

TAKING STOCK

AN UPDATE ON VIETNAM'S RECENT ECONOMIC DEVELOPMENTS

Special Focus:
Towards a High-Quality Fiscal Consolidation

July 2017

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THE WORLD BANK

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ACKNOWLEDGEMENTS



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ACRONYMS AND ABBREVIATIONS



AEC	Association of Southeast Asian Nations Economic Community
CIT	Corporate income tax
CPI	Consumer Price Index
D	Vietnamese dong
EAP	East Asia and Pacific
EMDE	Emerging Market and Developing Economies
FDI	Foreign direct investment
GDC	General Department of Customs
GDP	Gross domestic product
GSO	General Statistics Office
IMF	International Monetary Fund
MOF	Ministry of Finance
MOLISA	Ministry of Labor, Invalids and Social Affairs
MPI	Ministry of Planning and Investment
ODA	Official development assistance
OOG	Office of Government
PIM	Public Investment Management
PIT	Personal Income Tax
PMI	Purchasing Manager Index
SBV	State Bank of Vietnam
SEDP	Social Economic Development Plan
SOEs	State-owned enterprises
VAMC	Vietnam Asset Management Company
VAT	Value-added tax
y/y	Year-on-year

OFFICIAL INTERBANK EXCHANGE RATE: US\$ = VND 22,432

Government Fiscal Year: January 1 – December 31



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OVERVIEW

Recent Economic Developments

A broad-based recovery in global economic activity has been taking hold since late 2016. Industrial production has picked up and global trade accelerated after two years of pronounced weakness. A gradual recovery in commodity prices diminished growth constraints among commodity exporters, including major emerging economies. Despite heightened policy uncertainty, growth in major advanced economies, including the United States, the European Union, and Japan, has strengthened, reflecting buoyant domestic demand and rising exports. Growth in developing East Asia and Pacific (EAP) continues to be resilient as already robust domestic demand was supported by a pickup in external demand and a gradual recovery in commodity prices.

Despite some moderation in economic activity in the first half of 2017, Vietnam's economy continues to show fundamental strength. Real gross domestic product (GDP) expanded by 5.7 percent (y/y) during the first half 2017 (about the same pace the first half of 2016). A significant contraction of mining output, especially in the oil sector, was offset by strong momentum of Vietnam's fundamental growth drivers—domestic demand and export-oriented manufacturing. The service sector—which accounts for about 42 percent of GDP—accelerated, driven by buoyant retail trade growth, which benefited from sustained strength of domestic consumption. Industrial production outside of the mining sector also remains robust, and growth has gradually recovered in agriculture, though the recovery is still fragile.

After a large surplus in 2016, Vietnam's external current account balance started to decline in early 2017. Robust growth in exports, tourism receipts, and private remittances led to a current account surplus of about 4 percent of GDP in 2016, marking the sixth consecutive year of a widening current account surplus. The financial account also saw large net inflows of foreign direct investment (FDI) and long-term loans, allowing the State Bank of Vietnam to gradually rebuild foreign reserves. The current account surplus started to decline in early 2017 due to a recovery in import growth.

Bolstered by a strong external position, the nominal exchange rate has been relatively stable but the real exchange rate continues to appreciate. The reference rate was devalued modestly by 1.23 percent in 2016 and around 1.3 percent year-to-date in 2017. Meanwhile, the real effective exchange rate continued to appreciate by about 5 percent in 2016 and 24 percent since 2010. Real exchange rate appreciation is driven by a large external surplus of the FDI sector, but is a concern for Vietnam's domestic private enterprises, which continue to face significant external imbalance and competitiveness challenges.

Monetary policy continues to balance growth and stability objectives. Driven by rising administrative prices—mainly of health care services and education fees, Vietnam's Consumer Price Index rose 4.7 percent in December 2016—the highest level since August 2014. Inflation moderated during the first months of 2017 and core inflation remains subdued at below 2 percent. Meanwhile, monetary policy remains accommodative, with low real interest rates and rapid credit growth of about 20 percent (year-on-year) in the first months of 2017. While supporting investment growth, the credit intensity of growth is rising, and sustained acceleration of credit may raise concerns over asset quality, particularly given the unsolved balance sheet risks related to past bad debts.

The government has made a strong commitment to restore fiscal discipline, which now needs to be underpinned by high-quality fiscal consolidation measures. The fiscal deficit (including off-budget items) is estimated to have widened to about 6.5 percent of GDP in 2016 from 6.2 percent in 2015. As a result, Vietnam's total outstanding public debt (government, publicly guaranteed, and local government) was estimated at 63.7

percent of GDP at the end of 2016, inching quickly toward the legally mandated ceiling of 65 percent of GDP. Fiscal outturns in the first quarter of 2017 suggest stronger revenue performance (mostly of non-tax revenue) and greater spending discipline, which helped contain the budget deficit and rising public debt. But the adjustment has so far largely resorted to ad-hoc, one-off measures. For a high-quality fiscal consolidation to be sustained over the medium term, further structural measures are needed to boost revenue potential and spending efficiency while protecting growth-enhancing investments in infrastructure and human capital (see special focus note).

Outlook, Risks and Policy Implications

Vietnam’s medium-term outlook remains positive. Real GDP growth is projected to accelerate slightly to 6.3 percent in 2017, underpinned by buoyant domestic demand, rebounding agricultural production, and strong export-oriented manufacturing, aided by a recovery in external demand, which will be only partially offset by declining oil production. Inflationary pressures will remain moderate, reflecting stable core inflation and tapering of administrative price hikes. The current account is expected to remain in surplus, albeit at a lower level as stronger import growth resumes. Over the medium term, growth is projected to stabilize at around 6.4 percent in 2018–19, accompanied by broad macroeconomic stability.

Vietnam Key Medium-Term Indicators

	2014	2015	2016/e	2017/f	2018/f
GDP Growth (%)	6.0	6.7	6.2	6.3	6.4
Consumer Price Index (annual average, %)	4.1	0.6	2.7	4.0	4.5
Current Account Balance (% GDP)	4.9	0.1	4.0	2.5	1.8
Fiscal Balance (% GDP)	-6.3	-6.2	-6.5	-5.7	-5.6
Public Debt (% GDP) – MOF Definition	58.0	61.8	63.7	65.0	65.4
Public debt (% GDP)	54.5	59.6	62.2	64.6	65.2

Sources: GSO, MOF, SBV, and World Bank.

Note: e = estimated; f = forecast.

Several domestic and external risks cloud the outlook. On the external front, these include surges in global financial market volatility, higher global interest rates, and a slowdown in global integration and trade liberalization. On the domestic front, medium-term growth prospects may be clouded by slower than expected progress in addressing SOE legacy weaknesses and banking sector vulnerabilities – especially NPL resolution. In addition, delays in and/or poor quality of fiscal consolidation could not only raise the risk of debt distress but also affect longer-term growth prospects, if deficit reduction is achieved at the expense of growth-enhancing investment in infrastructure and human capital. Meanwhile, steady upward pressure on the real exchange rate may intensify existing competitiveness challenges, especially of the domestic private sector.

Elevated global uncertainty strengthens the case for macroeconomic prudence and a focus on addressing critical structural bottlenecks to medium term growth. In view of sustained growth momentum, solidifying macroeconomic stability and rebuilding policy buffers remains the foremost priority. Lowering the fiscal deficit would help to contain rising risks to fiscal sustainability and provide fiscal space to accommodate potential future shocks. Containing risks from rapid credit growth requires continued improvements in supervision and prudential regulation. The longer term challenge for the Vietnam is to sustain rapid growth and poverty reduction. Considerable gains are possible from structural reforms that alleviate constraints on productivity growth, including

through SOE reforms, further improvements in the business environment, resolution of NPL and improved factor markets for land and capital.

Special focus - Towards a High-Quality Fiscal Consolidation

Over the past few years, Vietnam's fiscal position has been expansionary. While fiscal expansion helped avert a sharper economic downturn during 2009-11, larger subsequent deficits have eroded fiscal buffers, shortened the maturity profile, and increased the debt service burden on the budget. Sizable fiscal deficits, rapidly rising public debt, declining fiscal revenues (as a share of GDP), and inefficiencies in public expenditure, especially public investment, pose headwinds to future stability and growth. While risks of acute debt distress are limited, fiscal space to address growing infrastructure and social spending needs is shrinking, and the lack of fiscal buffers limits the government's ability to cope with external volatility and potential shocks.

The National Assembly and the Government have made a commitment to start addressing these fiscal vulnerabilities over the medium term. The Medium Term Fiscal Plan 2016–20 envisages a gradual fiscal adjustment of the fiscal position over the coming four years aiming to reduce the fiscal deficit to 3.5 percent of GDP by 2020 and to keep the level of public debt below the current statutory limit of 65 percent of GDP. While broad fiscal policy directions for the coming five years have been set, specific policy measures should be further elaborated as the basis of a concerted effort to boost revenue mobilization, restructure and enhance efficiency in spending, strengthen the utilization of public asset management and effectively manage public debt and fiscal risks.

A gradual, high-quality fiscal consolidation is recommended to entrench fiscal sustainability while protecting necessary growth-enhancing public investment. The quality of the fiscal adjustment matters. The composition of measures to reduce the fiscal deficit needs to strike an appropriate balance between revenue mobilization and expenditure containment. The pace of deficit reduction should be gradual but consistent to avoid the need for a sharper and hence more painful adjustment down the line. On the revenue side, enhancing revenue administration to improve collections and lower the compliance burden on taxpayers should be accompanied by tax policy changes to enhance domestic revenue mobilization. Specific policy options include VAT reforms (base broadening and potential rate increases), increases in excise taxes for selected goods, a review and rationalization of tax expenditures (especially incentives) to broaden the CIT base and introduction of recurrent property tax. On the spending side, productive investment in infrastructure and human capital should be protected while focusing on efficiency gains with regard to both capital and recurrent spending. Enhancing public debt management to enable the transition to a financing model, that will increasingly rely on domestic and international capital markets as the primary fiscal financing sources would also help manage the costs and risks associated with the public debt portfolio.

This special focus issue is part of two-part series on fiscal reforms. While this installment of the Taking Stock special topic is focused on specific revenue and debt management options to underpin more sustainable and efficient fiscal management, the December issue will focus on expenditure restructuring.



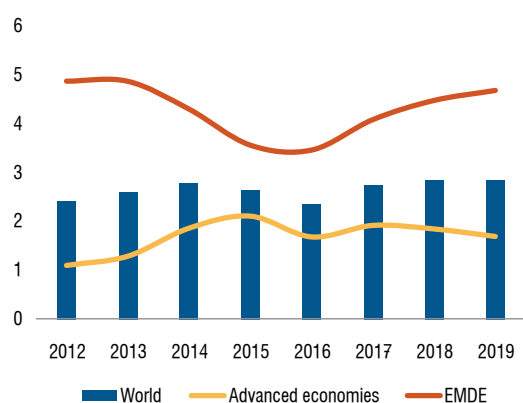
SECTION I

RECENT ECONOMIC DEVELOPMENTS

I.1: External Economic Environment

1. Global growth is firming, contributing to an improvement in confidence (figure 1). A recovery in industrial activity has coincided with a pickup in global trade, after two years of marked weakness. In emerging market and developing economies, obstacles to growth among commodity exporters are gradually diminishing, while activity in commodity importers remains generally robust. Activity in advanced economies is expected to gain momentum in 2017, supported by strengthening domestic and external demand. Investment activity across advanced economies has strengthened, while private consumption growth has moderated. Nevertheless, structural headwinds, including slower trade liberalization and value chain integration, as well as elevated policy uncertainty, continue to weigh on the outlook for trade (figure 2).

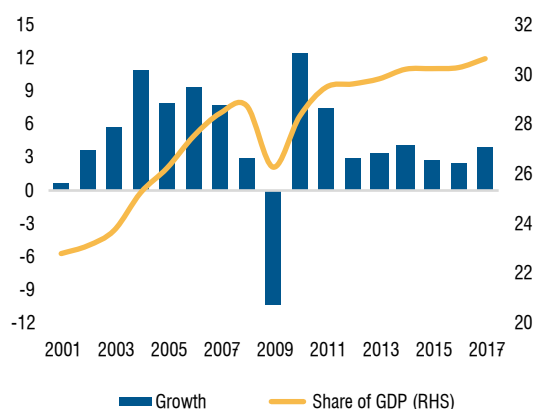
Figure 1 Global GDP Growth (%)



Source: World Bank.

Note: EMDE = emerging market and developing economies.

Figure 2 Global Trade Growth (%)



Source: World Bank.

Note: RHS = right-hand side.

2. Growth in developing East Asia and Pacific (EAP) continues to be resilient. Already robust domestic demand was supported by stronger external demand and a gradual recovery in commodity prices (table 1). Monetary policies remained accommodative, and credit continued to grow rapidly in most major economies. Inflation is edging up and producer prices are rising quickly across the region as commodity prices increase. Capital outflows intensified toward end-2016, leading to depreciation pressures, but financial markets have since recovered. The growth outlook for 2017–19 remains broadly positive across the region. China is expected to continue its gradual transition to lower, more sustainable growth. In the rest of the region, growth is projected to pick up moderately. Continued buoyancy in domestic demand, including public and increasingly private investment, will be supported by gradually strengthening external demand.

