic worker protections. They will also demand more voice, in independent-worker representation in the workplace, citizen oversight of public services, and broader civic participation. Middle classes globally have also tended to prefer avoiding high income inequality.

These changes will bring with them substantial new risks. For individuals, with aging and the rise of urban and sedentary lifestyles, health risks are shifting to noncommunicable diseases, which require more complex treatment regimens than the infectious diseases that previously dominated Vietnam's risk profile. The shift from family farming to wage jobs offers the promise of a better life but also exposes workers to new risks from economic volatility. These individual risks are

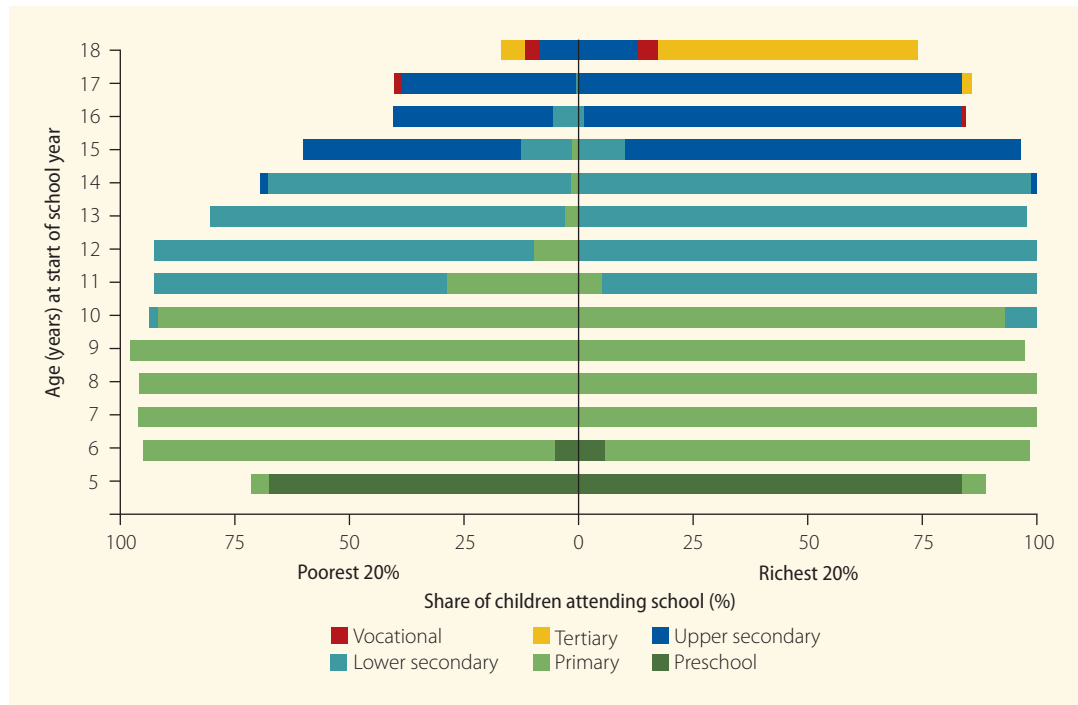
mirrored by emerging societal risks: the demands of health care as well as social protection for an aging and middle-class population will create acute fiscal risks.

Ensuring high-quality basic education for all

In Vietnam's increasingly market-oriented economy, the prospects for success in life are far greater for those with a high-quality education. Despite large gains over time in education attainment among Vietnamese at all incomes, the goalposts are constantly moving, and the country will require increasingly higher levels of educational attainment to meet its economic and social goals. The picture remains mixed, however, and suggests a need for continuing improvement. A child from a wealthy family in Hanoi or Ho Chi Minh City will typically receive high-quality instruction through upper-secondary school, supplemented by private tutoring, and go on to complete a university degree. In contrast, a child from a poor family in a rural area is unlikely to advance past lower secondary school (figure O.13).

Advances in education are also critical to Vietnam's overall economic success. High-income countries have workforces with high levels of advanced skills gained through education. These skills are essential to economic growth. The myriad specific skills combine in complementary ways with technology, and the educational foundations of the workforce allow individuals to change and adapt more quickly as the changes in technology and the demands of work accelerate.

FIGURE O.13 A large gap in upper secondary school attendance remains between the poorest and richest 20 percent



Source: Vietnam Household Living Standards Survey 2014.

The Vietnamese education system is inclusive, high-quality, and largely equitable through lower-secondary education. It then becomes exclusive, inequitable, and mediocre. It provides students with excellent foundations for success, but then fails to build on those foundations. Too many students fail to graduate from high school. Too few continue on to tertiary education; those who continue often do not receive a high-quality, relevant education.

A key policy priority will be ending the exam-based allocation of upper-secondary-school places and replacing it with universal secondary-school attendance. This is consistent with global experience—the Republic of Korea and other countries made high school completion universal as

they grew richer (figure O.14). In Vietnam, this change will also mean that upper-secondary schools will have students with a greater range of abilities. Currently, students not admitted to academic senior-secondary school are usually offered a place in a technical and vocational high school, many of which suffer from low skill relevance, low graduation rates, and low student motivation. The fast pace of technological change and the increasing skill needs of industry will put even more pressure on the system. Consideration could be given to transforming the two separate subsystems (academic and technical/vocational upper-secondary schools) into a single system offering two tracks to a high school diploma.

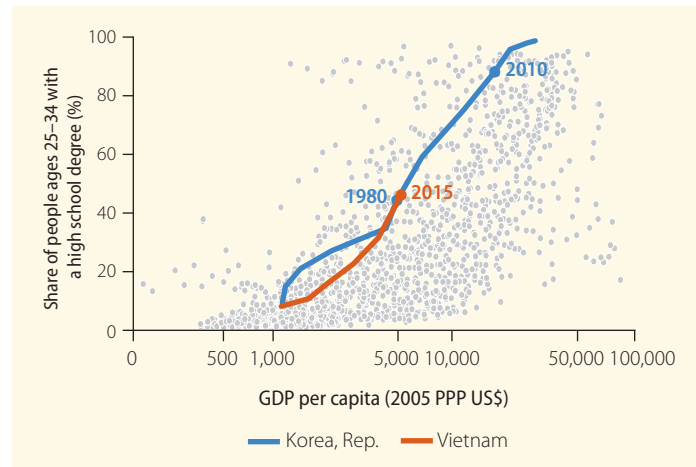
A second priority is to continuously improve the quality and relevance of what students learn, allowing them to succeed in a more diverse and demanding tertiary-education system. Such gains would let them offer employers up-to-date skills and a high capacity to adapt to constant change in the workplace. The Vietnamese school system excels at accomplishing tasks that are more straightforward, but faces new challenges in developing noncognitive and complex problem-solving skills to prepare young adults for the labor market of a competitive upper-middle-income country.

Effective labor-market institutions

To realize the full productivity benefits of a better-educated population, the Vietnamese labor market will need to encourage greater formality of employment while avoiding overly rigid regulation. This will depend in part on labor-market policies—and more specifically, on whether the country uses its current opportunity to address already-apparent weaknesses as it transitions from farms to factories and firms. Policy can help promote the growth of formal employment while ensuring that workers receive a fair share of the benefits of growth.

One concept that characterizes the policy goals toward which Vietnam might aim in its labor-market policies is “flexicurity.” This involves striking a balance between flexible labor regulation that maximizes productivity growth and “creative destruction,” and the needs of workers for decent, increasingly formal-sector employment that is equitably compensated. In other

FIGURE O.14 Vietnam can follow the Republic of Korea’s path in high school completion rates



Sources: Barro and Lee (2010) educational attainment data and Vietnam Household Living Standards Survey.

Note: PPP = purchasing power parity.

words, Vietnam can aim to protect workers rather than jobs as it deepens its structural transformation.

Improving industrial relations will be key, given the weakness of the current system, exemplified by the large number of wildcat strikes since 2006. In the medium term, Vietnam could consider more proactive measures to strengthen the system and promote harmony in the labor market. The Vietnam General Confederation of Labor and its affiliated unions could bar company executives and managers from key union positions (such as head of an enterprise union), following the example of other countries—such as Singapore, where company managers cannot hold principal union positions or sometimes even union membership. Vietnam could also continue to simplify regulations for resolving workplace disputes. And it could consider allowing firm-level worker councils or labor-management councils, as in

many European countries and the Republic of Korea.

Finally, Vietnam could move more fundamentally toward an industrial-relations system suited to the needs of a mature market economy, where the interests of workers, employers, and the state are more properly represented in a true bargaining process by independent unions. Vietnam has already made strong commitments along those lines in the United States–Viet Nam Plan for the Enhancement of Trade and Labour Relations, a side agreement to the TPP. The main provision is as follows:

Viet Nam shall ensure that its laws and regulations permit workers, without distinction, employed by an enterprise to form a grassroots labour union (*to chuc cua nguoi lao dong*) of their own choosing without prior authorization. . . . A grassroots labour union registered with the competent government body shall have the right autonomously to elect its representatives, adopt its constitution and rules, organize its administration, including managing its finances and assets, bargain collectively, and organize and lead strikes and other collective actions.

Vietnam further agreed that within five years, grassroots unions may form organizations “across enterprises and at the levels above the enterprise, including the sectoral and regional levels.” If fully implemented, these measures will address many of the weaknesses in the current system, making for effective mediation of worker-employer conflicts.

