

# Drivers of Economic Reform in Vietnam's Provinces

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**Abstract:** *Allowing provinces to find their own way forward was central to Vietnam's progress in institutional and economic development. This paper examines who drives the economic reform process in the provinces, exploring the role of business, government and the Party. The research shows that in those provinces which are making most progress in economic reform, the private sector played an important role; not against government, but with government. There was no formal public-private coalition but the dynamic was one of proactive government seeking the input from the private sector, and the latter lobbying for and contributing to responsive and effective government. Both national and foreign enterprises played a role but small enterprises tended to be marginalised from the process. Some of the best insights come from comparing provinces and observing how different alignments of interest influenced the reform process.*

**Keywords:** investment climate; economic reform; economic governance; private sector; state business relations; decentralisation; provincial government; Vietnam

## 1 Introduction

Establishing an economic order which encourages investment, growth and job creation is one of the key tasks of government. When business people take investment decisions, they take into account government rules, policies and practices. While a good investment climate is not the decider for *whether* the investment is made (that depends on the business opportunity), it can influence *where* the investment is made. This is why countries or regions compete by offering a “good investment climate”.

While there continues to be a debate on how much improving the investment climate matters for pushing up economic growth in the short run<sup>1</sup>, there is little doubt that the key elements of good investment climate are desirable in the long run, notably legal property protection, enforceability of

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<sup>1</sup> For critiques of the investment climate approach, see Altenburg and Drachenfels 2006), Khan (2008), Moore and Schmitz (2008), Abdel-Latif and Schmitz (2011), Patunru *et al.* (2012), McCulloch *et al.* (2013).

contracts, easy business registration, simple customs procedures, and so on. What is not clear is the process of getting there. Which are the forces that drive the process forward? Not surprisingly, international development agencies assume that the governments which they support are the main drivers of this process. But is this true?

In spite of the enormous efforts made world-wide in reforming investment climates and measuring progress, there is relatively little research on the political process of getting from a bad to a good situation. Who drives the process forward, which actors or coalitions of actors make a difference? What formal and informal processes are at work? This paper seeks answers to these questions by drawing on the case of Vietnam.

Studying the transition economies is particularly interesting because they started from a very bad regime which outlawed private property of the means of production and shunned the market. Vietnam is particularly interesting because it has been successful in making the transition to a market economy, and recording high rates of economic growth. While still struggling to reduce the privileges afforded to state owned enterprises (SOEs) and to contain preferential access of some SOEs to political leaders, the country has made enormous progress in reforming itself. A key feature of this reform was the decentralisation of certain economic powers to the provinces. While the central government is in overall charge, provincial governments have considerable room to manoeuvre.

This paper analyses the forces that drive economic reform in the provinces. The central question is who drives the improvement in the quality of local economic governance? We are particularly interested in whether and how the private sector plays a role in the reform process. Who initiates the reform process in the provinces? Who drives it forward? What are the roles of big investors, small investors, business associations, provincial government agencies, provincial leaders and central government? Is there active cooperation between government and business people? What form does it take? Is it formal or informal? Who tries to slow down the process? We examine these questions for four provinces, two provinces in the North and two in the South. They are located in the Red River and Mekong River Delta respectively. In each pair, one province is successful in reforming its investment climate and one is less successful. We try to understand each province in its own right but also learn from comparing them.

In seeking answers to the above questions, we focus on the provinces but do not look at them in isolation. We ask how the provinces are conditioned by 'The Centre', notably the central government and the Communist Party. Seeking to understand how the Centre influences what happens in the provinces had an unexpected consequence. It opened our eyes to a bigger story with a clear message: the empowerment of the provinces contributed to Vietnam's success. This is a controversial story to tell at a time when decentralisation is criticised for leading to wasteful investment. We agree that such criticism is valid in particular instances, but we believe that it fails to grasp the bigger picture:

Vietnam is a big laboratory and has been a big laboratory for the last 25 years. The challenge was first the transition from a centrally planned to a market economy and then the integration into the world economy. Under the political control of the Communist Party, the market was allowed to play an increasing role and propel the economy forward. The economic transformation was deep and fast, but was in fact based on experimentation. Ceding powers over the investment climate to the provinces is part of this experimentation. Provinces have used the policy spaces granted to them in many different ways, unleashing unexpected dynamics within and between provinces.

Understanding these dynamics is what we seek to do. Our initial intention was more modest, namely to understand who drives the investment climate reform in the provinces. As it turns out, precisely because we have started in the provinces (outside Ha Noi and Ho Chi Minh City), we begin to see processes which are central for understanding the economic transformation of the country. The insights we learn from Vietnam finally lead us to ask what lessons there are for other countries.