Table 1 East Asia Pacific: GDP Growth Forecasts

	Forecast				
	2015	2016	2017	2018	2019
Developing EAP	6.5	6.4	6.2	6.1	6.1
China	6.9	6.7	6.5	6.3	6.3
Developing EAP excl. China	4.8	4.9	5.0	5.1	5.2
Developing ASEAN	4.8	4.9	5.0	5.1	5.2
Indonesia	4.9	5.0	5.2	5.3	5.4
Malaysia	5.0	4.2	4.3	4.5	4.5
Philippines	5.9	6.8	6.9	6.9	6.8
Thailand	2.9	3.2	3.2	3.3	3.4
Vietnam	6.7	6.2	6.3	6.4	6.4
Cambodia	7.0	6.9	6.9	6.9	6.7
Lao PDR	7.4	7.0	7.0	6.8	7.2

Myanmar	7.3	6.5	6.9	7.2	7.3
<i>Assumptions about the external environment</i>					
World	2.7	2.3	2.7	2.9	2.9
Advanced economies	2.1	1.7	1.8	1.8	1.7
Emerging and developing economies	3.5	3.4	4.2	4.6	4.7
Crude oil (spot, US\$/barrel)	51	43	55	60	61
Non-energy commodities (index, 2010 = 100)	82	80	83	84	85
Food (index, 2010 = 100)	91	92	93	94	95

Source: World Bank.

3. Global and regional uncertainties and risks persist. The tentative recovery in global trade could be undermined by waning support for trade liberalization and global integration in major economies. Stronger economic activity and rising inflation in major economies raise the prospects of faster-than-anticipated monetary tightening. Market reassessment of advanced-economy monetary policy, or disorderly exchange rate developments, could contribute to swings in asset prices and capital flows, potentially amplified by vulnerabilities in some countries. A further increase in policy uncertainty from already high levels could dampen confidence and investment and trigger financial market stress, after a period of unusually low financial market volatility. Over the longer term, persistently weak productivity and investment growth could erode long-term growth prospects in emerging market and developing economies.

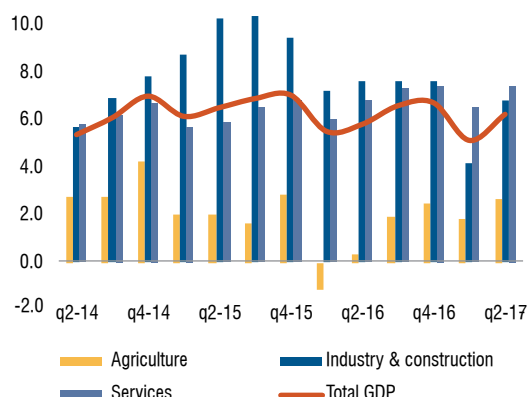
I.2: Recent Economic Developments in Vietnam

Declining oil production weighs on growth in the first half of 2017, but underlying momentum remains strong

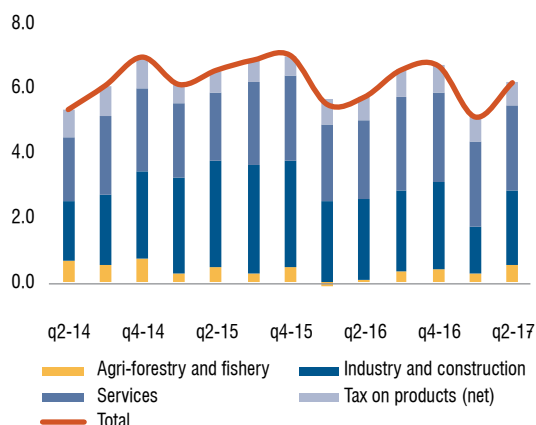
4. The economy continued to exhibit fundamental strength during the first half of 2017. Following strong performance in the second half of 2016, growth momentum was sustained during the first half of this year, driven by export-oriented manufacturing and robust domestic demand. Gross domestic product (GDP) expanded by 5.7 percent year-over-year (y/y) about the same as during the same period in 2016 (figure 3, panel A). While agricultural output has gradually recovered from the severe drought last year, the industrial sector has suffered its smallest expansion since 2011. This is mainly due to a substantial 8.2 percent drop in value addition in the mining sector. Meanwhile, non-mining industrial production remains strong at 8.5 percent. The construction sector also slowed partly because of slowing disbursement of public investment. In contrast, growth picked up further in the service sector (figure 3, panel B), driven by strong retail trade growth, which benefited from sustained strength of domestic consumption which benefitted from moderate inflation and rising real wages.

Figure 3 Sustained Growth Momentum

Panel A GDP growth (y/y, %)



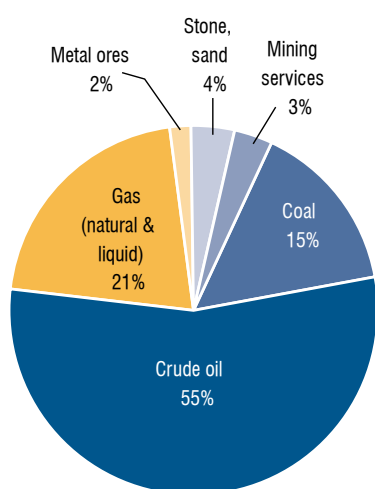
Panel B Contribution to GDP growth (pct. points)



Source: GSO.

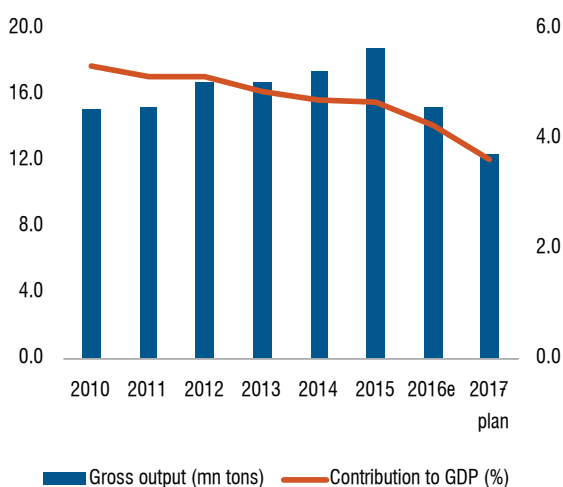
5. Mining output, particularly oil production, declined significantly in the first half of 2017 (figure 4). The mining sector, which currently accounts for about 7.4 percent of GDP, suffered from a substantial output decline of 8.2 percent, subtracting 0.6 percentage points from overall GDP growth in the first half of 2017. Reflecting the increasingly constrained technical production capacity of Vietnam’s major oil fields (aging oil fields) and deliberate policy to refocus the economy away from natural resource sectors, the 2017 oil production target is only 12.3 million tons (about 246,000 barrels per day) of crude, down 19.2 percent from the 2016 level (figure 5). In the first five months of 2017, crude oil output fell 14.6 percent from a year ago to an estimated 5.7 million tons. However, to prevent further declines in the mining sector, the government has recently proposed that Petro Vietnam ramps up production by at least an additional 1 million tons (20,000 barrels per day) of crude oil this year.¹

Figure 4 Mining Sector



Source: GSO.

Figure 5 Declining Crude Oil Production



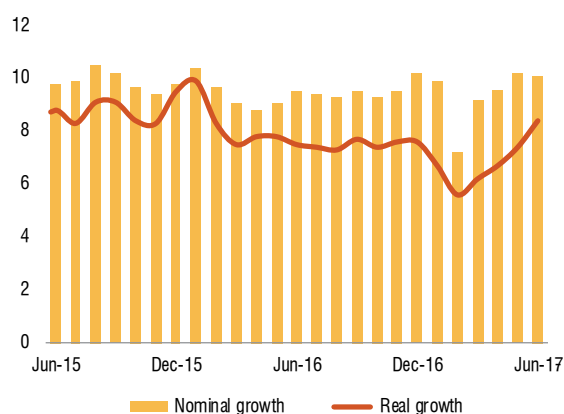
Source: GSO.

¹ The General Statistics Office (GSO) estimates that the production of 1 million tons of crude oil would contribute approximately 0.25 percentage points to overall GDP growth.

6. The manufacturing sector continues to provide strong support to headline growth, aided by strong FDI in labor intensive export oriented manufacturing. Benefitting from a continuing inflow of foreign direct investment, relatively low cost of production and abundant labor force, the manufacturing sector accounts for nearly 15 percent of GDP and expanding by 10 percent on average in the period of 2011-2016. Performance of the sector remained robust in 2017. The sector grew 8.4 percent y/y in Q1 and accelerated strongly to 12.3 percent in Q2, helping to compensate the substantial decline of mining sector and sustain the growth of entire industrial sector at 5.3 percent in the first half of 2017. Manufacturing and processing industries account for more than 70 percent of foreign direct investment committed in the first half of 2017 which is expected to further expand the production base for the sector in the medium-term. While benefitting from high productive FDI enterprise, participation of domestic private enterprises in global manufacturing value chains remains relatively limited.

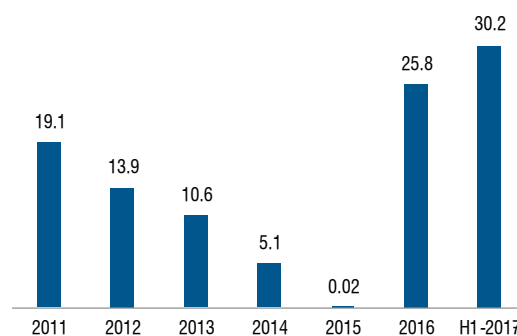
7. Service sector performance continues to be robust fueled by buoyant private consumption and rising tourist entries. The service sector expanded 6.9 percent in the first half of 2017, compared to 6.5 percent in the first half of 2016. The retail sales index, an indicator of consumption growth, grew by 10.1 percent in nominal terms in the first six months of 2017, compared with 9.2 percent in the same period of 2016 (figure 6). The tourism sector also contributed to robust service sector growth, with the number of tourist arrivals increasing 30 percent year-on-year. Last year, Vietnam received 10 million of tourists (figure 7). Vietnam has recently made great efforts to upgrade tourist infrastructure, improve the quality of tourism services, bolster the sector’s human resources and simplify visa procedures for foreign visitors. The country set a target of receiving 19 million foreign tourists in 2020.

Figure 6 Retail Sales (change in %, y/y)



Source: GSO

Figure 7 Tourist Arrivals (change in %, y/y)



Source: GSO

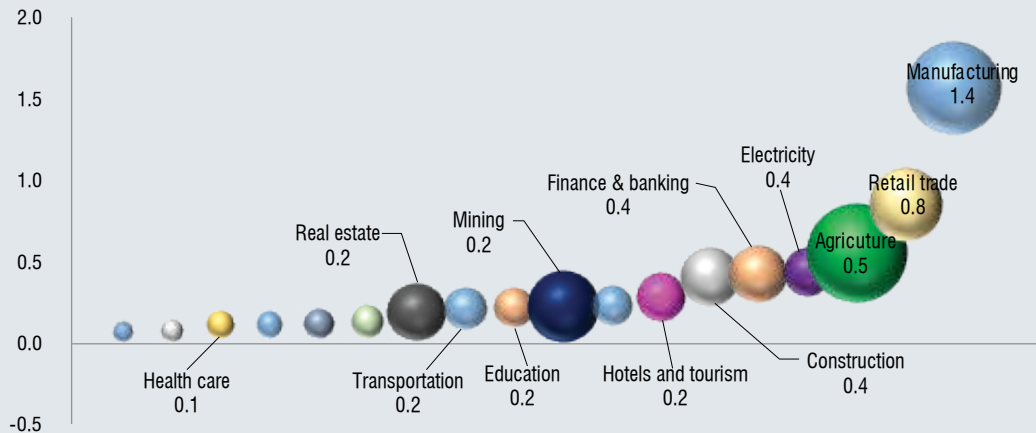
8. A gradual recovery was recorded in the agriculture sector. The agriculture sector grew by 2.7 percent in the first three months of 2017, rebounding after a severe drought last year. While the recovery remains fragile, barring additional natural disasters growth in the sector is expected to strengthen, lending additional support to overall growth for the remainder of this year. Over the medium term, improving product quality and food safety, adding value to primary commodities, and strengthening natural resources management continue to be important to ensure the sustainable growth of the sector that could lead to higher incomes for farmers, and a significant contribution of the sector to overall economic growth, as it represents approximately 15 percent of the economy.

Box 1 What Are the Fundamental Drivers of GDP Growth?

During 2011–16, manufacturing and retail trade (a proxy of domestic consumption) continued to be the leading contributors to growth. These two sectors account for a quarter of Vietnam’s GDP and contributed about one-third of overall GDP growth in those years. Agriculture also contributed significantly to GDP growth, but agricultural output has been relatively more variable across years.