A crucial element in determining productivity and labor-market-equity outcomes is the minimum wage, which would be most effective if determined primarily with reference to productivity and competitiveness. Vietnam has so far taken a “living wage” approach, with a primary focus on the cost of living. Shifting to a “wage floor” approach that puts a primary emphasis on productivity and competitiveness as the drivers of minimum wage adjustments should be considered.

To achieve this shift, in the short run, the private sector would benefit from moderating the rate of minimum wage adjustments. In the medium run, existing plans to anchor minimum wage adjustments to real productivity growth could be put in place. (Many upper-middle- and most high-income countries exemplify the elements that Vietnam could incorporate in a minimum wage-setting mechanism.)

Vietnam would also benefit from streamlining regulations in employment protection to promote greater labor-market flexibility. It would benefit, first, from loosening regulation of labor-leasing enterprises and temporary and outsourcing contracts. To ensure that increased flexibility in the regulated labor market is accompanied by adequate worker security, Vietnam would ideally gradually expand its coverage of unemployment insurance and active labor market programs which, when well designed and implemented (such as public-employment services), can help enhance labor-market efficiency and worker welfare.⁵² Since such interventions tend to have important social-protection and fiscal implications, Vietnam should keep close track

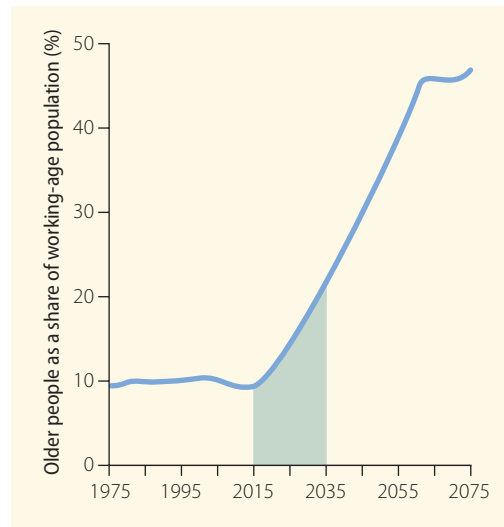
of the fiscal impacts of any expansion of unemployment insurance. It should also monitor the labor-tax wedge and explore options for financing a greater share of social insurance and active labor market programs out of general tax revenue.

Pensions and the social safety net

As countries move up the development ladder, they typically expand their social protection systems to respond to the demands of a growing middle class. A key social protection challenge for Vietnam will be to expand pension coverage in a fiscally sustainable manner even as the ranks of the old-age population grow rapidly. This can be accomplished through diversifying the country's approach to pensions, reforming the existing public pension system, and gradually increasing pension spending. Separate from changes to pension policy, reforms are also needed to modernize and defragment the social safety net system. Additionally, as the old-age population expands, policy will need to address the growing need for aged and long-term care (ALTC).

Part of the social protection reform agenda is driven by the fact that Vietnam is at a demographic turning point, facing a slowdown in the growth of the labor force and a sharp expansion of the old-age population. The old-age dependency ratio—a common measure of the age structure of the population—has been roughly constant for decades in Vietnam but will climb from 10 to 22 between 2015 and 2035 and continue to rise in the following decades (figure O.15.) In other words, Vietnam will soon have many more old-age

FIGURE O.15 The old age dependency ratio will increase rapidly



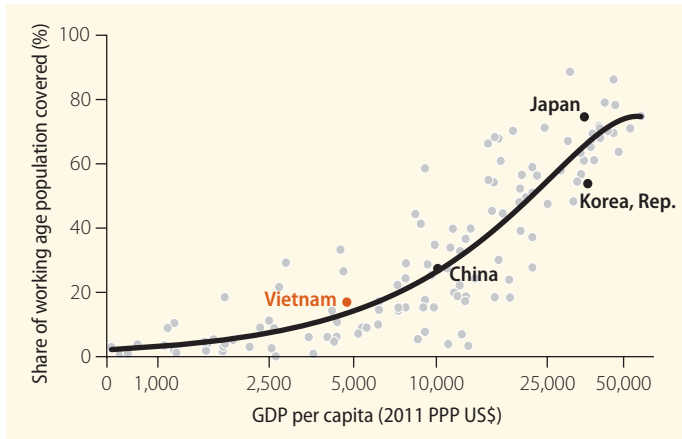
Source: UN World Population Prospects, the 2015 Revision (medium variant).

people to support for every person of working age.

Overall, contributory pension coverage in Vietnam is currently low, though not out of line with countries at similar levels of income (figure O.16). The pension system faces the common problem of middle-income countries of a “missing middle” in coverage: roughly the top 20 percent are in formal pension schemes, and a small bottom segment is covered by targeted social pensions, but the majority of the population do not have any pension at all until age 80 when they qualify for a social pension. Countries typically expand contributory pension coverage as they move toward upper-middle-income status, and Vietnam has set a goal of 50 percent coverage by 2020. Currently, however, it lacks a viable strategy to achieve this goal.

Scaling up pension coverage so dramatically will require a diversified ap-

FIGURE 0.16 As countries move to upper-middle-income status, pension coverage usually increases



Source: World Bank, Pensions database.
Note: PPP = purchasing power parity.

proach, including subsidized coverage for informal-sector workers to incentivize their participation in contributory schemes, and phased lowering of the age for access to social pensions. Changes to the existing contributory pension system will also be needed. The formal-sector pension scheme is not financially sustainable, despite some reforms in 2014. It will begin to incur deficits from the 2020s and exhaust accumulated funds by around 2035. Even at current low coverage levels, the country cannot afford both the existing system and the contribution subsidies and wider social pensions that will be needed to expand coverage to informal workers. Needed reforms to the contributory system include raising the official retirement age, gradually eliminating the difference in retirement ages for men and women, removing incentives for early retirement, further reducing the annual accrual rate while broadening the base for collections to full compensation,

and cutting the number of special categories of workers entitled to preferential early retirement.

Even with these cost-cutting measures, the combination of an aging population and ambitious pension coverage goals means that pension spending is likely to rise considerably. Countries with old-age dependency ratios equal to Vietnam's projected level in 2035 typically spend 8–9 percent of GDP on public pensions, well above the 2–3 percent that Vietnam has spent over the past decade. At the same time, average pension spending relative to country income and old-age dependency rates has generally been lower in East Asia than in other parts of the world. Projections for pension spending in Asia-Pacific Economic Cooperation countries suggest spending for lower-middle-income countries of around 6 percent of GDP by 2035. While these estimates need to be treated with caution, it seems reasonable to project pension spending by 2035 of 6–8 percent of GDP, a marked increase from current levels.

Changes will also be needed in the social safety net by 2035. Vietnam devotes considerable resources to its social safety net system, but fragmentation, poor targeting, and outdated delivery systems limit its effectiveness. Reforms are needed along four dimensions.

First, a more coherent policy approach is needed for social transfers to households, moving away from multiple fragmented programs with overlapping target populations and objectives. Fragmentation leads to high costs and poor program delivery.

Second, better systems for beneficiary identification and screening in

targeted social-assistance programs will be needed to improve their poverty reduction impact. This would be built on improved integration of the proposed national ID system in social assistance program delivery, an improved poverty census to identify poor and vulnerable households, and more systematic enrollment procedures for social-assistance programs.

Third, modernization of the administrative machinery of the social assistance system is needed. This will require significant investment in payment systems, management information systems, and improved client outreach and case-management mechanisms.

Fourth, the design of area-based antipoverty programs needs to be rethought to emphasize more diversified, community-driven income-generation approaches. Given Vietnam's rapidly aging population, these area-based programs could also expand to include community-based care services for elderly people and people with disabilities.

Distinct from the pension and social safety net reform agendas is the need to respond to rising demand for ALTC beyond traditional family support. While there is a need for greater public support for ALTC, it is equally clear that the state cannot do it all, and the expressed preferences of older people in East Asia and the Pacific are typically for care in the home or community.

ALTC systems should be built principally around a system of home- and community-based care, though with an enhanced financing role for the state. The framework is the "continuum of care": the large majority of older people in need of care receive it in the home,

those with somewhat higher needs access community-based care, and only a small and very frail portion require residential care. China's national policy, for example, is that around 90 percent of people should be cared for at home, 7 percent in the community, and 3 percent in residential care.

It is important to recognize that the government's role in financing ALTC can be distinct from the role of providing care. While the state may provide *financing* for ALTC (usually with copayment for all but the poor and people with disabilities), the private sector may have a substantial role in provision of care. But this, in turn, will place new demands on the state for standard-setting, human-resource development in the caring industry, and regulation of quality and the market rules of the game.

Universal health coverage and the health system

The major policy challenge facing Vietnam's health system over the next 20 years will be to achieve universal health coverage—that is, to ensure that everyone has access to high-quality services without suffering financial hardship. The objective of universal health coverage is closely linked to Vietnam's overall equity agenda, both in ensuring access to services to promote social inclusion and in reducing poverty due to out-of-pocket payments for health care. Health-system performance will also become increasingly relevant for many of the broader trends facing Vietnam, including meeting the expectations of a growing middle class, addressing the challenges of an

aging population, and pursuing economic growth. There is now strong evidence that conditions during early childhood—especially child nutrition—have a substantial impact on a wide range of economic and social indicators later in life, including schooling, learning, employment, and productivity. Ultimately this reality also has implications for economic growth. Increasingly the health of older adults will matter for economic performance, as Vietnam's aging population will pose new challenges to maintaining a healthy and productive workforce. Healthier older workers can help mitigate the impact of a rising dependency ratio.