The paper is structured as follows: section 2 sets out briefly what the literature tells us about the drivers of investment climate reform. As stated above, a wealth of research and advice is concerned with what governments should do but is much less concerned with the political process of making it happen. Section 3 explains how we studied this process, setting out the data sources and methods used in our research. Section 4 provides a comparative overview of the findings from the provinces. Sections 5 to 8 zoom in on the role of particular actors in the reform process, notably the private sector, Government, the Party and, most importantly, the relationships between them. These sections bring out how the reform evolved in a process of experimentation and learning and why this led to both substantial improvements and new problems. The comparisons between provinces and over time yield new insights relevant for both research and policy.

## **2 The starting point: what do we know and what do we not know?**

In the academic literature on economic development and in the policy debate on promoting economic development there is a strong view that good economic governance and strong economic growth go together (North 1990, Helpman 2008). Indeed, a close look at the advanced countries of North America, Western Europe and Japan – particularly over the period from 1950 to 2000 – confirms this view. This experience has been the bedrock for advice to latecomer countries: improving the investment climate is seen as essential for economic development. Latecomers are offered a lot of advice on what measures they should take but little advice on who would bring about the reform in laws and regulations? The widely held assumption is that government drives the process. The assumed dynamic is: government undertakes the governance reform and private investment follows. This seems plausible but is it right?

Examining this question is of relevance for many countries that seek to accelerate growth and transform their economies. So as to make this debate relevant for them it is important to concentrate on the starting point and not the end point of the journey they seek to undertake. In other words, the relevant question is how to get from ineffective to effective economic governance.

Countries which have made this journey in recent decades – characterised by rapid globalisation – are more likely to provide insights than countries that have been prosperous for some time. The experience of the rapidly growing countries of East Asia, notably China and Vietnam, is particularly interesting in this respect. Both countries challenge the dominant view. When they embarked on their reform process, they did not have in place the key elements of a good investment climate: property rights, legally enforceable contracts and regulation of business activity which is transparent and fast.

Yet both countries have grown rapidly and transformed their economies over the last 35 and 25 years respectively. And both countries have gradually transformed their legal and regulatory frameworks. Clearly the dynamic was not one of investment following governance reform, but was it one of investors leading governance reform?

The official view in both countries is to attribute leadership in the reform process to the Communist Party and central government. Indeed they have retained overall control, setting the direction and boundaries for reform but the boundaries can be challenged and there is political space for other actors. This paper examines what happened in this space in the case of Vietnam. Before presenting the findings of our research, this chapter sums up what we can learn from the literature.

We start with a quote which expresses in stark terms the issues we are concerned with. It comes from research on the legal and institutional reform in post-communist countries of Eastern Europe and the former Soviet Union:

Foreign investors... are not passive bystanders in the legislative and institutional reform process, as is widely assumed. Rather, foreign investment is a dynamic force in the forefront of the push for change and an agent for such reform. This phenomenon has been largely misunderstood by the international development community and ignored in the prevailing literature. (Hewko 2003: 72)

In other words, trying to find the drivers of reform within the public sector alone would miss an essential part of the picture. The role of the private sector needs attention.

This is precisely the focus of Edmund Malesky's (2004, 2008) research on the politics of economic reform in Vietnam. He demonstrates how a coalition of foreign investors and provincial officials induced far-reaching economic reforms. His research concentrates on the 1990s and early 2000s and on key issues of the reform debate at that time: opening up to the international system, reducing the

role of state-owned enterprises, and decentralising government authority. Malesky depicts the power struggles going on in the Centre but concludes that the reform battle was in fact won in the provinces. By working with foreign enterprises, provincial leaders could obtain fiscal room to manoeuvre. Direct and indirect tax income from foreign direct investment was key. Some of the daring provinces were able to exceed the fiscal targets set by the Centre and keep the surplus revenue. Provincial officials thus had an incentive to attract foreign investment and in order to do this they experimented by modifying regulations and introducing new measures.

This came to be known as ‘fence breaking’ because the provinces took initiatives which were – at that time – beyond their remit, meddling with things that were under the jurisdiction of the central government.<sup>2</sup> The fence breaking and experimentation in the provinces caused a lot of controversy in the Centre. The outcome was that some provinces were disciplined but others were allowed to get away with it because their attraction of foreign investment showed results on the ground: increases in economic growth and jobs. More than that, some of the provincial policy reforms – worked out in conjunction with foreign enterprises – were eventually adopted into national-level legislation (Malesky 2004, 2008).