Figure B1.1 Contribution to GDP Growth (percentage points) in Average 2011–16

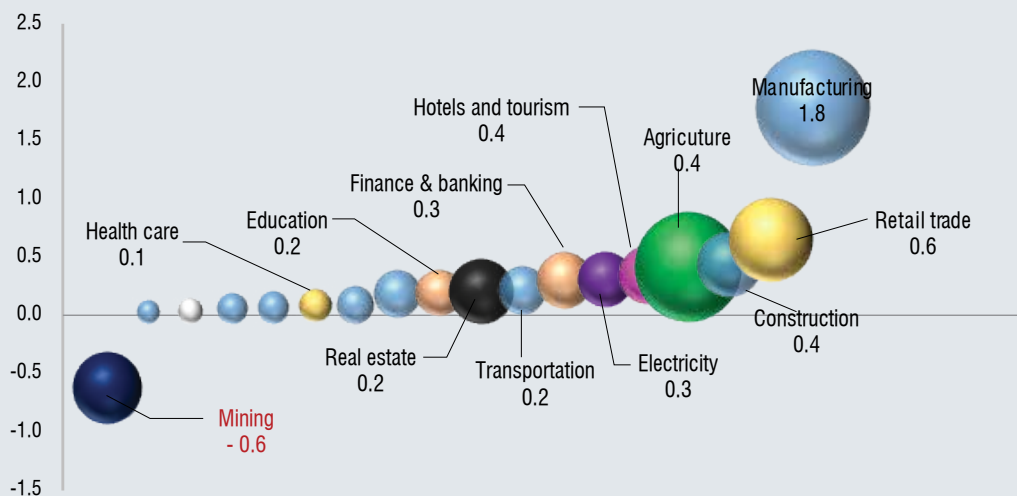
Size of bubble indicates the sector’s share of GDP



During the first half of 2017, growth momentum picked up except for the mining sector. Excluding the mining sector, non-mining GDP growth accelerated from 6.3 percent in H1-2016 to 6.8 percent in H1-2017. In the first half of 2017, the sector accounted for about 7.4 percent of GDP and negatively contributed (-0.6 percentage points) to the overall 5.7 percent increase in real GDP. Meanwhile, the two fundamental growth drivers—export-oriented manufacturing and domestic demand—continue to perform strongly. While agriculture rebounded from the severe drought last year, the recovery remains fragile and the contribution of the agriculture sector to overall economic growth remained small (0.4 percentage points) in the first half 2017 (compared to 0.5 percentage points over the longer term). Last year, the sector also negatively contributed to overall growth by -0.33 percentage points.

Figure B1.2 Contribution to GDP growth (percentage points) in H1-2017

Size of bubble indicates the sector’s share of GDP



Sources: World Bank estimates based on GSO data.

Monetary policy remains accommodative amidst subdued core inflation

9. Monetary policy continues to balance growth and stability objectives. The monetary policy directions for 2017 embody the State Bank of Vietnam's (SBV's) dual focus on ensuring stability while boosting growth. The targets include achieving economic growth of 6.7 percent, maintaining the Consumer Price Index (CPI) at about 4 percent, and maintaining a stable exchange rate, reaching a credit growth rate of 18 percent, accelerating the total liquidity (M2) growth rate to 16 to 18 percent, and ensuring nonperforming loans remain below 3 percent of total banking sector assets. While the SBV has managed to balance these different objectives, over the medium term, the multiplicity of the SBV's objectives needs to be reduced, giving monetary policy a more explicit price stability focus, while providing flexibility with regard to the choice of appropriate policy instruments.

10. Inflationary pressures remain moderate. Driven by rising administrative prices—mainly of health care services and education fees—Vietnam's CPI rose 4.7 percent (year-on-year) in December 2016—the highest level since August 2014. However, headline inflation softened in the first months of 2017 and underlying core inflation² remains well below 2 percent. Reflecting decreasing food prices and still low energy prices, the CPI fell 0.17 percent month-on-month in June, bringing the year-on-year CPI increase to 2.5 percent, down significantly from 5.2 percent in January 2017 (figures 8 and 9). While immediate inflationary pressures are contained, low real interest rates, rapid credit growth, and tight labor markets may pose risks to long-term price stability.

Figure 8 CPI (%)

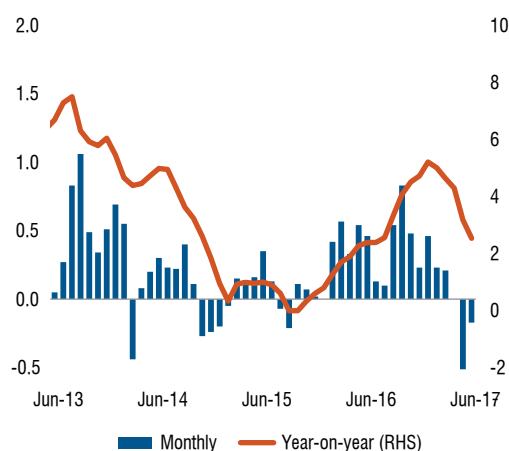
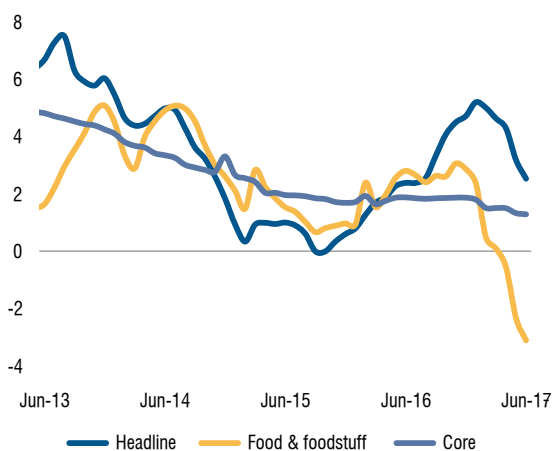


Figure 9 Declining Food CPI (% y/y)



Source: GSO

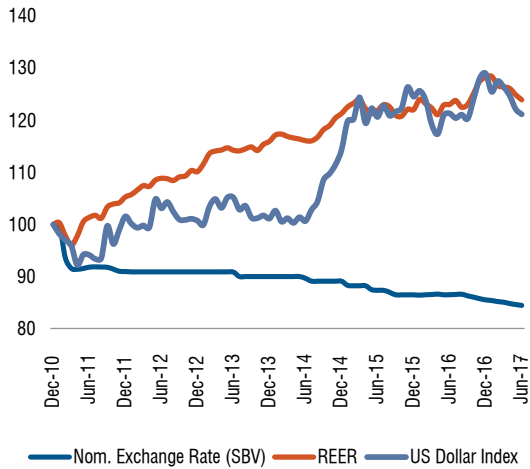
Note: RHS = right-hand side.

11. Bolstered by a strong external position, the real effective exchange rate continues to appreciate. The SBV moved toward more market-driven management of the exchange rate since the beginning of 2016. Since then, the reference exchange rate is being set daily, taking into account market conditions and a basket of currencies of key trading partners. Significant inflows of foreign liquidity due to the current account surplus and record foreign direct investment (FDI) provided space for foreign reserve accumulation during most of 2016. Despite large foreign exchange inflows, the dong depreciated slightly by 1.23 percent in 2016 and around 1.3 percent year-to-date in 2017. Reflecting Vietnam's significant external surplus, the real effective exchange rate continues to appreciate by about 5 percent since 2016 and 24 percent since 2010 (figure 10). While real exchange rate appreciation is driven by the FDI sector, it is a concern for Vietnam's domestic sector, which continues to face significant external imbalance and competitiveness challenges.

² Core inflation excludes food, foodstuff, fuel and administered prices in education and healthcare

Figure 10 Relatively Stable Exchange Rate

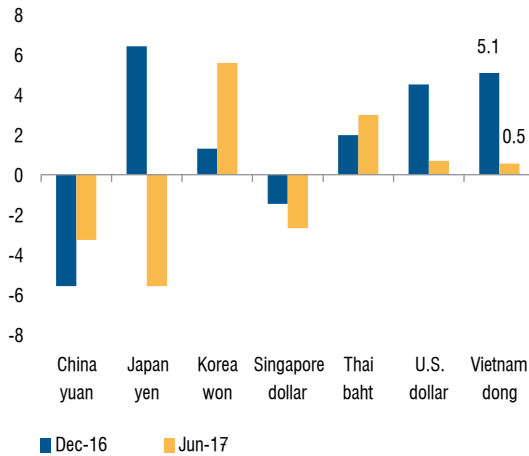
Panel A Vietnam Dong Exchange Rate (Dec 2010 = 100)



Source: SBV and World Bank.

Note: REER = real effective exchange rate.

Panel B Real Effective Exchange Rate (change in %, y/y)

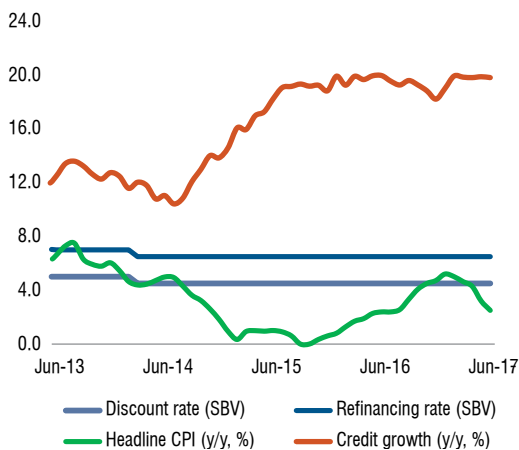


Source: World Bank.

12. Credit continues to surge amid accommodative monetary conditions. There has been no change in policy rates since late 2014. Since the beginning of the year, interbank rates have remained close to the repo rate, which implies real interest rates close to zero. Following strong growth in 2015–16, credit continued to accelerate quickly during the first months of 2017, expanding at about 7.6 percent since the beginning of the year and equivalent to roughly 20 percent year-on-year (figure 11, panel A). Recently, the government has also directed the SBV to expand the credit growth target beyond 18 percent. Although supporting investment growth, the credit intensity of GDP growth is high (figure 11, panel b), raising concerns over the productivity of new credit and mispricing of risk. The acceleration of credit also heightens concerns over asset quality, particularly given the unsolved balance sheet risks related to bad debts accumulated in recent years.

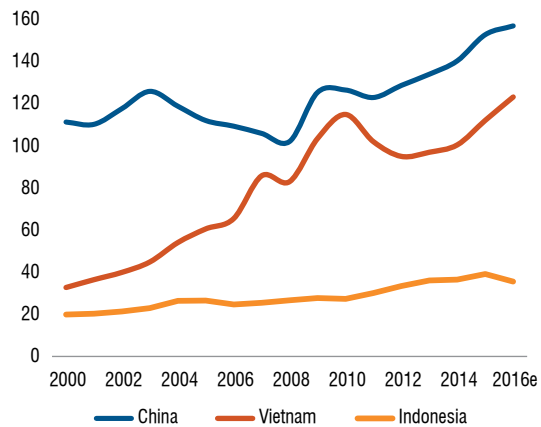
Figure 11 Strong Credit Growth

Panel A CPI, Policy Rate, and Credit Growth (% y/y)



Source: SBV and GSO.

Panel B Credit Intensity of GDP (%)

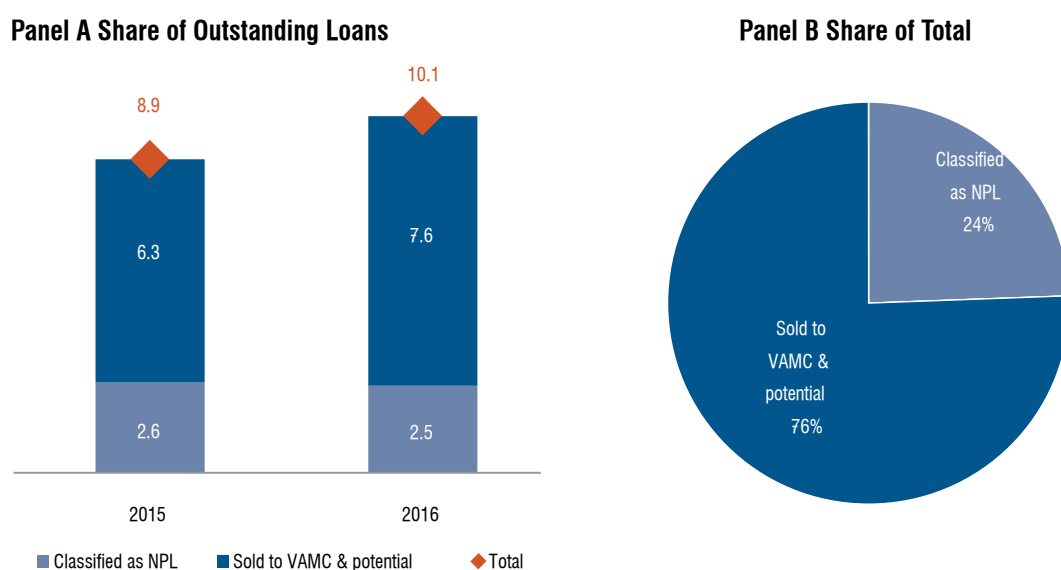


Source: SBV and World Bank.

13. To address rising concerns about adverse impacts of rapid credit growth on lending quality, the SBV adopted tighter prudential regulations on lending activities. Circular 39 which became effective on March 15, 2017 restricts Bank's from using new loans to refinance non-performing loans and also introduces penalties for delinquent borrowers. These steps are expected to prevent ever-greening of nonperforming loans, and to encourage more prudent lending standards, mitigate potential asset-liability mismatches, and potentially moderate credit growth.

14. While some steps have been taken to resolve nonperforming loans (NPLs), asset quality problems remain a concern. The State Audit and the State Bank of Vietnam reported that total bad debts (including NPLs reported by commercial banks, bad debts of banks sold to the Vietnam Asset Management Company (VAMC), and potential bad loans³ held in commercial bank accounts were estimated at 10.1 percent of total outstanding loans of the banking sector in 2016 compared to 8.85 percent in 2015 (figure 12, panel A).⁴ At the end of 2016, loans classified by commercial banks as nonperforming accounted for a quarter of total bad debts Large accumulated bad assets sold to VAMC and those loans identified as potentially bad account for the remaining three-quarters (figure 12, panel B).