Two big policy questions stand out for Vietnam's health system—on service delivery and health financing. On service delivery, will the health system maintain its current orientation, in which too many health-care services are delivered at hospitals while too little is done at primary level facilities? Or will the system transition to focusing on primary care, with primary providers at the center of an integrated system? On health financing, how can the currently high level of total health expenditure be stabilized, with a concurrent reduction in reliance on out-of-pocket spending? An important question here is how the current pace of insurance enrollment can be accelerated, because by some estimates it may not be rapid enough to achieve 100 percent coverage by 2035 (from 70 percent today).

Service delivery

The challenge is rooted in two inter-related problems: Hospitals are doing too much, and primary care is doing too little. In addition, the different lev-

els of the system are insufficiently coordinated. Vietnam has a hospital-centric system in which referrals and self-referrals to overcrowded facilities at the central and provincial levels are largely a result of low public confidence in the quality of primary-care health systems at the district level and below. The primary-care system is fragmented and ill prepared to address the challenge of noncommunicable diseases. There is a split between the preventive health system, which primarily implements independent disease control programs, and the curative system, which is largely responsible for treating illness, but not detecting or preventing it. For many patients the first point of contact is a private pharmacy, which is not connected to the public service delivery or health insurance system at all.

Strengthening service delivery for primary care is arguably the most important task facing health policy makers over the next 20 years. For quality and cost reasons, a strong primary-care function based on a continuous doctor-patient relationship is central to a modern, efficient health system. International evidence shows that a disease profile dominated by noncommunicable diseases requires more complex case management and coordination of care, and an integrated primary-care system is critical in the process.

To strengthen the primary-care system, a sustained program of reforms would include human-resource policies and development, more efficient resource allocation through reforms of provider payment mechanisms, improved gatekeeping modalities to ensure that people are treated at the appropriate level of care, coordination

of care across levels of the health-care delivery system, and quality-assurance mechanisms. This long-term agenda will require sustained commitment and investment. Strengthening primary care can also be supported by strong public health measures, especially related to tobacco control.

Strengthening hospitals can be done by balancing hospital autonomy granted under the “socialization” policy with greater accountability. Both the government and the public can play a role. For the government, a major factor will be to exert greater influence over hospitals through a more active role for a strategic purchasing agency (whether Vietnam Social Security or another agency) to promote quality and efficiency. This objective will require a shift from simply paying the bills submitted by providers to using information to ensure that patient care and cost-effectiveness are emphasized over hospital revenues. For the public, patients need recourse to grievance-redress mechanisms in case of clinical or financial wrongdoing.

Health financing

The agenda over the next 20 years will be to stabilize the share of GDP spent on health near its current level and to shift the composition of spending to reduce reliance on out-of-pocket (OOP) expenditures. Vietnam now spends a larger share of its GDP on health—about 6 percent—than almost any other country in developing Asia, a burden on household budgets and the public purse. About 50 percent of total health expenditures are paid OOP. Most upper-middle- and high-income countries rely on OOP spending for

less than one-third of the total. Some mix of government spending and insurance contributions will be needed to lower OOP spending.

Key to reducing reliance on OOP spending will be to expand insurance coverage to the roughly 30 percent uninsured population, but the current approach may not be adequate to achieve full coverage by 2035. Vietnam is relying on individual or household contributions and the gradual transition to a larger formal workforce. This process is slow and uncertain, and there will likely be a greater need for publicly financed contribution subsidies to encourage wider participation of nonpoor informal workers in health insurance.

The rebalancing of health expenditure between the state and citizens would require higher public spending on health care by 2035. A strong achievement would be for current health spending of around 6 percent of GDP to remain stable over the coming two decades, but with a gradual increase in the share of government spending from 2.5 percent of GDP to around 3.75 percent and a concomitant decline in OOP spending by individuals from 3 percent of GDP to around 1.75 percent. Donor and private insurance contributions are likely to remain modest. However, keeping overall health spending stable in the face of a rapidly aging population will require sustained efficiency improvements to control cost escalation.

Strengthening the efficiency of the health system will depend primarily on stronger provider-payment mechanisms for hospitals to discourage overtreatment and reforms to pharmaceutical procurement to control high costs. Hos-

pitals purchase drugs at widely varying prices, and the high costs are passed on to the government or the population. Centralized procurement and better use of state purchasing power to negotiate prices under a framework contract with pharmaceutical companies would help control costs.

Public and private roles in health

An important question for both service delivery and health financing is the role of the private sector. Around the world, governments are trying to achieve the right balance between public and private participation in all aspects of health-system reform. Global experience indicates that public financing will play a dominant role in paying for health care, but a significant role for private provision is more common.

There is no clear evidence from international experience that either public or private provision is “better.” What matters most is strong accountability. Depending on organizational

and financing arrangements, the public and private sectors may be equally prone to under- or overprovision, low quality, inefficiency, and other shortcomings. As with public providers, if private providers are to receive government funds, they should be held accountable for their activities. Accountability requires clearly delegating tasks, adequately financing service provision, collecting and analyzing information on what providers are doing, and enforcing the rules of the game. Regulatory and supervisory authorities can oversee public and private providers.

As Vietnam charts a path toward a stronger health system by 2035, a central challenge will be the difficult political economy of health reform. From tobacco lobbies to pharmaceutical companies to doctors, vested interests are likely to resist certain reforms. But Vietnam has made significant strides in the past decade or more—an important foundation for further progress.

Pillar 3 A Capable and Accountable State

Why Institutional Quality Matters for Growth and Development

Institutions—the formal and informal rules of the game for interactions in society—facilitate economic growth and development over the long term. They constrain or condition behavior by providing incentives to individuals and groups. These incentives determine whether and to what extent activities are fostered to create wealth, promote efficiency, and enhance welfare. For instance, an institutional framework that allows for easy and quick business registration provides greater incentives for new firms to enter the market, increasing competition, allocating resources more efficiently, and ultimately fueling economic growth. A rich literature documents the strong positive correlation between institutions and development—such as that between property-rights enforcement and economic growth and between the quality of educational institutions and educational attainment.

No country (barring some resource-rich ones) has risen to high-income status without strong economic and political institutions. While there is much country variation in political and economic organization, aggregate indicators such as the Worldwide Governance Indicators (WGI) show a robust correlation between high rankings on institutional quality and overall prosperity (figure O.17). Advanced economies have a system of highly evolved economic institutions that convey prices, define property rights, enforce contracts and competition pol-

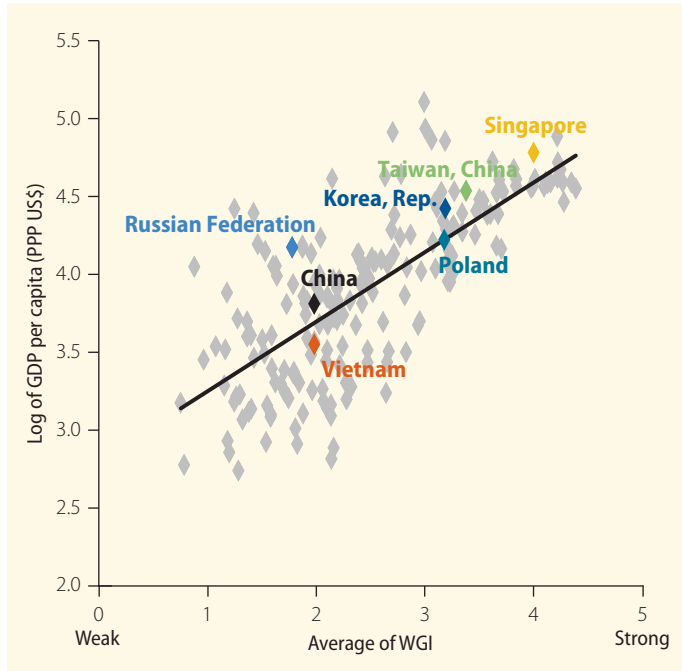
icies, and close informational gaps between buyers and sellers.⁵³ Almost as a rule, they also have highly developed political institutions—of voice and accountability. All the countries that have reached 50 percent of productivity of the United States are either 1s or 2s (the highest scores) on the Freedom House civil liberties index,⁵⁴ with one exception (Singapore).⁵⁵

There is also a surprising confluence in eastern and western thinking on institutions and even on their desired attributes (box O.3).

Not only are institutions important for economic and social development—a capable and accountable state is also desirable in and of itself. For a given level of income, it is safe to say that almost all societies would prefer a more accountable and less authoritarian state to a despotic one. The Vietnamese constitution describes the country as a “rule of law State of the People, by the People, and for the People,” reflecting its people’s desire to live as an open, democratic, and rule-based society.