We have referred to Malesky’s research in detail because it provides robust quantitative and qualitative evidence for the role which foreign investors (especially export-oriented investors) have played in Vietnam’s reform process. His subsequent work shows that foreign investors were also agents of change in other transition economies (Malesky 2009). To be precise, his research covers export-oriented foreign investors and the early phase of the transition process. Our research is concerned with the later phase of the transition process – or what is referred to in Vietnam as the second wave of reforms. We are particularly concerned with the reforms from 2005 onwards when all provinces were formally empowered to determine their own investment climate. Most provinces embraced with enthusiasm their new policy space and many of them were able to make substantial changes in the rules and regulations governing business activities.

We are particularly interested in the role of the private sector in influencing the recent reform process, not just foreign enterprises but also domestic enterprises. Very little is known about whether and how domestic enterprises have played a role in the reform process. This is hardly surprising for the first wave of policy reforms. At the start of the transition there was no class of private domestic investors. But then such a class emerged rapidly, often from the upper ranks of the Communist Party. In the words of Gainsborough (2010: 16):

In Vietnam, the reform years have certainly seen the emergence of a new business elite.

However, while this elite is new in terms of its business interests, it is in fact rather old in

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<sup>2</sup> The term ‘fence breaking’ goes back to Vietnam’s early reform years and was introduced into the academic debate by Fforde and de Vylder (1996).

terms of its political ties. That is, many of the new entrepreneurs have emerged from within the existing system, are currently serving or former officials, or are the children of the political elite.

The implication is that discerning the role of domestic business in the early reform process would have been both difficult and sensitive. Difficult because it did not (yet) constitute a separate social grouping, sensitive because acknowledging that there was a private entrepreneur in the family was ideologically painful. Membership of the Communist Party was a condition for success in public office but private entrepreneurs were not allowed to join the party.

Discerning the role of national entrepreneurs in the second wave of reforms has become less difficult for several reasons: the entrepreneurs are seen as more legitimate, there are more of them and they have had a chance to organise. This does not mean that it is an easy topic to explore. The main problem is no longer ideology but corruption. Both business people and public officials fear that by talking openly about the connections between them they will be suspected of corrupt practices. In this respect, present-day Vietnam is no different from most other places in the world. And in line with most other places, there are instances of corruption, but it is by no means a defining characteristic of close relationships between public officials and private investors. Focussing on corruption would prevent us from understanding the dynamics of the reform process forward.

In analysing whether the public or private sector drives the reform process we distinguish on the public side between the Communist Party and the government and within government between the policymakers and the bureaucracy. On the business side we distinguish between foreign and domestic business, between big and small business and between individual business leaders and collective organisations such as business associations. We look for alliances between public and private actors, always asking questions about their incentives for being against or in favour of specific reforms.

### **3 Methods and sources**

In order to unravel who drives economic reform in the provinces we combine economic and political analysis and draw on quantitative and qualitative information.

The assessment of improvements (and deterioration) in economic governance is based on panel data available for all provinces and for five years. The Provincial Competitiveness Index (PCI) captures the perceptions of domestic private investors about governance at the provincial level.<sup>3</sup> This index is

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<sup>3</sup> The Index is constructed by asking a randomly selected set of firms in every province questions about nine different aspects of the investment climate: Entry costs; Land access and tenure security; Transparency; Time costs of regulatory compliance; Informal charges; Proactivity of the provincial government; Business support services; Labour training; and Legal institutions. Sub-indices are constructed for each of these components and then combined to provide an overall indication of the quality of economic governance. The sub-indices

available for each year from 2006 to 2010 in a disaggregated form by province and governance component.<sup>4</sup> Where appropriate and possible we draw on additional quantitative and qualitative information relating to earlier years.

The research on who drives these improvements in governance is based primarily on qualitative research in four provinces, two in the North and two in the South. We picked provinces which made substantial and sustained improvements, since the objective was to identify the contributions of the various actors to the improvement. The bigger the improvements the greater is the chance of identifying these contributions and capturing the political dynamic behind the change. In order to identify factors critical for success and failure we compared the successful provinces with provinces which were less successful.

Comparability is an issue because there are many factors that can influence improvements in governance. Propensity Score Matching helped us to identify provinces with similar endowments: human capital, infrastructure (roads and telephones), and distance from major cities (Malesky 2011). These steps led us to the selection of two pairs of provinces: Bac Ninh and Hung Yen in the North and Dong Thap and Ca Mau in the South. The selected Northern provinces are both in the Red River Delta and the selected Southern provinces are both in the Mekong River Delta.