Figure 12 Composition of Bad Debts



Sources: SBV and Vietnam State Audit.

Note: NPL = nonperforming loan; VAMC = Vietnam Asset Management Company.

15. Resolution of bad debts is impeded by legal constraints on collateral sale and restructuring, insufficient capacity, and inability to recognize losses. Banks are required to provision against NPLs sold to the VAMC over a 5-to-10-year period and to repurchase the NPL from the VAMC at the end of the provisioning period. They also continue to manage the NPLs even after they are transferred to the VAMC. This has reduced incentives of VAMC to resolve impaired loans quickly. In addition, the VAMC's ability to restructure or sell NPLs is also hampered by legal constraints on collateral sale and restructuring, insufficient capacity, and legal limitation on recognition of losses.

³ Potential bad loans include: loans with restructured payment by Decision 780 and Circular 09 of SBV; potentially- nonperforming investment in corporate bonds; receivables and projected interest from bad debts. Legally, those loans are not recorded as non-performing yet.

⁴ Data from Vietnam's State Audit and State Bank of Vietnam.

16. The Banking Sector Restructuring Plan 2016–2020 has been prepared by the SBV. It restates the Vietnamese government’s goal to resolve the NPL problem and bring Vietnam’s banking sector up to international standards. The crucial need for developing deeper capital markets is also highlighted in the Draft Restructuring Master Plan 2016–2020.

17. Recent steps have also been taken to reinforce the legal framework for bad debt resolution. In June 2017, the National Assembly approved a Resolution on addressing bad debts (effective in five year started from 15 August, 2017). In addition, the National Assembly also discussed the proposed amendments to the Law on Credit Institutions which is scheduled to be ratified in the next plenary session. This legal framework is expected to provide the authorities sufficient powers to address the challenges to advance the second phase of the banking sector restructuring plan (2012–2020), in a manner that serves the public interest in financial stability at a lower cost to the taxpayer. The key result of newly adopted important regulations is a legal framework better aligned with international best practices for banking supervision and emerging new standards for banking resolution. This would allow the authorities to overcome some of the constraints associated with collateral sale and banking sector restructuring.

Box 2 The Definition of Bad Debt of the Banking Sector

Bad debt of credit institutions is classified by Circular 02/2013 of the State Bank of Vietnam. Accordingly, those loans in group 3, 4, and 5 are being classified as bad debt.

Group 1 (standard loans) includes loans assessed as fully and timely repayable, both principal and interest.

Group 2 (loans that need attention) includes (a) loans that are overdue between 10 days and 90 days; and (b) loans that are restructured repayment term for the first time.

Group 3 (substandard loans) includes (a) loans that are overdue between 91 days and 180 days; and (b) loans that are extended repayment term for the first time.

Group 4 (doubtful loans) includes (a) loans that are overdue between 181 days and 360 days; and (b) loans that are restructured repayment term for the first time but are still overdue for less than 90 days under the restructured repayment terms.

Group 5 (potentially irrecoverable loans) includes (a) loans that are overdue for more than 360 days; and (b) loans that are restructured repayment term for the first time but are still overdue for 90 days or more than under that first restructured repayment term.

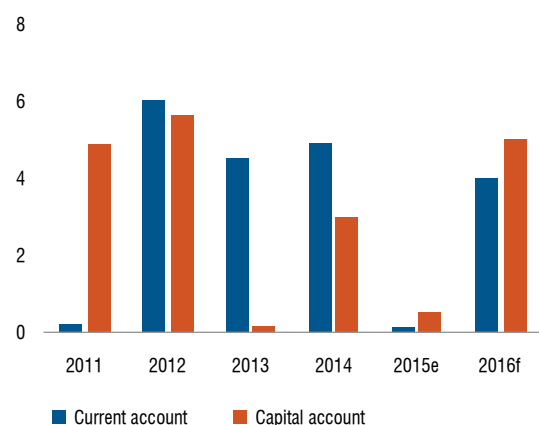
Source: SBV

Note: More detail guidelines in Circular 02/2013/TT-NHNN and Circular 09/2014/TT-NHNN.

The FDI sector continues to record a large external surplus

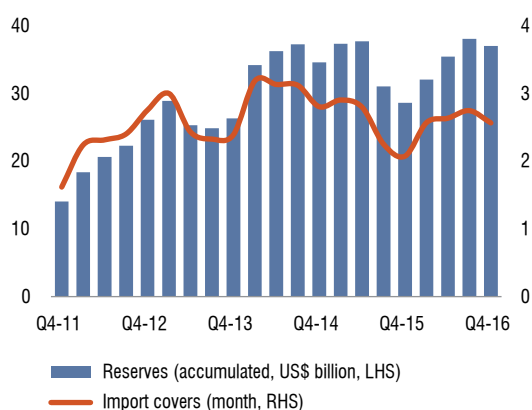
18. Vietnam’s external position remains in surplus, underpinned by sustained export growth and record inflows of foreign direct investment. During 2016, the current account recorded a significant surplus, and international reserves increased. Robust growth in exports, tourism receipts, and private remittances led to a current account surplus of about 4 percent of GDP in 2016 (figure 13), marking the fifth consecutive year of a current account surplus. The capital account also achieved a sizable surplus, with record inflows of FDI and long-term loans. Inflows of foreign liquidity allowed the SBV to rebuild reserves during most of 2016. Some pressure on the dong emerged in November, which the SBV accommodated by devaluing the reference rate slightly and by direct interventions. Pressure subsided in early 2017, and reserve losses incurred in late 2016 have been recovered since, with foreign reserves standing at about 2.6 months of imports (figure 14).

Figure 13 External Accounts (% of GDP)



Source: SBV, IMF, and World Bank.

Figure 14 Foreign Reserves

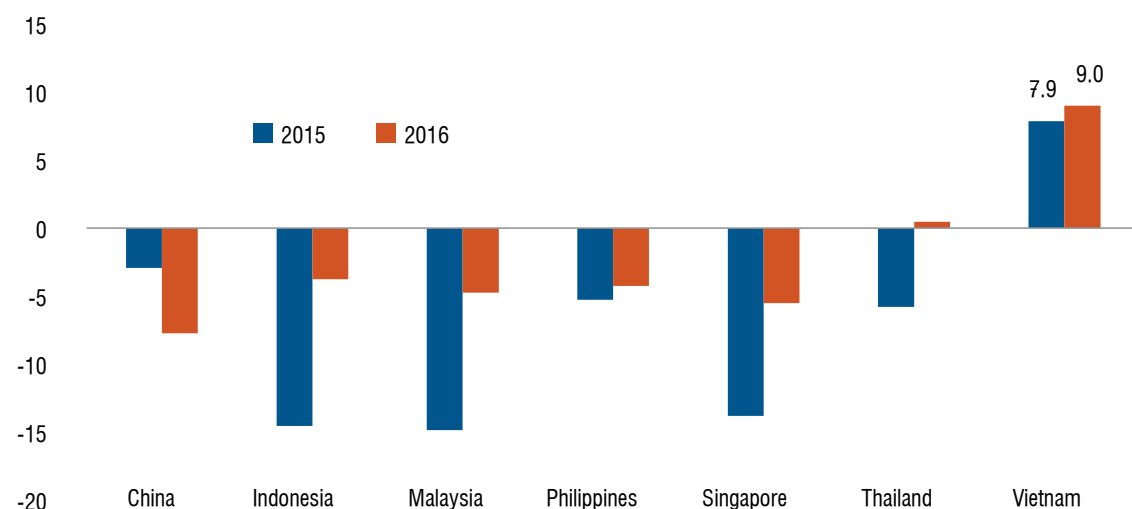


Source: SBV, IMF, and World Bank.

Note: LHS = left-hand side; RHS = right-hand side.

19. Despite weak global trade, Vietnam’s trade performance remained strong in 2016. Despite the slowed global trade growth since the global financial crisis, Vietnam’s exports continued to gain global market share, in part reflecting overall cost competitiveness and the ability to attract export-oriented FDI, which remained strong throughout 2015 and 2016. Vietnamese merchandise exports rose by 7.9 percent in 2015 and 9 percent in 2016, which is far above both global trade growth and regional competitors (figure 15).

Figure 15 Merchandise Exports Growth (% , current US\$)



Source: World Bank.

20. Vietnamese exports continued to accelerate over the first months of 2017, driven in part by improved terms of trade and strengthening external demand. Preliminary data of the General Department of Customs show that Vietnamese merchandise export value rose by 18.4 percent year-on-year in the first five months of 2017, compared to 6.2 percent in the same period in 2016. Despite falling oil production, exports of crude oil rose 26.2 percent in value terms thanks to rising oil prices and low statistical base effects (due to the significant decline last year). Improved export prices of coffee, rubber, and cashew has helped agriculture exports increase by 14.5 percent. Manufacturing exports also benefited from a strengthening demand in some of Vietnam’s key export markets (table 2).

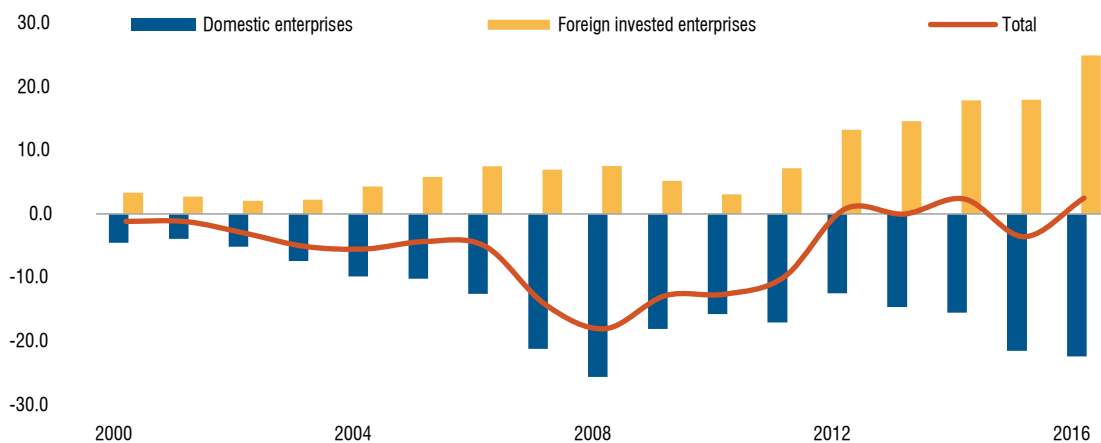
Table 2 Vietnam's Merchandise Exports (y/y change in %)

	2015	2016	5M-16	5M-17
Total export value	7.9	9.0	6.2	18.4
Crude oil	-48.5	-36.5	-47.2	26.2
Non-oil	10.8	10.1	7.7	18.3
Agriculture products	-6.9	7.7	7.0	14.5
Rice	-4.5	-22.4	0.3	2.4
Fisheries	-16.0	7.4	4.4	13.8
Low-value manufacturing	7.6	8.3	6.6	16.2
Garment	9.1	4.6	6.4	9.1
Footwear	16.3	8.3	8.0	12.0
Technology manufacturing	31.0	15.3	12.1	24.1
Phones and parts	27.9	13.8	19.1	13.7
Computer and electronics	36.5	21.5	6.0	46.7
<i>Domestic sector</i>	-2.5	5.4	3.8	14.1
<i>Foreign invested sector</i>	13.0	10.5	7.2	20.1
<i>Foreign invested sector (excl. oil and phones)</i>	14.3	11.5	5.7	22.7

Source: Vietnam Department of Customs.

21. Vietnam's trade performance is driven by the FDI sector, while the domestic sector faces a persistent external imbalance. Vietnam's economic structure and external current account is bifurcated. Highly competitive FDI enterprises, which are integrated in global and regional supply chains mostly in labor-intensive manufacturing sectors such as electronics, textiles, and apparel, generate about 70 percent of Vietnam's exports with a large trade surplus of about 12 percent of GDP (figure 16). In contrast, the domestic sector, which is dominated by state-owned enterprises and small and micro enterprises in agriculture and non-tradable sectors, incurs a deficit of 8 percent of GDP. Productivity in the domestic sector is generally lower, and the vast majority of domestic enterprises lack the scale, access to capital, and technology to become efficient and competitive producers. Participation of domestic firms in global value chains is generally limited, and links with FDI firms remain weak. Incomplete market institutions, a cumbersome regulatory environment, and distortions in factor markets all impede the development of a more productive domestic private sector.

Figure 16 Vietnam's Trade Balance (in US\$ billion)



Source: General Department of Customs.

22. Imports rebounded strongly during the first months of 2017, reflecting higher oil prices and an acceleration in imports of investment and intermediate goods. Total merchandise imports recovered strongly by 24.7 percent in the first five months of 2017, from a sluggish performance during the same period last year (table 3). Imports of machinery and equipment in the first four months of 2017 soared by 39.2 percent, reflecting growing demand for investment from both domestic and foreign investors. Imports of raw materials and intermediate goods have also increased remarkably as a result of rising import prices and increasing orders for exports (given the high import content of Vietnamese manufacturing exports, there is a strong link between export and import performance).