Nevertheless, while global experience is clear on the long-term importance of good institutions, there is less clarity both about the specific institutions most important at various points in a country’s development and about the precise path for institutional reform in different countries. The interplay between political institutions—to promote accountability, transparency, and inclusion in the political system—and income growth is especially complex and hard to determine. A strong

FIGURE O.17 The robust long-term correlation between prosperity and the quality of governance



Sources: Kaufmann, Kraay, and Mastruzzi 2010; World Bank, World Development Indicators; World Bank, Worldwide Governance Indicators (WGI); and authors' calculations.
 Note: "GDP per capita (PPP US\$)" is the average of GDP per capita in purchasing power parity in current U.S. dollars from 1996 to 2013. "Average of WGI" is the average of the six WGI Good Governance Indicators from 1996 to 2003. The scale of the WGI scores has been transformed from -2.5 (weak)/+2.5 (strong) into 0 (weak)/5 (strong).

positive link between political openness and the quality of economic institutions appears only at higher incomes.⁵⁶ In addition, the shape of political reform and how to bring it about are even harder to establish.

How Vietnam Performs on Institutional Quality

How should international experience be interpreted in light of Vietnam's positive record on growth and poverty reduction? Has the quality of its institutions kept pace with its economic and social progress, and can they support sustained progress in the future? These questions first require delving further into the various components of institutional quality and comparing Vietnam with other middle-income countries. The WGI dataset provides one way to unbundle and measure different aspects of institutional quality (or governance). Since 1996 the WGIs have measured

BOX O.3 State effectiveness and development: Confluence of Eastern and Western thought

Economists who have studied in the Western tradition look to Adam Smith for the first definitive statement of the role of the state in economic development. For Smith, the proper realm of state action was limited to defense, justice, the rule of law, the establishment of public institutions, and the provision of public goods.^a While often cited as an advocate for a limited state, Smith made it clear that state action included public education, control of monopolies, and other forms of business regulations. He understood the importance of an effective state to economic prosperity.^b

Vietnamese economists have recourse to an older tradition, similar in many respects to the ideal state that Smith described. Confucian political philosophy is based on the creation and

maintenance of a meritocratic bureaucracy, legal protection for property rights and contracts, military defense, and public works, especially water control. The aim of government was to protect the general welfare of people through mechanisms like stabilizing food prices, redistributing rice to the poor, and providing famine relief.^c The ideal monarch was expected to govern virtuously and to give equal emphasis to administration and moral guidance.

The characteristics of modern bureaucracy that Max Weber describes would not be unfamiliar to Chinese or Vietnamese officials under the *ancien régime*: fixed jurisdictions, hierarchical organization, meticulous record keeping, meritocracy, full-time employment (no moon-

(Box continues next page)

BOX 0.3 State effectiveness and development: Confluence of Eastern and Western thought*(continued)*

lighting), and rule-based authority with all citizens subject to the same treatment.^d Like the philosopher-officials of ancient China, Weber had in mind an ideal type of a properly functioning state, a model that governments in the real world may aspire to but rarely achieve. In the real world, rules, often unclear, are designed to serve special interests. Appointments are made on the

basis of patronage rather than merit. Hierarchical structures are undermined by politics and clientelism. And overlapping responsibilities create confusion and lead to power struggles. The philosopher-kings of the Confucian ideal were challenged in practice by regional aristocrats and warlords in China, the Republic of Korea, and Vietnam.

Source: Pincus 2015, background paper for the *Vietnam 2035* report.

a. Smith 1904.

c. Nolan 2004.

b. Viner 1927.

d. Weber 1946.

six dimensions of institutional quality, and they now cover 215 economies.⁵⁷ Collectively, these indicators measure perceptions of “the process by which governments are selected, monitored and replaced; the capacity of the government to formulate and implement sound policies; and the respect of the citizens and the state for the institutions that govern the economic and social interactions between them.”⁵⁸

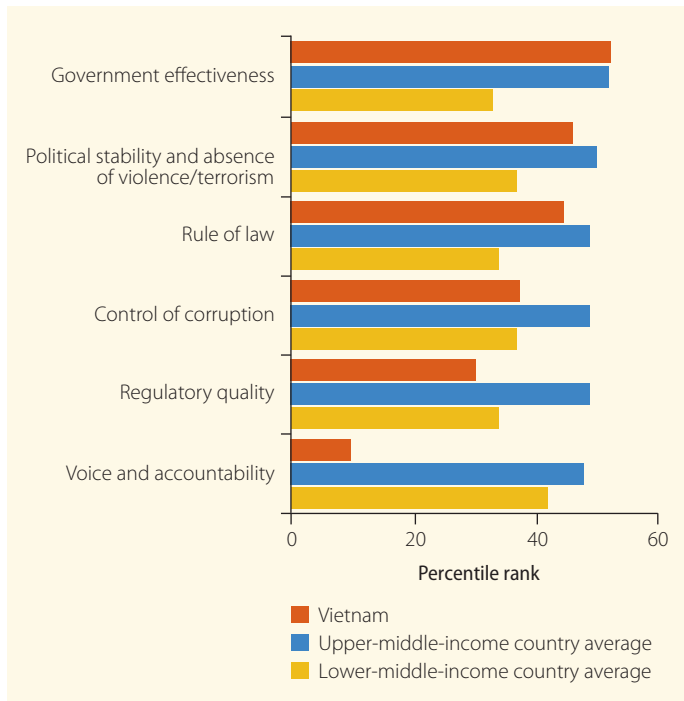
Among these dimensions, Vietnam does best on government effectiveness and on political stability (figure O.18). On both aspects, it is close to the average for all countries. It compares well with upper-middle-income countries and does better than other lower-middle-income countries. On government effectiveness, which measures perceptions related to the quality of public services and the government’s commitment to sound policies in that regard, Vietnam has improved its relative performance in recent years.

But on two dimensions Vietnam does particularly poorly. First, on voice and accountability, it remains in the bottom tenth of all countries, and its

relative ranking across all countries has fallen since 1996. Second, it also compares poorly with middle-income countries on regulatory quality, which measures the perceptions of the capacity of the state to formulate and implement policies aimed at private-sector development; its ranking on this dimension has stagnated in the past 20 years.

On the other two dimensions—rule of law (which measures confidence in societal rules, including in contract enforcement and property rights) and control of corruption (which looks at perceptions of the extent to which public power is used for private gain and to which the state has been “captured”)—Vietnam does worse than the average of upper-middle-income countries although it is roughly the same or better than other lower-middle-income countries. Its ranking has remained roughly the same on both aspects since 1996.

These comparisons indicate the aspects of institutional quality (or governance) that Vietnam might focus on in the coming years if it is to achieve the biggest development impact. As countries move up from lower to upper-

FIGURE O.18 Worldwide Governance Indicators, 2014

Source: World Bank, Worldwide Governance Indicators, www.govindicators.org.
 Note: The Worldwide Governance Indicators (WGI) are a research dataset summarizing the views on the quality of governance provided by a large number of enterprise, citizen, and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, nongovernmental organizations, international organizations, and private-sector firms. The WGI do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources.

middle-income status, their economies become more complex and diversified. The quality of government and particularly its ability to work with and regulate the private sector efficiently become even more important. This can be seen in the large difference between lower-middle- and upper-middle-income countries in such indicators as regulatory quality, rule of law, and control of corruption. Voice and accountability in turn appear to become more important as countries make the transition to high-income status, even if the exact timing and nature of the relationship are hard to determine.

There is compelling evidence that in the long run countries with more open and inclusive political institutions generate greater room for innovation and personal creativity, thus stimulating productivity improvements and higher standards of living.⁵⁹ For Vietnam, finding ways of building more open and accountable political institutions will eventually be essential.

Institutional Constraints to Vietnam's Development

What institutional factors are likely to limit Vietnam's development prospects? To answer this, the discussion here adopts a framework that has three specific elements underpinning state effectiveness.⁶⁰ The first is bureaucratic capacity based on hierarchy, unified jurisdiction, meritocracy, and rule-based authority. The second is the use of market signals to allocate resources and fiscal discipline to match policies with the state's financial capacity. And the third is popular participation to align policies and programs with the needs and aspirations of citizens. The crucial point of this framework—and one directly relevant to Vietnam's program of developing modern institutions—is that all three legs of the state effectiveness tripod are necessary for satisfactory results. Reforming state structures but rejecting market discipline, or assigning a larger role to the market mechanism while insulating government decision making from the community, are unlikely to generate positive outcomes.

Three mutually reinforcing factors dominate in explaining Vietnam's state effectiveness challenge: commercial-

ization of state institutions, their excessive fragmentation, and few checks and balances within the government and limited voice and participation of citizens.⁶¹

Commercialization of state institutions

Commercialization of state institutions in Vietnam refers to emergence of an entrepreneurial business class within or closely connected to the state (rather than outside it). It also refers to the continuing strong engagement of the state in economic activity directly through SOEs, particularly through large state economic groups, and indirectly through close links between the state and an exclusive segment of the domestic private sector. Vietnam is not alone in having influential vested interests, but the degree to which relationships to the state are integral to economic success appears to be unusually high.

Commercialization of state institutions is not new, dating as far back as the beginning of central planning in the mid-1970s (immediately after Reunification). Pressure for reform started from below and grew from the cracks in central planning. With pervasive shortages and the economy on the brink of collapse shortly after central planning was instituted, individuals and entities with access to external aid began to trade outside the central planning system.⁶² Managers of state companies became adept at trading in scarce commodities, and local authorities tolerated cross-border smuggling to gain access to essential supplies in exchange for illegal levies, with part channeled into local govern-

ment budgets to reduce deficits. Over time, growing tolerance toward these and other “fence-breaking” activities created underground markets for commodities and factors of production that gradually gained legitimacy and acceptance. The state increased the space for market transactions and, more important, was itself effectively marketized or commercialized.⁶³

State commercialization has imposed efficiency costs on the economy and contributed to the stagnation in productivity (Pillar 1). One set of costs arises from the poor performance of SOEs, which have consistently been inefficient users of land and capital and which retain a dominant role in key sectors of the economy. Their presence is not unusual in many economies, especially in sectors that are natural monopolies (public utilities) or are capital intensive (large infrastructure), with competitive markets leaving plenty of room for the private sector to prosper. But in Vietnam the SOE presence is almost across the board—from garment manufacturing to mobile telephone services and to banking—in activities where private players could do a better job.