The 2010 ranking of our four provinces shows clear differences in governance performance. The positions which they occupied in the total of 63/64 provinces were as follows: Dong Thap no. 3, Bac Ninh no. 6, Ca Mau no. 51 and Hung Yen no. 61. But as can be seen in Table 3.1, their rankings changed over time and it is these improvements (or deteriorations) we want to understand.

Table 1 shows the aggregate index. For each province and each year, we can decompose the index and focus on particular components.<sup>5</sup> For example, Figure 1 shows how the four provinces differed in 2010.

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include both perception-based and concrete indicators. There is a strong correlation between the perception and concrete indicators suggesting that changes in PCI are not being driven simply by improved perceptions of the investment climate in places where economic performance has been good. For full details of the construction of the PCI, see VCCI (2008). For evidence of the causal connection between the PCI and firm investment see McCulloch *et al.* (2013).

<sup>4</sup> Both the collection and the processing of the data were carried out to high standards, conducted by the Legal Department of the Vietnam Chamber of Commerce and Industry and led by Dau Anh Tuan. The PCI was designed by Edmund Malesky who was an advisor to our project.

<sup>5</sup> The PCI components (sub-indices) are explained in detail in each year's PCI Report. See, for example, pages 3–4 of VCCI (2010) [www.pcivietnam.org/uploads/report/PCI%202010%20final%20report.pdf](http://www.pcivietnam.org/uploads/report/PCI%202010%20final%20report.pdf) (accessed 12 October 2011).