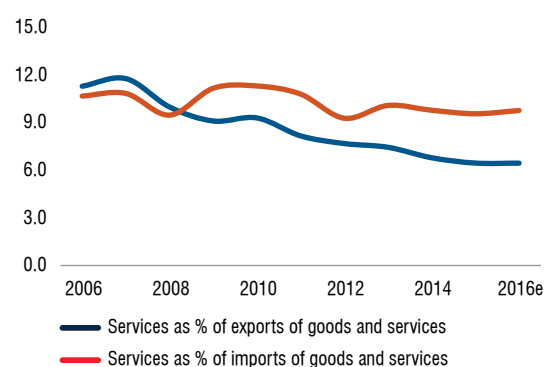
Table 3 Vietnam's Merchandise Imports (y/y change in %)

	2015	2016	5M-16	5M-17
Total export value	12.0	5.2	-1.7	24.7
Petroleum	-26.2	-11.4	-22.9	30.4
Machinery and equipment	23.1	2.9	-7.2	39.2
Materials and intermediate goods	11.9	6.5	-0.3	23.3
Animal feed	4.2	2.1	-17.6	20.6
Fabrics	7.8	3.2	2.2	7.8
Metal	4.7	2.0	-5.2	27.0
Plastic material	-5.7	5.0	0.1	19.8
Consumer products	21.3	7.8	8.2	11.2
<i>Domestic sector</i>	<i>7.5</i>	<i>5.2</i>	<i>-0.1</i>	<i>19.8</i>
<i>Foreign invested sector</i>	<i>15.5</i>	<i>5.2</i>	<i>-2.8</i>	<i>28.1</i>

Source: Vietnam Department of Customs.

23. In contrast to strong merchandise trade, Vietnam's trade in services remains underdeveloped. Growth of trade in services has generally lagged behind the rapid growth of merchandise trade. In 2016, exports (receipts) of commercial services accounted for about 6.5 percent of total exports of goods and services, while imports (payments) of commercial services represented about 9.8 percent of total imports of goods and services (figure 17). Receipts from travel services and transportation account for 65 percent and 22 percent of total Vietnamese service exports, respectively (figure 18). Vietnam has great potential to enhance its tourism and logistics sectors, but this will require further strengthening the quality of service provision. If this can be realized, services exports could represent a stronger part of Vietnam's overall exports in the years to come.

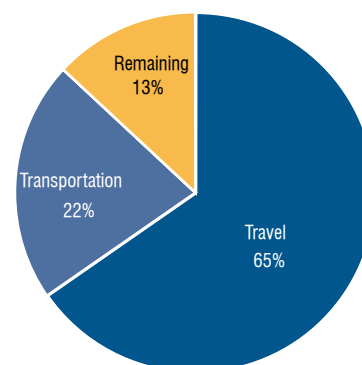
Figure 17 Trade in Services (% of total)



Source: GSO.

Note: e = estimated.

Figure 18 Exports of Services



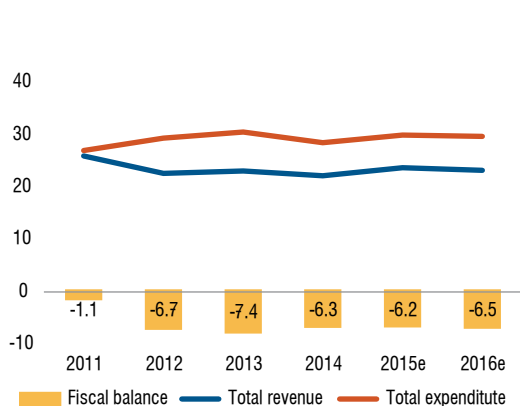
Source: GSO.

24. FDI has continued to accelerate in recent months, reflecting positive investor sentiment about Vietnam’s long-term economic potential. In the first six months of 2017, foreign investors committed US\$19.2 billion to Vietnam—a 55 percent increase over the same period last year. At the same time, foreign-invested firms disbursed US\$7.7 billion—an increase of 6.5 percent in nominal terms over the previous year. By June 2017, Vietnam had investments from 120 countries and territories, with total accumulated FDI commitments of around US\$306 billion in a broad and diversified range of investment activities. Currently, the foreign-invested sector contributes about 18 percent of Vietnam’s GDP, nearly a quarter of total investment, two-thirds of total exports, and millions of direct and indirect jobs.

Early signs of fiscal consolidation

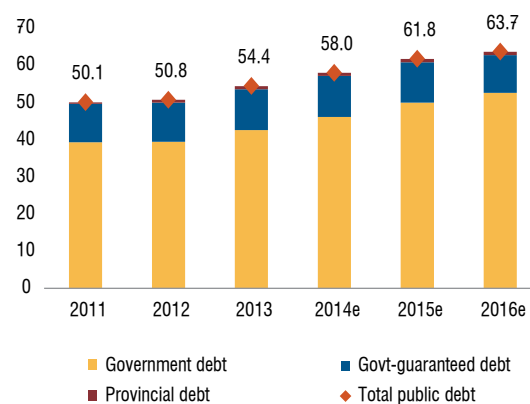
25. Driven by a persistent fiscal deficit, public debt continued to rise in 2016, inching closer to the statutory limit of 65 percent of GDP. The fiscal deficit averaged 5.8 percent of GDP during 2011–16, compared to 2.2 percent of GDP during 2006–10. Preliminary data show that fiscal pressure remains in 2016 where the fiscal deficit was estimated at 6.5 percent of GDP. The widening fiscal imbalance has been mostly the result of a structural decline in the revenue-to-GDP ratio, which decreased from 27 percent of GDP in 2011 to about 23 percent of GDP in 2016. Meanwhile, the expenditure-to-GDP ratio has been relatively stable, hovering around 29 percent of GDP on average over the past five years. According to government reports, Vietnam’s total outstanding public debt (government, publicly guaranteed, and local government) increased to 63.7 percent of GDP⁵ in 2016—about 15 percentage points higher than the level in 2010. Additional financing needs were mostly met by domestic debt. While the average maturity of domestic bonds has been extended gradually to five years, medium-term fiscal financing needs—including for the redemption of relatively short-term domestic debt—are substantial, and interest expenditure is on the rise. At the same time, access to concessional external financing will naturally continue to tighten as Vietnam solidifies its middle-income status and becomes more reliant on international and external capital markets as a source of government financing.

Figure 19 Revenue and Expenditure (% of GDP)



Source: MOF.

Figure 20 Public Debt (% of GDP)



Source: MOF.

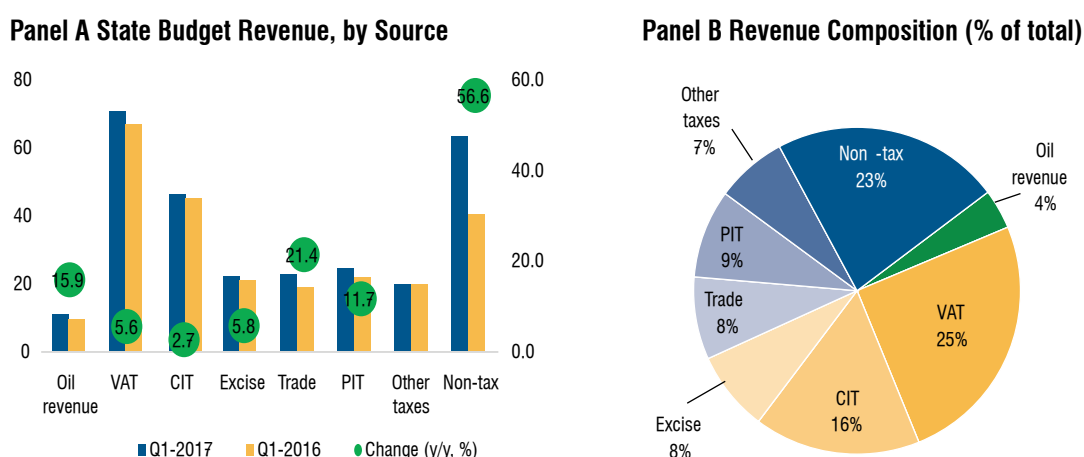
26. The government has reinforced its commitment to rein in the fiscal deficit over the medium term in order to contain further increases in the public debt-to-GDP ratio. Fiscal consolidation is crucial to contain the fiscal deficit and stabilize public debt over the medium term (see part 2). The medium-term financing plan 2016–20, adopted by the National Assembly in November 2016, envisages a gradual fiscal adjustment over the next four years. The plan aims to reduce the fiscal deficit to 3.5 percent of GDP by 2020. The government’s fiscal strategy is predicated on the following broad measures:

⁵ Data from MOF

- On the revenue side, the plan emphasizes modernization of the tax environment and enhancing revenue administration to lower the compliance burden on taxpayers while stabilizing domestic revenue mobilization as key priorities. There is a strong focus on tax administration reforms (risk management, a large taxpayer office, and a new transfer pricing decree). Commitment to tax policy reforms is more tentative. The government is planning to raise environmental taxes, but wider tax policy reforms have not been specified. Several options are still under discussion, including a recurrent property tax, reform of the value-added tax (VAT) (both unification of the VAT tax rate and possible rate increases), and reforms to broaden the corporate income tax (CIT) base by rationalizing tax expenditures.
- On the spending side, the government aims to moderate recurrent spending growth to provide more room for capital spending while continuing to focus on improving investment efficiency. The government is liberalizing education and health care prices to reduce the need for budgetary financing of service providers. There is also some curtailment of government investment while steps are taken to improve the coordination of fragmented infrastructure spending.
- The government's plan also envisages divestment of major state-owned enterprises (about D 250 trillion over the next five years, equal to about 1 percent of GDP annually) to reduce the need to raise debt to finance the deficit. Issuance of government guarantees is also being tightened.

27. Revenue collection in the first quarter of 2017 improved, but mainly thanks to higher collection of non-tax revenue and one-off measures. The latest Ministry of Finance (MOF) estimate shows budget revenues increased 15.2 percent year-on-year in the first quarter of 2017 and equaled to 23.2 percent of annual budget plan (figure 21). Most importantly, non-tax revenue (including fees, charges, capital revenue, and collection of dividends from state capital) performed strongly, increasing nearly 50 percent. Oil revenue rose by almost 16 percent thanks to rising oil prices. Trade taxes (mainly import tariffs) also improved because of a recovery in imports. Revenue from the lottery, which has been moved on budget this year, contributed 3.5 percent of total budget revenue. While non-tax revenue helps boost budget revenue, some of the increase was based on one-off effects. Since these do not represent recurrent revenue sources, there are concerns about whether the recent increases are sustainable.

Figure 21 Improved Revenue Collection in Q1-2017, Driven by Non-Tax Revenue



Source: MOF.

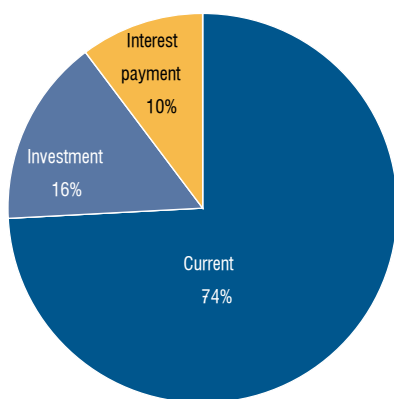
Note: CIT = corporate income tax; PIT = personal income tax; VAT = value-added tax.

28. Despite this overall strong revenue performance, collections from major taxes underperformed. The collection of the value-added tax and the corporate income tax (excluding oil), which together account for half of total tax revenue, growing by just 4 percent. Enhancing domestic tax revenue mobilization through structural measures to broaden the tax base and revenue potential remains an important priority to achieve a sustainable and growth-friendly fiscal consolidation. Tax policy changes that could be considered include introduction of a recurrent property tax, unifying VAT rates, and higher excise taxes. A review of tax expenditures that have eroded the CIT tax base should also be conducted to rationalize exemptions and incentives.

29. Growth in public expenditure, and especially recurrent spending, moderated in the first quarter, reflecting a stronger focus on imposing fiscal discipline. Total public expenditure increased by 7.8 percent year-on-year in nominal terms during the first quarter of 2017 (figure 22). While recurrent expenditure rose by 7.5 percent, capital spending increased 9 percent as a result of large public investment projects. Expenditure on social development areas such as education, training, and health care has also been protected from rising budgetary pressures. Interest payments continued to rise during the first months of 2017, and now account for nearly 10 percent of total expenditures and revenue. In the first quarter of 2017, the MOF issued D 56.5 trillion of domestic bonds to finance the deficit and rollover of maturing debt.

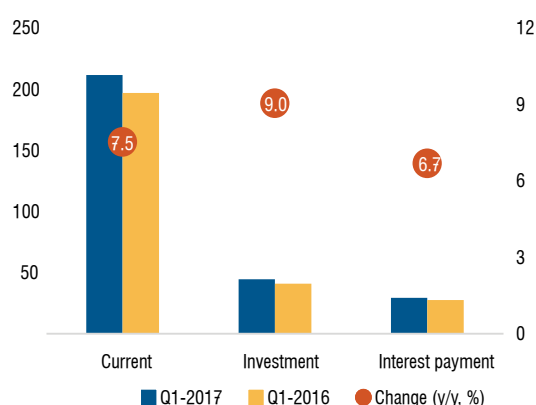
Figure 22 State Budget Spending

Panel A Composition of Budget Expenditure



Source: MOF.