And if the state decides to keep its extensive role in production, it needs to be neutral to private competition. This argues against state subsidies to SOEs, preferential tax treatment, and privileged access to land, finance, and government procurement contracts—all undermining the viability of domestic private firms. Crowding out a genuinely private commercial class independent of the state or its functionaries is the second cost of the commercialization of state institutions.

BOX O.4 Webs of state connections driving the pharmaceutical industry

The pharmaceutical industry has 170 companies, including 20 joint-venture foreign-invested firms, with the largest company controlling less than 5 percent of the market. SOEs have emerged in every province to supply generic medicines to local hospitals and clinics. Direct sales to hospitals account for about one-third of the market, and pharmacies the remainder.

Although the largest former SOEs have been equitized, they continue to prosper on the basis of close relationships with distributors and hospitals in their areas. Procurement is largely by individual hospitals, and bidding is open to cor-

ruption, with allegations of high markups for producers making payments to hospital administrators. Foreign enterprises, prohibited from distributing pharmaceutical products in Vietnam, rely on local distributors. Product registration, a responsibility of the Drug Administration of Vietnam, requires lengthy local trials and is conducted case by case, with the regulator retaining considerable discretion. Under these conditions, genuinely private and foreign firms are disadvantaged in market access, enabling small producers of generic drugs to survive in what on the surface looks like a highly competitive market.

Source: Pincus 2015.

The blurred division between the state and the private sector imposes static inefficiencies on the economy as high-cost producers are rewarded at the expense of consumers and more efficient firms (box O.4). Dynamic inefficiencies also arise as potential investors are discouraged by regulatory risk and concerns that markets will be captured by connected firms. Beyond its costs to the economy, commercialization of state institutions weakens the effectiveness of the state itself. It creates powerful incentives for public officials to exploit their regulatory powers and allocations of property rights to lock in long-term benefits for themselves, their families, or their networks. Such abuses of public authority undermine the legitimacy of state institutions.

Excessive fragmentation of the state

In tandem with commercialization of state institutions is their fragmentation—

related and mutually reinforcing. State fragmentation refers to the lack of clear hierarchy and assignment of roles and responsibilities within the central government and between the center and the provinces—and to the inertia and inefficiencies this generates in formulating and implementing policy. Horizontal and vertical fragmentation of power has resulted in overlapping mandates, conflicting rules and decisions, and space for interagency bargaining in the bureaucracy. Apex institutions in central government include the Office of the Government, the Ministry of Finance, and the Ministry of Planning and Investment. These entities formulate policies, often deploying interministerial task forces to achieve consensus. Cohesion in planning is in theory provided by the guiding role of the Communist Party. However, in practice power within the state apparatus is fragmented across numerous agencies at every level, and between the center

BOX 0.5 Narrow interests block a master plan

The development of the Ho Chi Minh City port system is a good example of institutional fragmentation. As a major producer of exported goods, Ho Chi Minh City and surrounding provinces need a modern port easily accessed from the main industrial zones. Ho Chi Minh City residents would like to move inner city ports to places where they will cause less traffic congestion—a change that would also free land for riverfront property development.

The prime minister approved a master plan in 2005 calling for four ports to relocate to the coastal province of Ba Ria-Vung Tau by 2010. Shortly afterward the Japan Bank for International Cooperation approved a loan of ¥36.4 billion (US\$328.6 million) for the Cai Mep-Thi Vai port complex. But each of the ports in Ho Chi

Minh City is owned and operated by different companies or government agencies. Saigon Port is a subsidiary of Vinalines, the national shipping general corporation. Ben Nghe port is operated by a local state-owned company under the People's Committee of Ho Chi Minh City. The Vietnam International Container Terminal is a joint venture of the state-owned Southern Waterborne Transport Corporation, the NOL Group of Singapore, and Mitsui & Co. of Japan. Saigon New Port is owned by the navy.

In the end, the central government could not implement the master plan because the individual state agencies saw it as against their interests. Each agency used the regulatory powers and political influence at its disposal to advance a set of narrow financial interests.

Source: Nguyen and Pincus 2011.

and provinces. The absence of a clear hierarchy and distribution of authority creates room for individual agencies to resist decisions they see as against their interests (box O.5). The result is often gridlock or decisions that are suboptimal from society's point of view.

The origins of state fragmentation, too, date back a few decades. The rejection of the planned economy that started with the *Đổi Mới* reforms shifted the balance of power from the central state to enterprises and local authorities in various ways. As output and prices were no longer centrally determined, the central government had fewer resources to allocate, so it became increasingly dependent on provinces for contributions to the treasury. Constraints on central budget funding meant that provinces were forced to rely on alternative sources of revenue,

notably by creating and supporting local state enterprises to raise funds and implement infrastructure projects.⁶⁴ Foreign direct investment and international trade were no longer a monopoly of the central state units, and the high concentration of foreign participation in just a few provinces strengthened the hand of these localities immeasurably since the central government relied on them for the surplus needed for redistribution to poorer areas.

Vietnam is one of the most fiscally decentralized countries in East Asia, which has its benefits but also makes it more difficult for central institutions to set policy and to monitor and enforce delivery standards. The 1996 Law on the State Budget, revised in 2002 and in 2013, recognized the increasing role of local authorities and put in place a form of fiscal decentralization in the

unitary state budget. Decentralization has included granting provinces powers over planning public investment, licensing foreign investment, and managing public-sector human resources. Provinces have been granted increasing fiscal powers to raise revenues and broad provincial discretion in determining the composition of expenditures and transfers to lower-level governments. Subnational governments account for more than half the total public expenditures and more than 70 percent of public investments. This is accentuated by the numerous provincial-level governments—63 (58 provinces and 5 municipalities), a large number for a country of 90 million.

The growing diffusion of state power has created tensions between the attempts of central agencies to coordinate and rationalize policy and the efforts of subnational governments and subordinate units of central government to assert their autonomy. In addition, the lack of adequate incentives for regional coordination on investment decisions, despite the regional steering committees chaired by the deputy prime minister, has exacerbated the inefficiencies created by Vietnam's nested budgeting and planning systems. A prime example is excessive capital investment by subnational units. For example, almost all of Vietnam's coastal provinces have their own deep seaports. Similarly, there are about 260 industrial parks, in nearly every one of the 63 provinces, with plans to build 239 more by 2020. Yet the average occupancy of existing parks is well below half their capacity.

The absence of merit-based management of public servants exacerbates the adverse effect of commercialization

and fragmentation of the Vietnamese state institutions on the quality of public administration. Developing meritocratic systems takes a long time and responds to particular political imperatives,⁶⁵ but some features of Vietnam's system present problems for efficiently recruiting and deploying public-sector staff. While low pay and difficulties in recruiting people with skills are challenges in most developing countries, two specific features impede a more strategic approach to the civil service in Vietnam.

First, though reforms were enacted to switch to a position-based system in 2008, they have not been implemented, and recruitment and promotion continue largely on seniority rather than merit. Second, managing the civil service remains incoherent, with human-resource functions carried out by three entities within the government plus the Central Committee Secretariat and Organization Commission. Third, duplication between party and government rules prevents deploying talent where it is most needed and limits the development of talent across the services. As a result, a highly professional public service has yet to emerge that can plan, design, and implement policies and strategies for an increasingly sophisticated economy and society.⁶⁶

Few checks and balances in government—and limited citizen voice and participation

Vietnam's political system has adapted to create space for informed discussion of policy issues and assessment of government performance. The institutionalization of the National As-

sembly, provincial People's Councils, and "grassroots democracy" at the village level are examples. But Vietnam does not yet have a robust accountability system that can strengthen the state's effectiveness. Two constraints are fundamental.

The first is the absence of an effective system of checks and balances in the functioning of the different branches of the state. The National Assembly now engages in more meaningful discussion when passing legislation and is thus less of a rubber stamp for the executive's proposals. Indeed, in a few recent cases it has turned down proposals by the executive, such as rejecting the plan for a high-speed rail link from Hanoi to Ho Chi Minh City. But its role in formulating policy and supervising government remain weak. And while disseminating information and attracting public interest in political affairs, it is not yet a vehicle that can transform interest and opinion into accountability.⁶⁷

A key factor is a nomination process that limits competition and the resulting composition of the assembly. Membership is overwhelmingly part-time, with members in regular jobs in the executive at national or provincial levels. Quite a few are also leaders of SOEs, which creates conflicts of interest and a resulting bias to accepting whatever the executive proposes. Part-time membership and high rates of turnover between sessions (70 percent of deputies are new in the present convocation) also constrain the assembly's professionalization. People's councils, the equivalent of the National Assembly at the provincial, district, and commune levels of government, elect the mem-

bers of the people's committees, which form the local executive.⁶⁸ But constraining their autonomy is an array of intersecting relationships and reporting requirements involving the Vietnam Fatherland Front, the council's party organization, the local people's committee, the standing committee of the National Assembly, and the central government. The supervisory function of the councils, limited to compliance with national policies and laws, does not touch on the performance of local government in implementing policies and programs.⁶⁹

The judiciary—the third branch of government—is also weak, with its impartiality undermined by heavy dependence on the executive. Appointing judges is subject to political and administrative pressures, while the hierarchical system of control in the judiciary undermines judges' independence in carrying out their duties. Many aspects of the executive's operations expressly do not fall under judicial supervision, while the courts are beholden to the executive for administering the court system. So, it is unsurprising that Vietnam's rankings on its judiciary's independence are below those of regional peers.