Panel B State Budget Expenditure



Source: MOF.

Employment and labor market

30. The labor force participation rate remains high in Vietnam. The labor force participation rate of the population aged 15 and above was 76.8 percent in the fourth quarter of 2016. The labor force participation rate for females was 72.2 percent, significantly lower than the 81.7 percent for men, but still relatively strong compared with other developing countries. The labor force participation rate of young people aged 15 to 24 increased from 52.9 percent in 2012 to about 57 percent in 2016, suggesting that more young people are leaving the education system and seeking employment. This latter trend may require closer attention from policy makers to ensure adequate job creation to mitigate risks of youth unemployment.

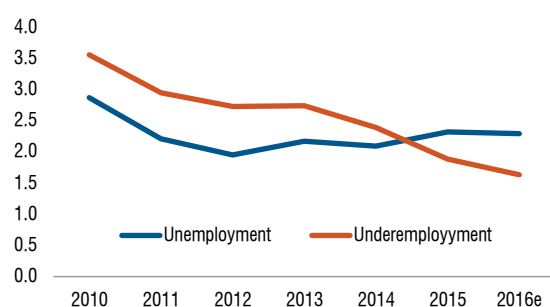
31. The official unemployment rate in Vietnam is very low, at around 2.3 percent in 2016.⁶ However, the unemployment rate among youth (aged 15 to 24) remains elevated at 7.3 percent, an increase from 6.3 percent

⁶ Because the official unemployment rate only measures officially reported unemployment in the formal sector, it does not fully capture the extent of unemployment in either the informal sector or in the agriculture-based rural areas. It also does not factor in the extent of “underemployment” in the economy.

in 2015. This is a common phenomenon across the world, although the gap between the youth and overall population is somewhat higher in Vietnam than is the norm. Furthermore, the unemployment rate was higher among women and in urban areas, and considerably higher among skilled workers. The latter may reflect a skills mismatch in the labor market, reinforcing the necessary focus on the quality and relevance of higher education and the technical and vocational school system. In addition, nearly 56 percent of total workers in 2016 were in the informal sector (own-account and unpaid family workers). Without access to the social security system, these workers can be considered “vulnerable.”

32. The quality of the labor force remains a challenge. In 2016, only 21.4 percent of the labor force was educated with a technical or college degree (table 4). There has been some improvement in recent years in the number of people receiving degrees from colleges and universities. However, worker skills and availability remain concerns for employers. Many employers identify hiring new workers as a particularly serious challenge due to inadequate skills, especially among those applying for technical, professional, and managerial occupations.

Figure 23 Unemployment (% of total)



Source: MOLISA.

Note: e = estimated.

Table 4 Quality of the Labor Force (% of total)

	2013	2016
No professional or technical skill	81.6	78.6
Vocational training	5.3	5.3
Technical school	3.8	3.9
Junior college	2.1	2.9
University	7.2	9.3

Source: MOLISA.

I.3. Medium-Term Economic Outlook and Risks

33. The economic outlook remains favorable, with resilient growth accompanied by broad macroeconomic stability. Economic growth is expected to accelerate through the second half of 2017, underpinned by rising private consumption, export-oriented manufacturing, and foreign direct investment. For 2017, real GDP growth is projected at 6.3 percent. On the production side, robust performance of export-oriented manufacturing is expected to continue to boost overall GDP growth, aided by the strengthening global recovery and rebound in global trade growth. The agriculture sector is also anticipated to improve further thanks to the diminishing impact of last year’s drought. The services sector will continue to expand due to strong retail trade and tourism sector. On the demand side, buoyant private consumption and expansion of investment (especially foreign direct investment) in the second half of the year continued to be a driving force for the growth. Fiscal policy is expected to tighten in 2017 and afterwards which will reduce aggregate demand, but the composition of the adjustment is expected to protect necessary growth-enhancing investments. The monetary stance is expected to remain accommodative and growth in credit this year looks likely to achieve the government’s target of 18 percent. Inflation is expected to remain below 5 percent due to subdued energy and food prices. The current account is projected to record a surplus, albeit at the lower level than last year, as imports, especially of capital goods rebound. Over the medium term, growth is projected at around 6.4 percent, accompanied by moderate inflation. A gradual fiscal consolidation would result in declining fiscal deficits and with public sector debt hovering around the legal limit of 65 percent of GDP (table 5).

Table 5 Vietnam Key Medium -Term Indicators

	2014	2015	2016/e	2017/f	2018/f
GDP growth (%)	6.0	6.7	6.2	6.3	6.4
CPI (annual average, %)	4.1	0.6	2.7	4.0	4.5
Current account balance (% GDP)	4.9	0.1	4.0	2.5	1.8
Fiscal balance (% GDP)	-6.3	-6.2	-6.5	-5.7	-5.6
Public debt (% GDP) – MOF definition	58.0	61.8	63.7	65.0	65.4

Source: GSO, MOF, SBV, and World Bank.

Note: e = estimated; f = forecast.

34. The outlook is subject to downside risks. Externally, a high degree of openness and reliance on FDI make the economy vulnerable to slower growth in major trading partners. A weakening of the still fragile recovery in the United States and the European Union, and a sharper slowdown in China, could dampen growth due to Vietnam's high export orientation. Waning support for trade liberalization and global integration also pose risks to Vietnam's FDI and export-oriented growth model. Increasing inflation and narrowing output gaps in major economies have raised the prospects of a more pronounced tightening of monetary policy, which would in turn trigger tighter global financial conditions. While Vietnam is financially less integrated than other countries in the region, surges in global financial market volatility and higher global interest rates could put pressure on external accounts. On the domestic front, slower growth may intensify demand for further loosening monetary and fiscal policies, which risk reversing the recent gains in macroeconomic stability and heightening unresolved macroeconomic imbalances. Slow structural reform progress also poses risks to medium-term growth prospects, as structural reforms remain critical for Vietnam's competitiveness. Delays in implementing fiscal consolidation could pose a risk to debt sustainability and future stability and growth.

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SECTION II

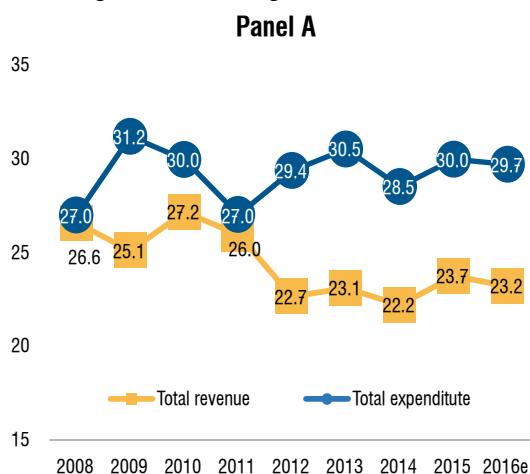
TOWARDS A HIGH-QUALITY FISCAL CONSOLIDATION⁷

Context

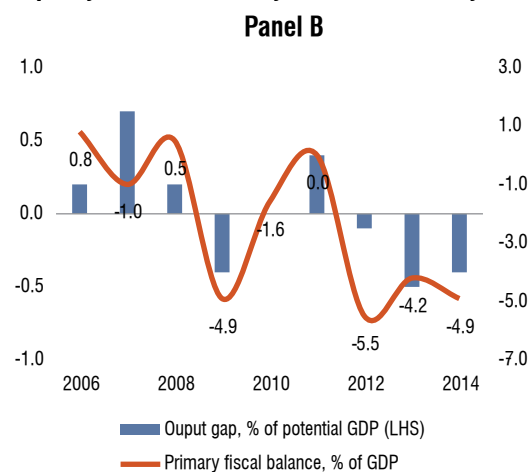
35. Over the past few years, Vietnam's fiscal position has been expansionary. While fiscal expansion helped avert a sharper economic downturn during 2009-11, larger subsequent deficits have eroded fiscal buffers, shortened the maturity profile, and increased the debt service burden on the budget. Sizable fiscal deficits, rapidly rising public debt, volatile fiscal revenues, and inefficiencies in public expenditure, especially public investment, pose headwinds to future stability and growth. While risks of acute debt distress are limited, fiscal space to address growing infrastructure and social spending needs is shrinking, and the lack of fiscal buffers limits the government's ability to cope with external volatility and potential shocks. On the revenue side, low oil prices, tax reforms to enhance the investment climate, and elimination of import tariffs have led to a steady decline in the revenue-to-GDP ratio over recent years. On the spending side, recurrent expenditure has been on the rise, in part driven by a growing wage bill but also rising expenditure on interest payments, further constraining fiscal space for needed investment. These fiscal challenges are compounded by sizable refinancing needs for short-term domestic debt (which was the main source to finance growing deficits), declining access to concessional financing, and volatile global financial markets and, hence, volatile sovereign spreads.

⁷ This section was prepared by Quyen Hoang Vu (Senior Economist) and Sebastian Eckardt (Lead Economist), with inputs from Duc Minh Pham (Senior Economist) and Rodrigo Cabral (Senior Financial Officer).

Figure 24 Widening Fiscal Imbalances...



...partly reflect Countercyclical Fiscal Policy



Sources: World Bank staff estimates based on MOF data.

Note: output gap is estimated, using simple HP filter on annual GDP data.

36. The National Assembly and the Government have made a commitment to start addressing these fiscal vulnerabilities over the medium term. The medium-term financing plan 2016–20, adopted by the National Assembly on November 9, 2016, set the fiscal policy directions for the coming five years. The plan envisages a gradual fiscal adjustment of the fiscal position over the coming four years aiming to reduce the fiscal deficit to 3.5 percent of GDP by 2020.⁸ On the revenue side, the plan emphasizes modernization of the tax environment and enhancing revenue administration to lower the compliance burden on taxpayers while stabilizing domestic revenue mobilization as key priorities. On the spending side, the government aims to moderate recurrent spending growth to provide more room for capital spending while continuing to focus on improving investment efficiency. On the financing side, the plan envisages to mobilize financing from divestment of major state-owned enterprises to reduce the need for borrowing while mobilizing a mix of domestic and external debt, including official development assistance (ODA) to meet remaining financing needs.

State revenue trends

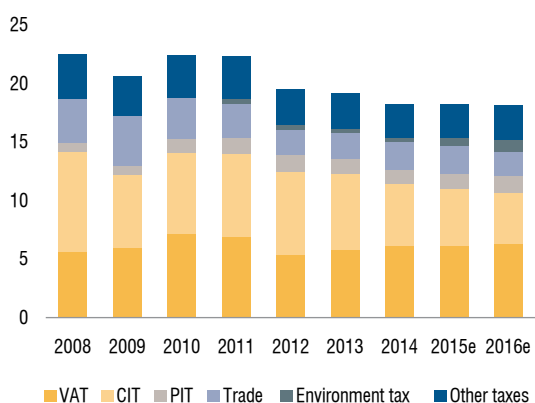
37. High economic growth over a prolonged period, with an annual average growth rate of above 6 percent between 2006 and 2015, has helped raise Vietnam’s state budget revenue. However, revenue collection during 2011–15 while continuing to grow in real terms has done so at a slower pace than the economy. State budget revenue mobilization as a percentage of GDP has decreased from 26.4 percent in the period 2006–10 to 23.4 percent in the period 2011–15. The main contributors to the lower revenue-to-GDP ratio include a decrease in oil revenue (from 4.8 percent to 3 percent), tariff revenue (from 5.5 percent to 4.2 percent) and land revenue (from 2.5 percent to 1.7 percent).

38. Vietnam has successfully managed its tax policy and administration system through a smooth transition toward one that is less reliant on external sources (oil and trade revenues). The share of domestic revenue in total revenue increased from 52.3 percent (in 2001–05) to 58.9 percent (in 2006–10), and is expected to rise to over 68 percent (in 2011–15). In 2015, the share of domestic revenue to total revenue reached 74.2 percent, higher than the target of 70 percent. This increase partially helped to offset the decline in revenue from foreign trade due to economic integration and oil revenue. In the meantime, Vietnam has recently adopted some preferential tax policies aimed at enhancing competitiveness, attracting investment and easing the difficulties facing enterprises in

⁸ Based on government definition of deficit, accounting privatization proceeds as above-the-line revenue.

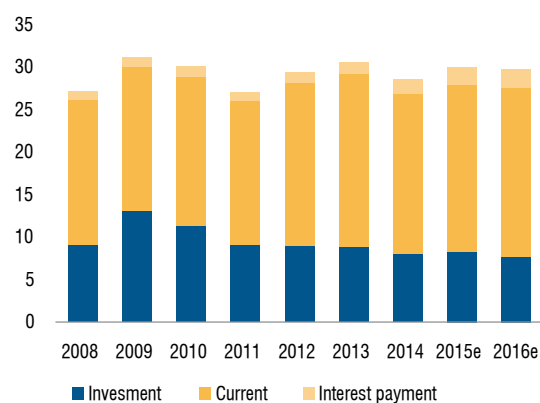
the context of the economic slowdown. These include (a) cutting the corporate income tax (CIT) rate; (b) raising the level of deductions for family circumstances in personal income tax (PIT) payers; (c) reducing or exempting agricultural land tax; and (d) extending the time limit for payment of VAT, CIT and land-use fees. Although CIT declined by 6 percent from the previous period, non-oil CIT between 2011 and 2015 was 3.8 percent of GDP; 0.3 percent of GDP lower than that between 2006–10. If the CIT collected from household businesses collected as PIT is taken into account, the CIT revenue during 2011–15 was essentially the same as during 2006–10. Despite a series of recent incentive policies, the share of VAT in GDP remained stable at 6.1 percent. In particular, the domestic VAT rose slightly from 4 percent to 4.3 percent between the two periods. Personal income tax (PIT) increased significantly in the period from 0.8 percent to 1.3 percent of GDP.

Figure 25 Tax Revenue to GDP is on a Consistent Downward Trend



Sources: World Bank staff estimates based on MOF data.

Figure 26 The Composition of Expenditure is Gradually Moving towards Recurrent Spending



Sources: World Bank staff estimates based on MOF data.

39. There have also been some major achievements in recent years in tax administration reform. The implementation of two government resolutions (both No.19) issued in 2014 and 2015 led to a considerable reduction in the time spent to pay taxes. This was particularly due to the simplification of tax compliance regulations⁹ and the application of the Tax Management System for core tax functionalities, such as registration, filing, return processing, taxpayer accounting, tax payment and arrears management. However, for the tax system to be effective, information based systems need to be supported by a comprehensive business process reengineering exercise that includes all tax, risk management and taxpayer service functions to increase voluntary compliance and reduce compliance cost. Strengthening of the tax administration database and adoption of value-added IT applications is also required. Coordination between the General Department of Taxation (GDT) and social insurance funds should be strengthened with a view to transferring responsibility for collecting social security contributions to the GDT on behalf of the social insurance funds.

Public expenditure trends

40. Government expenditure has been maintained at a high level against GDP. The composition of expenditure has changed with the rising proportion of recurrent expenditure. From 2011 to 2015, total state budget expenditure—including capital outlays financed by off-budget bonds—averaged 29.2 percent; rising moderately from 28.9 percent in the previous period and remains high compared with regional and peer income level countries. The proportion of recurrent to capital expenditure was 70:30, compared to 65:35 from 2006–10. Recurrent expenditure grew faster than the growth of total revenue, mainly driven by increased outlays on social security,

⁹ Government Resolution 19/NQ-CP dated March 18, 2014, and Resolution 19/NQ-CP dated March 12, 2015.

salaries, wages and allowances and by interest payments. The wage bill outpaced average expenditure growth, expanding to about 20 percent of total budget expenditure. The rapid growth of the wage bill was attributed mainly to increase in base and non-base salaries and allowances¹⁰ and in the number of civil servants and government employees. The growth of public sector employment was much faster than population growth, particularly at subnational levels. International benchmarking comparisons indicate that the total wage bill of Vietnamese civil servants is not overly high, but its rapid growth warrants caution.

41. State budget capital spending, although having fallen as a share of total spending, remains higher than the rest of the world and regional peers. The state budget contributed 29.1 percent of gross capital formation to the economy during 2011–15, a moderate increase from 28.4 percent during 2006–10. The high level of state budget investment was sustained with an aim to develop further the country’s infrastructure system.

42. Vietnam is a highly decentralized country and is becoming more so. Capital spending is trending toward higher decentralization, while recurrent spending trends remain relatively similar. Between 2011 and 2015, subnational capital spending accounted for about 70 percent of total state capital spending, amongst the highest in the developing world (the average proportion in developing countries was nearly 40 percent). The change was attributed to rapidly increasing subnational investment sourced from subnational budget contingency provisions and over-realized budget revenues (that is, land and lottery revenues) as well as central budget transfers to subnational governments. Central targeted transfers in this period focused more on local development priorities on education, health, transport and irrigation. This has provided strong incentives for development at subnational level, as well as contributing to the development of rural infrastructure such local roads, clean water systems and the improvement of local education and health services; together contributing toward poverty reduction.

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

Performance in the management and use of public assets

44. Public assets constitute an important part of the public sector balance sheet. Globally, the book value of public assets is estimated to equal global GDP. In Vietnam, the recorded value of public assets in 2015 was only D 1 million billion, equivalent to US\$50 billion, or 25 percent of the GDP. However, the actual value of public assets in Vietnam may be much higher as the coverage of the public asset report only covers assets held in administrative and public service delivery units (i.e., land, natural resources, and infrastructure are not yet included or reported).

45. The 2008 Law on the Management and Use of State Assets came into effect in 2009 as an important milestone after decades of inadequate public asset management and assessment. The law established a strong legal framework to govern and enforce the management and use of State assets for precise purposes,

¹⁰ Since 2006, the government increased the base salaries and allowances 08 times, to cover inflation and to improve the living conditions of several target groups.

entitlements and policies, and to combat waste and leakage of resources. However, the above changes are not sufficiently robust and comprehensive, the value of assets has not yet been maximized. The law was just amended in June 2017, aiming to improve management for (a) More comprehensive and holistic management of public assets; including land, natural resources, assets of public and administrative agencies and infrastructure based on the Constitution 2013; (b) More efficient use of assets by adoption of professional management practices and market disciplines; (c) More public disclosure, transparency and community scrutiny of the management and use of public assets. It will also be important to ensure proper maintenance of assets to maximize their value and enhance investment efficiency.

Fiscal sustainability and public debt trends

46. Consistently high budget deficits resulted in rising public debt¹¹—debt-to-GDP ratio has increased rapidly, from 51.7 percent in 2010 to about 62.2 percent in 2015¹²—leaving Vietnam with shrinking space for borrowing. Of this public debt, 50.3 percent of GDP is debt directly owed by the central government, 11 percent of GDP is debt guaranteed by the central government and 0.9 percent of GDP is debt owed by provincial governments. Excluding guaranteed debt and intragovernmental borrowing, direct government debt is estimated to be 43.3 percent GDP (2015); close to both the average of regional and income comparators. However, it is of concern that Vietnam's debt-to-GDP ratio stands out as one of the steepest increases in the region (about 10 percent over the past five years), despite the country's impressive economic growth performance. If this trend continues, Vietnam is likely to face serious fiscal sustainability concerns.

47. Rising debt levels are associated with a recent shift in the composition of public debt. Given that borrowing needs are increasing while access to concessional external financing is increasingly constrained, the Government has mainly relied on domestic debt to meet its growing financing needs. The share of domestic debt in total public debt increased from 45 percent in 2010 to 55.4 percent in 2015. While the use of domestic debt has reduced exchange rate risks and also contributes toward the development of domestic capital markets, it has shortened the maturity of the debt portfolio. The domestic bond market recently experienced positive moves when commercial bank holdings declined (to about 77 percent at the end of 2015) and holdings of long-term investors such as insurers gradually expanded (about 8.4 percent in 2015) together with other investors (14 percent). However, as the investor base in the market is limited, there is limited demand for domestic debt with longer maturities.

48. The government has made significant efforts to lengthen the maturity of domestic Government bonds. The average time-to-maturity increased to 4.44 years by the end of 2015, compared with 2.93 years in 2013. Despite this improvement, the average maturity of government bonds in Vietnam compares unfavorably with those of other middle-income countries in the region. Refinancing pressures remain significant with about 50 percent of Vietnam's domestic public debt maturing in the next three years. This represents a great deal of pressure when taking into account the existing narrow base of investors in Government bond markets.

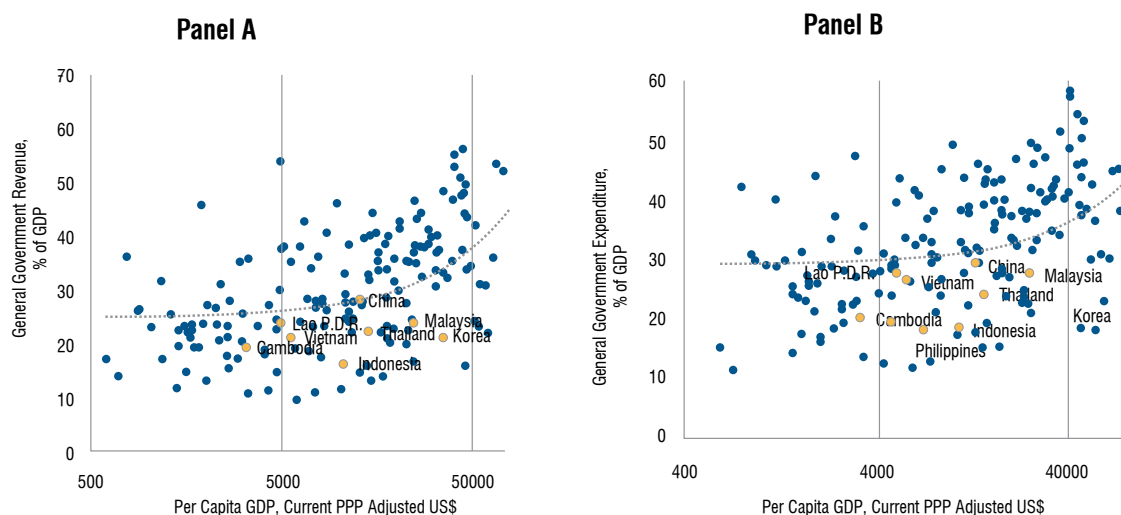
49. With available fiscal buffers becoming limited, even relatively moderate contingent liability shocks could render the debt trajectory unsustainable. Realization of explicit contingent liabilities—including from SOE and banking sectors—could exacerbate the vulnerability of Vietnam's current debt path. With its current high level of public debt, Vietnam has limited room for possible recourse to countercyclical fiscal policy. This underlines the importance of fiscal consolidation and acceleration of structural reforms.

¹¹ In this report, the scope of public debt as defined in the Public Debt Management Law (2009) includes government debt, government-guaranteed debt and subnational debt.

¹² Public debt report according to the Government.

50. From an international perspective, both Vietnam’s revenue and expenditure footprints are about average compared with regional and peer income level countries. While the levels of revenue mobilization and public spending are matters of policy choice for countries¹³, comparison with other countries suggests that Vietnam appears not to be an outlier in the sense that the government does not seem to collect revenue or to spend excessively (figure 13). However, it is of concern that the level of revenue mobilization as a proportion of GDP is on a declining trend, while the pressures for public spending for both capital and recurrent purposes are still high and debt thresholds are now close to their statutory safety limits.

Figure 27 Revenue and Expenditure Footprints Are Broadly in Line with Vietnam’s Income Level



Sources: World Bank staff estimates, based on the IMF World Economic Outlook (WEO) dataset of 150 countries.

51. A gradual, growth-friendly fiscal consolidation is recommended as a crucial element to entrench fiscal sustainability. The government has made a strong commitment to reduce the level of the budget deficit and keep the level of public debt below the current statutory limit of 65 percent of GDP. This would serve to rebuild fiscal buffers against possible future shocks and the possible realization of contingent liabilities arising from the financial and SOE sectors. Fiscal consolidation options could be considered as the basis of a concerted effort to boost revenue mobilization, restructure and enhance efficiency in spending, strengthen the utilization of public asset management and effectively manage public debt and fiscal risks. Restructuring of spending should protect social spending and investment and make space for potential restructuring costs (if any).

¹³ Many governments opt to be welfare states, in which the state plays a key role in the protection and promotion of the economic and social well-being of its citizens. Overall, they tend to levy higher taxes and spend more on social protection, including provision of both cash welfare benefits (such as old-age pensions or unemployment benefits) and in-kind welfare services (such as health care, child care and education services), or through redistribution of taxation. Through these provisions, welfare states can affect the distribution of wellbeing and personal autonomy amongst their citizens, as well as influencing how their citizens consume and how they spend their time. Modern welfare states include the Nordic countries, such as Iceland, Sweden, Norway, Denmark, and Finland as well as a number of other OECD countries mostly in Europe.

52. It will be important to continue to reform tax policies to strengthen domestic revenue mobilization. Several specific policy options that could help bolster revenue performance include:

- Broadening the value added tax (VAT) base: International practice suggests the efficacy of one single VAT rate and very limited tax exemptions. In Vietnam, there are currently 26 goods that are exempt from VAT, 15 goods which are subject to a 5 percent rate and the remainder are subject to a 10 percent rate. This existing practice not only erodes the tax base but also breaks the integrity of VAT and complicates administration. To address this, issue a gradual phasing out of VAT exemptions and the 5 percent base list should be considered, leading to a single VAT rate.
- Broadening the corporate income tax (CIT) base and reviewing tax incentives (tax expenditures¹⁴): Review and rationalization of tax incentives are necessary to promote their effectiveness and avoid irrelevance; avoid fragmentation and waste of resources; and ensure disclosure, transparency and equality in business competition. This needs to be undertaken without impacting the overall business environment in Vietnam where the CIT rate is currently significantly lower and competitive compared to its major competitors. The use of tax incentives and improvement of the business environment are important measures to attract further investment based on Vietnam's real competitive advantages. A systematic assessment of the impact of tax incentives in attracting investors and expanding the tax base would support fiscal policy decisions of the National Assembly and the Government in the future.
- Increasing excise rates: In Vietnam excise tax rates on several non-merit goods remain relatively low (for example tobacco, beer and alcohol). Gradual excise rate increases for these goods could help to mobilize additional revenue and also deter unhealthy behaviors. Gradually increasing the applicable scope and rates of excise tax for selected goods will have positive fiscal impacts on revenue collection and reduce consumption levels and their health and environmental externalities. The World Bank has estimated that between 2014 and 2020 a radical increase in the current tobacco tax rate¹⁵ would increase revenue from tobacco subject to the special excise levy by 12 percent, while the level of consumption of cigarettes per adult could decrease by 10 percent.
- Expanding the personal income tax (PIT) tax base in line with international practice. Current legislation on different tax rates for taxable incomes remains complicated. Personal income tax policies do not cover all taxable income; for example, income from transfers of digital resources, e-commerce or income from major lottery prizes. In the future, personal income tax policies must be adjusted to expand the tax base and adjust the number of tax rates on taxable incomes and taxpayers, to improve compliance, encourage incorporation of business activities, increase transparency and facilitate tax administration.
- Building a modern property tax system: It is important to consider a unified property tax to replace the existing agricultural and nonagricultural land tax policies. This will expand property tax to land related and other valuable assets relevant to the socioeconomic development of Vietnam and be in line with international practices. Property tax will be an important and stable source of revenue to the State budget, especially at subnational level. It could also improve incentives for the more efficient use of land and property.