Nor is the judiciary effective at arbitrating among economic and social interests. Vietnam's formal legal framework has been augmented to meet the needs of a more complex market economy and to support its global integration. But the court system has not kept pace. The complexity of cases is increasing, given the growing sophistication of economic transactions and the body of law regulating them. The court system has remained effectively

flat, with only a modest increase in the total number of courts and judges over the past 10 years. Underlining the weaknesses in the judicial system is the low public readiness to use the courts.

The second major constraint is the limited voice and participation of citizens. Vietnam has thousands of citizen organizations, and more than a third of the population is a member of one or more sociopolitical organizations.⁷⁰ The substantial increase in the number of business associations, credit groups, religious bodies, sports and cultural associations, and groups for the elderly is good. But they are not given the chance to participate in the same way as state-sanctioned organizations. So, the system is not inclusive enough, particularly as society becomes more complex and government-sanctioned mass organizations lose their relevance.

The government has only a few formal channels for consultations with citizen organizations on policy and planning. Grassroots democracy decrees have been put in place, beginning in 1998, to constrain the behavior of local officials. The decrees define or give a role to citizens in local decision making, including planning and managing locally funded projects, elaborating village codes, and handling some aspects of sanitation, village security, village boundary changes, development plans, and complaints. These decrees require holding more meetings between commune leadership and citizens, and making budget information available to the public.⁷¹ But the mode of citizen participation in local governance has not changed appreciably, and the ability to influence the decisions of commune governments remains limited.

Decision-making power remains with the local people's committees.

Access to information, key to citizens exercising citizen voice to hold the state accountable, is still lacking. The country's governance practices have neither encouraged openness and transparency nor promoted public discussion of the state's actions. Information and data are difficult to acquire, even when public officials are required by law to provide them. Limits on the independence of the media constrain its ability in making information available to citizens. Vietnam's transformation since *Đổi Mới* has included more openness and transparency in governance and more space for citizens to discuss a range of sensitive issues publicly. But a culture of more open public debate on the state's performance will be required to achieve the country's long-term aspirations. As Vietnamese citizens become more prosperous, they will want to participate more effectively in governance to influence policy choices. They will also want the economic, social, and political freedoms that citizens enjoy in more advanced societies.

The Way Forward for the State

Modernizing the state will involve addressing all three pillars of state effectiveness: building a coherent and hierarchically organized state, applying the rationality of markets in economic policy making, and strengthening accountability through greater public involvement in decision making and stronger accountability mechanisms within the government. In 2035, the government will be less horizontally

and vertically fragmented, with a clear separation between public and private interests and between the commercial and regulatory functions of the state. Economic regulations will be based on market principles, and the government will enforce clearly defined property rights. Greater separation between the executive, legislative, and judicial branches will enable each to perform the assigned roles without interference. Nonstate organizations, including social, religious, and professional organizations, will participate actively in public life, monitoring the performance of government and partnering with government agencies to implement activities and programs for the public good.

Building a rationally organized state with a meritocratic bureaucracy

The elimination of overlapping jurisdictions is essential for reducing vertical and horizontal fragmentation, and thereby decreasing the scope for bargaining and foot-dragging in the bureaucracy. A guiding principle should be to see that responsibility and authority for various public-sector functions are assigned to a single agency at the specified level of government. Delegation of tasks between and among levels of government would of course continue, but through clearly specified mechanisms and on the basis of objective performance targets.

Reforming center-local relations

Addressing state fragmentation will require mechanisms for efficient center-local relations to clarify accountabilities and enable both tiers to work in consonance with clearly defined na-

tional goals. Reforming Vietnam's decentralization framework is key.

Vietnam needs a much clearer assignment of public-sector responsibilities and associated expenditures, especially between the central and provincial governments. To the extent possible, responsibility for planning, financing, and implementing public-sector functions would rest with a single level of government. Of course, this would not rule out delegating tasks between levels of government or dividing tasks within an area of public service—such as education, where personnel issues are handled centrally while delivery is local.

Three adjustments to the intergovernmental fiscal framework are also needed to match these changes. First, the nested budgeting system could be reformed to have financing more clearly follow functional responsibility. Such reforms in functional assignment and the corresponding systems for intergovernmental finance will likely improve accountability both upward to the central government and downward to citizens. Second, a closer match between functions and finances could inform capital investment plans, providing greater discipline in sectors where subnational governments spend, as well as making more explicit responsibility for recurrent costs when assets are built. Third, greater incentives to subnational governments to raise own-source revenues should accompany their increased accountability for financial management. In addition to providing greater authority with greater clarity in responsibilities for services, building a stronger direct link between subnational taxes and

government outputs would strengthen accountability.

Strengthening the “center of government”

Given the scale and complexity of Vietnam’s transformations in the next two decades, strengthening the center of government will be critical in addressing fragmented decision making. A stronger center will have several roles that cut across government agencies, managing strategy, coordinating policy, monitoring and reviewing performance, communicating results, and being accountable for implementation. Coordinating different agencies of government and aligning their objectives with the overall priorities of the government will be part of this role, as will monitoring the performance of different units of government, whether in different sectors or in the provinces. Communicating information to citizens about development outcomes can contribute to greater accountability.

Improving public administration

Reforming the civil service can reorient it in line with the changing role of the state from producer and owner to regulator, facilitator, and service provider. The capacity of the civil service could therefore be enhanced and its organization revamped, along three lines. First, merit can be a much greater factor in recruiting civil servants. Second, the profile of the civil service can be determined in line with the functions expected of it (rather than historical trends). Third, the compensation system for civil servants can be upgraded to attract and retain the required talent. One advantage in undertaking

these reforms is that more than a fifth of civil servants will retire in the coming decade, increasing the freedom to reorient the age composition.

Applying market rationality to economic policy making

Vietnam aspires to be a fully fledged market economy and to be recognized as such by international partners. The legal framework for a market economy has been put in place incrementally, from amending the Law on Enterprise in 1999, 2005, and 2014 to giving equal treatment of all economic sectors in the 2013 constitution. The government understands the need to level the playing field for all economic actors and clearly separate the regulatory and commercial activities it assigns to itself. This will involve providing for security of property rights, enforcing free and fair competition, and transforming the state from a producer to an effective regulator and facilitator. The government will also need to make sure that agencies directly or indirectly involved in economic regulation do not engage in business of any kind to avoid the appearance and reality of conflicts of interest.

Creating the space for a genuinely independent private sector will require political commitment at the highest levels of government and reduced state control over business and professional organizations, including the Vietnam Chamber of Commerce and Industry. Allowing these organizations to operate as authentic representatives of independent business interests would give voice to the domestic private sector and enable these groups to do more in monitoring government policy.

Enhancing the security of property rights

The reform agenda would focus on transparency and on more stringent guidelines to reduce official discretion. The major challenge in the short to medium term is to reduce the opportunities for rents in valuing and converting land use.

First, publishing information on land transactions in auctions and (to the extent practical) in market sales of land-use rights needs to be enforced. All information in the property cadaster, including descriptions of each type of property, of rights held over the property, and of any restrictions on use, needs to be public. Any associated fees for access to this information could be minimized to reflect the actual costs of providing it. Land-use planning could be fully open to public consultation, and changes in land use, rather than ad hoc, could be planned with lead times for public review. Oversight mechanisms for procedural violations can be strengthened. And the rules for the government to expropriate land could be tightened to ensure a demonstrable public purpose and compensation could more closely match market terms.

In the longer run, the legal framework for property rights could include full fee-simple ownership rights. In addition, commercial investments could be made to obtain land through property markets, with voluntary participation of use-right owners, rather than state expropriation, which would be allowed only when there is a public-goods rationale such as building transport infrastructure.

Enforcing competition

Vietnam needs a comprehensive competition policy framework to open markets to entry and competition and enforce effective competition policies. This policy and legal framework would apply equally to all firms (private or public). It would combat the most harmful anticompetitive practices, such as cartels. It would concentrate on deterring anticompetitive behavior and not on price control and regulation. It would be fair, transparent, rule-bound, and nondiscriminatory, and deviations from these principles would be rare, and only for meeting clearly defined national objectives applied fairly and transparently. The reform agenda associated with defining and implementing this framework (besides leveling the playing field between SOEs and private firms, which is discussed in the next section) includes the following:

- *Strengthen and give more autonomy to the Vietnam Competition Authority.* Lacking operational independence, at a significant productivity loss,⁷² the VCA is a department directly under the Ministry of Industry and Trade, comprising ministerial representatives rather than independent technical experts. It lacks the basic authority to ask businesses for information to investigate competition cases. Remedying these anomalies would make the VCA more independent and more capable in its regulatory and enforcement functions.
- *Align the legal framework with consumer protection.* In addition to enhancing economic efficiency,

improving consumer welfare is the other major objective of competition policy. The laws on competition and consumer protection and their enforcement accordingly need to be closely aligned to maximize the impact on consumer welfare. But a review of the consumer protection and competition laws shows that they are far from aligned. The VCA's mandate could be expanded over time to include aspects of consumer protection directly related to competition—following the example of the United States Federal Trade Commission, an independent federal agency that enforces both competition and consumer protection.

- *Rationalize exemptions to tackle cartels and other forms of concentration.* Addressing cartel behavior is an essential part of antitrust enforcement. Cartels have been associated with price increases of 10–45 percent in developing countries⁷³ and reductions in labor productivity and innovation.⁷⁴ Hardcore cartels in Vietnam are exempt from anticompetitive enforcement if the market share of their participants is below 30 percent.⁷⁵ Even when the shares are above 30 percent, several exemptions protect them. These and other exemptions in the Competition Law need a critical review to eliminate most of them, if not all. They create economic distortions, and in some cases they open the door to political interference. For instance, the decision on whether to grant an exemption goes to the minister of industry and trade if the failing-firm

defense is used, and to the prime minister in some other defense such as contributions to exports.

Transforming the role of the state in the economy from a producer to an effective regulator and facilitator

Consistent with international good practice, the government could consider SOE ownership policy with clear ownership goals, focusing first on maximizing state capital. Globally, the best SOEs focus on financial performance. It may be useful to supplement this focus with explicit statements on supporting goals. Three fundamental and interrelated principles would drive this policy:

- *Adopt a commercial approach to state ownership.* This approach requires hard budget constraints and reliable and timely financial information, disclosing SOE financial statements for transparency, accountability, and fiscal discipline. Across-the-board improvements are also needed in accounting and financial disclosure practices. Vietnamese accounting standards could be made consistent with international financial reporting standards. In addition to internal audits, independent external audits of SOEs could be conducted in accord with International Standards on Auditing.

Each SOE could have an appropriate dividend policy, approved by its board of directors. The state shareholder would not allow an SOE to retain or reinvest substantial cash surpluses without careful supervision by the SOE's board and

the state shareholder. If an SOE cannot expect to earn an adequate risk-adjusted return on reinvested cash, the surplus cash could be returned to the Ministry of Finance as a regular or a special one-time dividend.

Vietnam has too many SOEs and the government could reduce its SOE portfolio to a manageable size. Many operate in manufacturing activities where there is no compelling rationale for state ownership. A central government target portfolio of about 20 “parent” SOEs seems reasonable for 2035, with a focus on strategic sectors, but even strategic SOEs should face competition.

- *Strengthen corporate governance.* Vietnam’s SOEs need an active designated state shareholder. In the inappropriate current arrangement, the government is the state shareholder, many ministries or agencies exert ownership authority, and no specific government official is responsible for SOE performance. Taking Singapore as a model, the government could establish four or so state shareholding funds. To exercise ownership rights, these funds could review regular financial reports and disclosures and participate in annual and special shareholder meetings. They would vote the state shares in appointing directors to the board (and other matters for shareholder consideration). And they would help appoint an effective board at each SOE, appropriately staffed and organized. Except for normal matters relating to economic, environmental, and social regulation that affect all enterprises,

government entities would have no authority or right to intervene in SOE affairs.

The state shareholding funds could support efforts to further professionalize SOE management, providing market-based compensation, linking pay to performance, and controlling and disclosing related-party transactions. To act with authority, an SOE board will require members to act in the interest of the company, face no conflicts in doing so, and have relevant experience and expertise, including in the private sector. Selecting the SOE chief executive officer (CEO) and top management should follow good practice, which calls for empowering the board to appoint or remove the CEO. This power reinforces the board’s key responsibility for overseeing management and ensures that the CEO is accountable to the board rather than to the government.

- *Level the playing field.* To complement stronger competition policies, the government needs to level the playing field between SOEs and private domestic or foreign firms. If an SOE is required to perform non-commercial work, the government could ensure that it receives adequate compensation. Relevant laws could be reviewed and amended to achieve greater consistency between the rules for SOEs and those for private firms. Vietnam’s insolvency and creditor-debtor regime would also need to be consistent with international good practice and applied to SOEs. Finally, the government could seek greater alignment between pub-

lic and private laws and regulations for labor and for procurement.

Strengthening state accountability

By 2035 the Vietnamese state will have a well-functioning system of checks and balances between the different branches of the state, and citizens will have the ability to hold the state accountable. Both should also promote a stronger sense of individual responsibility and accountability among state officials.

Enhancing checks and balances

The state will need to provide for genuine checks and balances among the executive, legislature, and judiciary. Allocating power among the three branches will increase deliberations over government policy, and greater scrutiny of implementation should improve policy making and implementation.

The National Assembly could have its oversight span all the state's operations—reflecting all resources, assets, and liabilities in which the state has an interest. It could also be better equipped with full-time members, backed by trained staff. And measures could be put in place to address conflicts of interest that may diminish their oversight and to allow constituents to hold their legislators to account.

Vietnam needs a modern, independent and professional judiciary. Moves in this direction include increasing its transparency, disclosing more judgments and case records, and clarifying the roles of judges as arbiters rather than participants in cases. Selecting and promoting judges and other per-

sonnel could also be independent of executive influence. In exchange for heightened autonomy, rigorous laws and enforcement mechanisms could ensure ethical conduct and counter any conflicts of interest among judges.

Finally, specialized oversight agencies such as the State Audit of Vietnam, the Government Inspectorate, and ministerial and subnational Inspectorates, could be strengthened with greater autonomy, resources, and technical capacity.

Enhancing the ability of citizens to hold the state accountable

Vietnam has made some progress in creating conditions for citizens to participate in governance and demand accountability from government. Membership in nongovernment citizen organizations has grown rapidly—though not in all locations. The last several years have seen more public debate on development challenges, including corruption, the performance of ministers, and the weaknesses and poor management by SOEs. High Internet penetration now allows more use of social media for public debate. Three areas for reform could further increase accountability to citizens:

- *Relax limits on the space for people's social organizations.* Enabling citizen organizations to take part in decision making would give them a platform to take up issues and influence state action. A stronger legal framework would allow citizens to address their concerns and interests, and to have organizations with the administrative and fiscal capacity to pursue these interests. The draft

Law on Associations, if enacted, would help autonomous people's social organizations develop.

- *Enhance citizen access to accurate and timely information.* Enacting the Law on Access to Information, under discussion for several years, and ensuring that the right to request information applies to all types of information (other than specific exclusions) and to all levels of govern-

ment would be major gains. Greater transparency would strengthen people's social organizations and increase their ability to hold officials to account.

- *Provide greater independence for the media.* Separating media regulation from management and using civil (not criminal) remedies to improve the quality of reporting would allow the media to be more constructive.

Summary and Conclusions

Building on the nation's extraordinary record of success and energized by the aspirations of a rising middle-class society, contemporary Vietnamese leaders are charting a bold and ambitious future. Their ambition is emboldened by the opportunities that continue to unfold for Vietnam with greater regional and international integration, including through the ASEAN Economic Community and the TPP. In the 2035 vision, Vietnam will be at the higher reaches of upper-middle-income status. It will be a modern, creative, equitable, open, and democratic society with clear blue skies, clean water, and equal access to opportunities for all its citizens. This vision also foresees a state rooted in the rule of law with clear roles for the state, citizens, and the market; economic freedoms ensured by strong market institutions; and robust mechanisms to hold the government to account.

The Vietnamese people realize that achieving these aspirational goals will not be easy. Stagnation in productivity growth, inadequate attention to vulnerable groups, and growing environmental degradation are particular concerns. Current rates of labor productivity growth, for instance, will yield per capita GDP growth in the range of 4.0–4.5 percent, well short of the aspirational 7 percent needed to take Vietnam to the higher reaches of upper-middle-income status by 2035. While a turnaround in productivity growth is yet possible, the reform agenda will be challenging. International experience on this front is also sobering, since only a handful of countries have mustered the necessary

political will to carry out the needed reforms. The broader reform agenda will also be financially demanding. Given the state budget constraints, the needed investments will require much greater involvement of private investment together with ways to increase the efficiency of public spending so as to free up additional resources for investment, scale up revenue mobilization, and enhance access to domestic and external capital markets.

The country's aspirations and the supporting policy and institutional agenda stand on three pillars. The first one is balancing economic prosperity and environmental sustainability. The immediate emphasis has to be on ensuring more competitive and productive domestic enterprises, for which development of critical market institutions is important. Particular attention is needed to the institutions that protect private property rights and enforce competition policies. A stable, well-regulated, and inclusive financial sector and transparent and functioning land markets will also be crucial. And as the country embarks on an ambitious growth and economic modernization trajectory, its cities will need to better nurture private enterprise and innovation, support the growth of industrial clusters integrated with global value chains, and attract and agglomerate talent. Sustaining high growth over an extended period will also require an aggressive agenda to spur learning and innovation. An incentive-based national innovation system, focusing on the demand for and supply of innovation, can be very useful in this regard.

Finally, Vietnam has to protect its natural resources, tap more clean energy sources and build climate resilience into economic planning, sectoral policies, and infrastructure investments so as to reduce the most severe risks posed by climate change.