¹⁴ Vietnam does not have a statutory definition of "tax expenditure" yet; possible impacts of tax incentives in various forms on the state budget have not been fully appropriated and presented in state budget documentation.

¹⁵ The WB recommended to raise excise rate for tobacco products from 70 percent in 2016-2017 and 75 percent in 2018 - 2020 (per existing policy) to 85 percent in 2016 - 2017, 100 percent in 2018 - 2019, and 110 percent in 2020.

- Rationalizing the revenue policies on natural resources and the environment: (a) natural resource tax policies should be revised to be relevant to each period of socioeconomic development. This will ensure preservation and efficient use of natural resources and promote the link between natural resource exploitation and processing and environmental protection. It will also minimize the export of raw resources, encouraging sustainable, efficient, effective and economic natural resource exploitation in the nation. (b) Environmental protection tax policies should be reviewed to expand the tax base and period and adjust the tax rates and ranges. They should also minimize the extent of harmful impacts on the environment and align with current international practices. They should encourage the production, use and consumption of environmentally friendly goods as well as improve the collection of revenue to the State budget.

53. In parallel with tax policy changes, tax administration reform remains a priority. The next phase of tax administration reform should include a more systemic review and implementation of business process reengineering. It should also move toward transparent information-based taxation operations and the application of risk-based audit for better compliance management. If implemented properly, these measures will help to strengthen the efficiency and effectiveness of tax administration to maximize revenue mobilization, help to reduce the compliance cost for taxpayers and improve the business environment in a fundamental manner. Other reforms that need to be undertaken include research into the feasibility of creating a self-sufficient large taxpayer office aligned with international best practice. Coordination between the General Department of Taxation (GDT) and social insurance funds should be strengthened with a view to transferring responsibility for collecting social security contributions to the GDT on behalf of the social insurance funds.

54. On the spending side, there is significant scope for the rationalization of other inputs in public service delivery sectors without jeopardizing service quality. In the education sector, there are signs of inefficiencies in the deployment of human resources which would benefit from an adjustment plan to increase teaching hours per teacher linked to curricula reforms. In the health sector, a number of drivers of inefficiency have been identified, including provider payment mechanisms that do not offer appropriate incentives; an over-reliance on hospital centered service delivery at the central and provincial levels, instead of grassroots based and preventive health care; and high pharmaceutical spending. In the agriculture sector, public spending was prioritized for irrigation with a focus on increasing rice production. More emphasis could be placed on increasing water productivity to enhance rice production, as well as diversifying crops and promoting other functions such as agricultural services to increase agricultural incomes. In the transport sector, high unit costs of construction and maintenance are amongst the issues that have hindered the overall value for money of the road subsector in Vietnam. While the initial unit cost of construction in Vietnam is generally comparable to other regions, there are two main elements that increase the costs: slow pace of land acquisition and the spreading of limited funds over too many projects.

Box 3 The Fiscal Plan 2016–2020

- **In its Resolution No. 25 (dated November 2016), the National Assembly, at the proposal of the Government, released its medium-term fiscal policy priorities,** building on the Socio-Economic Development Plan (SEDP) 2016–20 approved in April 2016. The policy priorities are set around 6 high level objectives, and 9 specific policy areas. The overarching objectives include (a) continue to improve the national financial mechanisms and institutional systems; (b) mobilize, distribute, manage and use financial resources efficiently in response to the national socioeconomic development requirements and targets; (c) gradually restructure State budget revenues and expenditures; (d) strike a balance between saving and consumption, with emphasis on strict thrift practices, anti-wastefulness, efficient use of public investment finance for relevant investment in human capital and good social safety nets, national defense and security; (v) strictly tighten financial and fiscal discipline in parallel to the acceleration of administrative reforms, modernization, strengthening of financial inspection, scrutiny, auditing and supervision; and (vi) strongly reduce and strictly control state budget deficits, public debt and national external debt to ensure macroeconomic stability and national financial security.

- **The plan envisages a gradual fiscal adjustment of the fiscal position as well as continued implementation of structural and institutional reform actions.** A gradual, growth-friendly fiscal consolidation is considered as a crucial element to entrench fiscal sustainability. There has been a strong commitment toward reducing the level of the budget deficit, to 3.9 percent for the 2016–20 period and 3.5 percent of GDP by 2020, and keeping the level of public debt below the current statutory limit of 65 percent of GDP. Fiscal consolidation options will be considered on the basis of a concerted effort to boost revenue mobilization, restructure, enhance efficiency, curb growth in spending, while still protecting social spending and investment. On the financing side, the Government’s plan envisages to mobilize financing from divestment of major state-owned enterprises (SOEs) to reduce the need for borrowing while mobilizing a mix of domestic and external debt, including ODA to meet remaining financing needs. In parallel, further institutional reforms will continue to be pursued, building on the improvements introduced by the Public Investment Law (2014), the State Budget Law (2015) and the Public Procurement Law (2013).
- **Accordingly, the Government has identified 9 specific areas of focus for reforms.** Notably, for the first time, the Government looks at fiscal policy options from a broader public sector financial statement perspective. As such, reforms focus on revenue mobilization, expenditure management, and assets and liabilities management areas:
- **On the revenue side, the plan prioritizes a slight boost to the level of revenue mobilization to 23.5 percent GDP and to the share of domestic revenue mobilization (from 80 percent in 2011–15 period to about 84 percent in 2016–20).** Specific policy options will be further considered to bolster revenue performance, including broadening the tax base and avoiding base erosion including through rationalizing tax expenditures and considering introducing a property tax. Meanwhile, it emphasizes modernization of the tax environment and enhancing revenue administration and tax audits to combat against tax avoidance and evasion, transfer pricing, and tax arrears, while lowering the compliance burden on taxpayers.
- **On the expenditure side, the government aims to moderate recurrent spending growth, particularly through right sizing of public sector employment, to provide more room for capital spending while continuing to focus on improving investment efficiency.** In addition, it mandates a number of actions to improve expenditure management. These include: strengthening fiscal disciplines particularly in relation to pre-financing and carryovers, improving fiscal transparency and reporting in line with international standards and practices, and a gradually shift toward performance-oriented budget management. The government also promotes a set of interrelated policies, designed simultaneously to improve government service delivery performance, increase citizen service choices, reduce the financial burden upon the state, and overall gradually rationalize the role of the state in the provision of public goods. Planned actions include gradual price adjustments in selected sectors such as education and health, accompanied by adequate protection and assistance for the vulnerable and the poor.
- **On the assets and liabilities sides, the plan is to accelerate SOE restructuring and divestment while strengthening corporate governance and financial oversight.** The establishment of a dedicated state ownership agency will be considered. As part of the overall debt management, the government will tighten the control over the issuance of guarantees and of subnational deficits and debts. The National Assembly explicitly prohibits using the state budget to cover either the restructuring costs for SOEs and banking sectors or the defaults of government on-lending and guarantee operations. Borrowing activities will be considered with a medium-term perspective, with an aim to increase the maturity profile and reduce risk of the debt portfolio. The government also expresses keen interest to further develop the domestic capital markets.

Strengthening public debt management

55. Going forward, in tandem with the concerted efforts to reduce the fiscal deficits, it will also be important for government to strengthen public debt management. Prudent fiscal and debt management will result in bolstering investor confidence, sovereign creditworthiness and lowering the risk premium for Vietnam. Aside from these immediate debt pressures, Vietnam will also need to prepare for transition to an environment where concessional (ODA) inflows will gradually subside and commercial debt, both domestic and external, will be the main source of government financing. Actions across several areas are needed:

- *Strengthening the debt portfolio*—optimize the cost-risk and extend the maturity profile, maximize the use of less costly ODA sources, and work with donors to ensure ODA financing is closely aligned with Government expenditure priorities.
- *Developing further the domestic debt market*—improve the functioning of both primary and secondary markets, diversify the investor base, and improve market infrastructure and support services.
- *Strengthening further debt management capacity*—keep strengthening the legal and institutional framework, addressing fragmentation on public debt management through better coordination to mitigate the risk of insufficient and untimely information sharing between the units, and unclear responsibilities which ultimately hinder the consistent implementation of the medium-term debt management strategy.
- *Enhancing fiscal risk management*—including through monitoring of major contingent liabilities in the SOE and banking sector.

56. On the legal framework on public debt management, the first-ever Public Debt Management Law (PDML, issued in 2009) and secondary regulations are widely recognized to have helped to consolidate and leverage regulations in resource mobilization under the oversight of the National Assembly, raise awareness of both the executive and the legislature on the importance of the issues, improve transparency and accountability of relevant stakeholders, and strengthen debt management reporting. The ongoing revision of the law is considered timely to cope with Vietnam’s transition.

57. Vietnam’s transition has opened up a wide range of more market-based borrowing options and financial instruments to alter the cost/risk balance of the public debt portfolio. In such an environment, it is essential to have in place robust legal and operational frameworks for efficient public debt management, which is essential for Vietnam’s transition. The public debt management paradigm should therefore shift from pure resource mobilization toward performance-based management with clear objectives, strategy development and evaluation. On this basis, the World Bank has recommended revisions of several aspects of the current law with the aim of promoting more effective management of government debt, in line with international sound practice. The main recommendations are as follows:

- **First, the revised law should make a clearer distinction between the fiscal policy and debt management functions.** The current law not only contains provisions related to managing debt but also covers issues relating to the use of loan proceeds, overall financing needs and debt levels. The latter, while clearly important, would normally not be considered part of debt management. Debt management is typically concerned with mobilizing government borrowing and optimizing cost-risk tradeoffs in the debt portfolio. Conversely, debt management should not focus on the level of debt (which is a direct consequence of the accumulated fiscal balances) or how debt proceeds are used (that is, the quality of public spending and investment), which instead fall into the fiscal and public expenditure policy domain. The distinction between fiscal policy and debt management is important to ensure accountability and avoid overlapping and possibly conflicting objectives. The enactment of both the Public Investment Law (2014) and the revised State Budget Law (2015) has made it relatively easy to achieve this distinction in a revised PDML.
- **Second, in order to support a performance-based approach to government debt management, the revised law should, in line with international best practice, clearly articulate the long-term debt management objectives.** In this vein, it should also require the preparation of a medium-term debt management strategy to achieve those objectives, and of annual borrowing plans to support the execution of the determined strategy.

The medium-term debt management strategy should be based on a sound cost/risk analysis of the debt service flow of the actual and forecast debt portfolio under different risk scenarios. Experience shows that the absence of a formal strategy to guide daily borrowing decisions can easily lead to poor choices and thereby amplify risks. The strategy and annual plans would in turn provide the basis for annual evaluation reports to be submitted to the National Assembly. Apart from rules on borrowing authorization and borrowing purposes, these are the key provisions on government debt management that should be included in the revised law.

- **Third, the law should allow more flexibility for the effective management of government debt.** As of now, the current law contains many detailed restrictions on borrowing and liability management that hinder flexible and effective management of government debt. In addition, the law should delegate the execution of the strategy to the Ministry of Finance and its debt management unit, which both follow (or should follow) developments in the capital markets and market behavior on a daily basis.
- **Fourth, the revised law should require a proper credit-risk assessment prior to any on-lending and issue of guarantees,** and clarify that the interest rate in the case of on-lending, and the guarantee fee in the case of loan guarantees, reflect the assessed credit risk and associated costs to the government. In general, on-lending and guarantees should be subject to the same level of scrutiny and authorization by the National Assembly as given to budget appropriations. In order to make this practical, it is proposed that all projects in the Law on Public Investment that are classified either as important national projects or Group-A projects should be approved by the National Assembly before they can be financed by on-lending or supported by government guarantees. Other projects, such as Group-B and Group-C projects, should be approved by the Prime Minister.
- **Finally, considering the likely increased borrowing requirement of the local administrations to finance new investments, particularly in the new on-lending arrangements for ODA and concessional financing, it will be imperative that subnational public debt management capacity be strengthened in a timely manner.** Similar to debt management at the central level, subnational governments should also be encouraged to prepare a medium-term debt management strategy to steer their borrowing operations. It is also recommended that for cities and provinces with vibrant borrowing activities, specialized units for public debt management should be established, as focal points for monitoring, reporting, and policy recommendations on the consolidated portfolio including both domestic and external debt. At the same time, there should also be requirements to ensure timely and accurately recording and transparent and consolidated reporting of different sources of finance; and to develop formal procedures for debt related payments, debt data recording, backup process, validation and storage for operational risk management at subnational level.