The second pillar is promoting equity and social inclusion. The main elements of the middle-class and aging population agenda are expanding the pension system to cover a majority of the population, ensuring that nearly all children complete upper secondary school with job-relevant skills, establishing effective representation of workers through independent unions, and achieving universal health coverage. To reduce the barriers to inclusion for ethnic minorities, targeted initiatives in education, nutrition, and sanitation can close the large gaps in opportunities for ethnic minority children, along with giving them more voice. To make people with disabilities full participants in society, Vietnam can regularly monitor implementation of its strong commitments and create opportunities for people with disabilities and their families to be their own advocates through social organizations. Eliminating the link between the resident registration system and access to public services (currently affecting 5 million people) will improve urban migrants' access to schooling, health care, and administrative services. And minimizing gender discrimination in the retirement age and using affirmative action as a short-term measure will create more opportunities for women in public leadership roles.

The third pillar is bolstering the state's capacity and accountability. Today's stagnant productivity and weak

environment for private-sector development are attributable to demonstrable gaps in state effectiveness. Vietnam's unique history has produced public-sector institutions that are commercialized and fragmented and that face insufficient scrutiny by citizens. Efforts to address these issues will build more coherent government structures and a stronger, more meritocratic bureaucracy. Market rationality can be applied more to economic policy making by clearly demarcating the public and private spheres, implementing conflict of interest provisions, enhancing the security of property rights (particularly around land issues), enforcing market competition, and streamlining state participation in the economy. And public accountability can be increased by allowing for genuine checks and balances among the three branches of government, providing a legal framework to promote the rights of citizens and improve their access to accurate and timely information, and assuring a stronger role for mass media.

Vietnam is at a turning point on its development path. There are tremendous opportunities on offer, as well as major challenges and difficulties. To achieve the 2035 vision, the only viable choice is for the country to carry out a bold program of reforms that is consistent with the three pillars. Without this, Vietnam will find it very hard to avoid the "middle-income trap" and will fall well short of its significant potential.

Current and future generations of Vietnamese people have the strong will, the spirit, and the capacity to implement the reform agenda successfully and to move toward a prosperous, creative, equitable, and democratic Vietnam.

Notes

1. The Commission on Growth and Development, 2008 *Growth Report*.
2. https://en.wikipedia.org/wiki/History_of_Vietnam.
3. The Maddison Project database, 2010.
4. Rama 2014.
5. Tran 2015.
6. Vu et al. 2015.
7. Major steps included the decollectivization of agriculture in 1988, the creation of tradable land-use rights under the 1993 Land Law, the 1992 Law on Enterprises, the 1996 Foreign Investment Law, and liberalization of the trade regime, which paved the way for World Trade Organization membership in 2007.
8. Rama 2008.
9. Van Arkadie and Mallon 2003.
10. Since 2008 the ratio of employment in the manufacturing sector to total employment has stagnated at about 14 percent.
11. The discussion on the four global megatrends draws on Centennial Asia Advisors (2015).
12. The three Asian economies are projected to contribute more than 40 percent of the increase in global GDP between 2014 and 2035, with their collective share in world GDP rising from 22 percent in 2014 to 29 percent in 2035.
13. ERIA 2012 and Thanh 2015.
14. Thanh 2015.
15. Petri and Plummer 2014.
16. This subsection draws on Centennial Asia Advisors (2015).
17. Rodrik 2015.
18. Nguyen, Renwick, and McGregor 2013.
19. Intergovernmental Panel on Climate Change (IPCC) 2007 report, available from the General Statistics Office of Vietnam.
20. MONRE 2012.
21. These projections do not take into account land subsidence, which further exacerbates the impacts of sea-level rise.
22. Wassmann et al. 2009.
23. Bunn et al. 2015.
24. Coker et al. 2011.
25. Tran 2015.
26. Eichengreen, Park, and Shin 2011 and Agenor and Canuto 2012.
27. Krugman 1994.
28. Today the government registry comprises more than 650,000 domestic private enterprises, compared with just 40,000 in 1999 and virtually none in 1990.
29. Malesky and Taussig 2008.
30. Van Thang and Freeman 2009, for example.
31. Nguyen and Le 2005.
32. Malesky and Taussig 2009.
33. Boly 2015.
34. Steer and Sen 2010.
35. Eighteen percent of Vietnamese adults have borrowed from a financial institution in 2015, up from 16 percent in 2011. In comparison, only about 7.5 percent of the population in the average lower-middle-income country has currently borrowed from a financial institution (World Bank's Global Findex database).
36. As per the Global Findex database, 31 percent of Vietnamese adults have accounts with financial institutions (the SBV estimates that 50 percent of adults have accounts), much less than the lower-middle-income country average of 43 percent. The gap is even worse for poor adults—19 percent in Vietnam compared with an average of 33 percent in lower-middle-income countries.
37. Cung 2015.
38. According to a report by Nhân Dân (The People), the official Communist

- Party news agency, the government received more than 1.2 million complaints and denunciations between 2003 and 2010, of which 70 percent were related to land. See http://www.nhandan.com.vn/mobile/_mobile_chinhtri/_mobile_tintucsukien/item/788102.html, accessed on October 19, 2015.
39. Changes in this realm typically involve a rising share of food distribution through modern supermarkets and out-of-home eating establishments, greater consumption of branded processed/convenient foods, a consolidation in agricultural collection and intermediate trading, the spread of cold-chain storage and logistical methods, and the application of increasingly stringent standards and sophisticated product traceability and quality management.
 40. <http://www.digitaltrends.com/mobile/iphone-cost-what-apple-is-paying/>.
 41. World Bank 2012.
 42. Customs procedures were evaluated before the 2014 rollout of Vietnam's web-based, single-window, e-customs system VNACCS/VCIS (Vietnam Automated Cargo and Port Consolidated System and Vietnam Customs Information System). This system will almost certainly lead to improved customs performance.
 43. World Bank 2013.
 44. Hai Phong port in the north has capacity shortfalls, while Cai Mep-Thi Vai port in the south has excess capacity.
 45. World Bank and Ministry of Finance of Vietnam Public Expenditure Review, 2015. Unpublished draft.
 46. Brand 2015.
 47. There are more than 30 extra-budgetary funds at the central and subnational levels, such as the Vietnam Social Security Fund, the Enterprise Restructuring and Development Support Funds, and the Accumulation Fund for Foreign Debt Repayment. In addition, fully state-owned, quasi-fiscal, special-purpose vehicles—such as the Vietnam Development Bank—intermediate official development assistance disbursements like lending to SOEs.
 48. Bloom and Van Reenen 2007; Maloney and Sarrias 2014.
 49. In countries like Japan and the Republic of Korea, the institutional mandates for land, infrastructure, transport, and water resources are vested in one line ministry, which enables better coordination of policies at the territorial and city levels.
 50. Including the regional corridors of Hanoi–Hai Phong, Ho Chi Minh City–Cai Mep-Thi Vai, and Can Tho–Ho Chi Minh City and the interregional corridor between the Central Highlands and Ho Chi Minh City. A compelling economic case has yet to be made for a corridor linking Hanoi and Ho Chi Minh City. This corridor may emerge organically once the economic returns of the regional corridors become apparent.
 51. World Bank 2009.
 52. World Bank 2014.
 53. The Commission on Growth and Development, 2008 *Growth Report*.
 54. The Freedom House civil liberties index captures freedom of speech, the press, association, and religion, on a scale from 1 (completely free) to 7 (unfree).
 55. Dollar 2015a.
 56. Dollar 2015b.
 57. Voice and accountability; political stability and absence of violence/terrorism; government effectiveness; regulatory quality; rule of law; and control of corruption.
 58. See the World Bank's Worldwide Governance Indicators 2014.
 59. Acemoglu and Robinson 2013.

60. This follows the “hybridity” model developed by Peter Evans (2005).
61. Pincus 2015.
62. Fforde and Paine 1987; Abrami 2002.
63. Cheshier 2010; Fforde 2007.
64. Vu 2014.
65. For instance, the introduction of meritocracy in Scandinavia emerged as the absolute kings had an incentive to establish a rule-based, capable, and independent—from anything but the absolute monarch—bureaucracy that could control the nobility and landed gentry. In the Republic of Korea, the legitimacy of the state depended on a capable and neutral public service when the meritocracy gained a foothold in the 1980s.
66. Phuc 2015.
67. Malesky, Schuler, and Tran 2012.
68. They are also responsible for monitoring local development plans and, since 2002, approving budget allocations for provinces, districts/wards, and communes/neighborhoods except for expenditures stipulated by central-government mandates.
69. Vasavakul 2014.
70. According to the CIVICUS Vietnam assessment (2006) and the VUFO-NGO Resource Center’s study of forms of engagement between civil society and state (2008). And these citizen organizations include sociopolitical organizations under the Fatherland Front, professional organizations, local nongovernmental organizations, and community-based organizations.
71. Fforde 2011.
72. De facto independence of the competition authority could translate into a 17 percentage-point reduction in the productivity gap with the United States (Voigt 2009).
73. Levenstein, Suslow, and Oswald 2003.
74. Broadberry and Crafts 2001; Evenett, Levenstein, and Suslow 2001; Symeonidis 2008.
75. Hard-core cartels include firms acting in collusion and engaging in price fixing, market partitioning, and bid rigging.

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