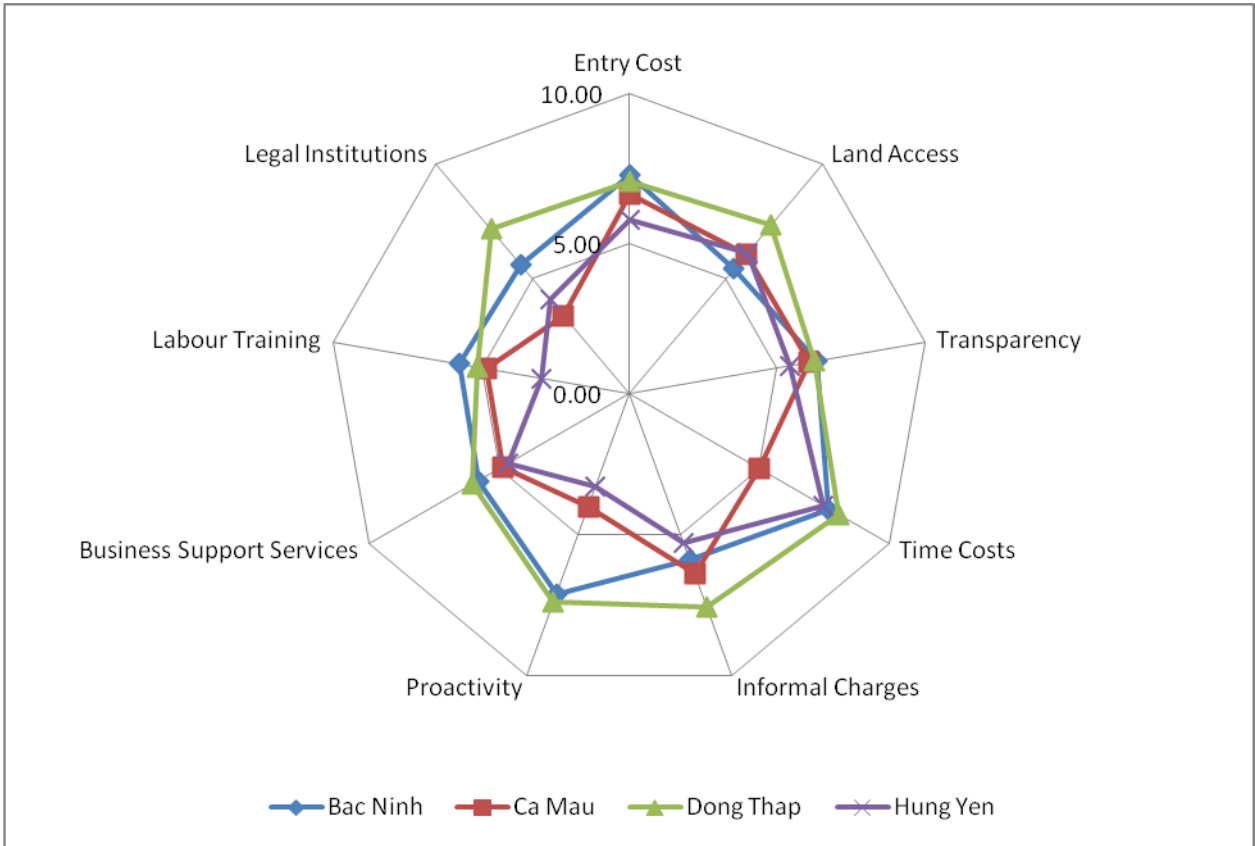


**Table 1 PCI scores and rankings of four selected provinces, 2006–2010**

Province	PCI				
	2006	2007	2008	2009	2010
Bac Ninh	54.79	58.96	59.57	65.70	64.48
Ca Mau	43.99	56.19	58.64	61.96	53.57
Dong Thap	58.13	64.89	66.64	68.54	67.22
Hung Yen	55.97	57.47	57.53	61.31	49.77
Province	Ranking				
	2006	2007	2008	2009	2010
	(64 provinces)			(63 provinces)	
Bac Ninh	22	20	16	10	6
Ca Mau	57	29	18	22	51
Dong Thap	11	9	5	4	3
Hung Yen	16	26	20	24	61

Note: The PCI ranges from 0 to 100 with higher scores indicating better economic governance. The total number of provinces was reduced from 64 to 63 over the period covered in this research.

**Figure 1 PCI for four provinces in 2010**



Although Figure 1 confirms the good performance of Bac Ninh and Dong Thap, it shows that performance can vary considerably by component. For example, Ca Mau scores poorly on the quality

of its legal institutions and the proactivity of its government, but its entry costs, transparency, labour training and lack of informal charges are similar to better performing provinces.

Unravelling the drivers of change was based on interviews. Careful selection of informants was important. The principle was that on most issues we would need to hear both the public and private sector and cross-check information within and across public and private sectors. In each province we talked to roughly similar numbers of government officials and business leaders, conducting a total of 121 interviews. Table 2 gives the breakdown according to ‘sector’: public, private, donor, media, experts. Table 3 gives the breakdown by province. It also includes the number of interviews carried out in Ha Noi – where we cross-checked information received in the provinces and gathered information on the Centre’s influence on the provinces.<sup>6</sup>

**Table 2 Interviews by category**

Category	Quantity
Government	47
Enterprises	58
Associations	8
Experts	4
Donors	2
Media	2
<b>Total</b>	<b>121</b>

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<sup>6</sup> Our interviews were conducted in the form of an open discussion but were structured around interview schedules. Each interview team had one person asking the questions and another taking notes and sometimes swapping roles in the process. In some cases the interview team included four people. Interviews led by Hubert Schmitz and Neil McCulloch had professional translators. Most interviews were led by the Vietnamese team members. The composition of the interview teams varied but overlapped both within and across provinces in order to share experiences and insights. While the interviews are our prime and main source of information for understanding the differences between provinces and changes over time we have also drawn on secondary material which is referred to in the course of the paper.

**Table 3 Interviews by province**

Province	Quantity
Bac Ninh	26
Hung Yen	26
Dong Thap	31
Ca Mau	24
Ha Noi	14
<b>Total</b>	<b>121</b>

#### 4 Similarities and differences across four provinces

We learnt a great deal in each of the four provinces and have presented the findings in a detailed research report (Schmitz *et al.* 2012). We will concentrate in this paper on the overall findings, arising from the comparison between the provinces and interpretation of the findings in the national context.

The main findings are drawn together in Table 4. The findings that stand out are as follows: first, it is clear that in the two cases where there have been substantial and sustained reforms (Bac Ninh and Dong Thap) the private sector was very much involved. However, the nature of private sector involvement was different in the two cases, with large firms playing an important role in Bac Ninh, whilst SMEs played the key role in Dong Thap. In part this reflects the different natures of the two economies, with Bac Ninh dominated by large export-driven firms, whilst Dong Thap, being remote and rural, relies on much smaller and more local firms. In the other two provinces, large firms did not play a leading role in reform, but did lobby for their own interests, particularly in Ca Mau, whilst small firms were ignored and generally irrelevant in the reform process. Thus on the private sector we tentatively conclude three things: large firms will always lobby for their own interests; small firms are often (although not always) excluded from influence on the reform process; and, critically, organisational capacity and leadership in the private sector is necessary (but not sufficient) for successful reform.

The second conclusion we draw relates to the role of provincial government. Again, it is clear that both cases of success (Bac Ninh and Dong Thap) were heavily influenced by proactive, competent and stable leadership from the provincial government. Without this, private sector lobbying merely serves particular interests but does not translate into broader-based reform. Thus it is the combination of an organised and capable private sector and proactive local leadership that seems to give rise to success, rather than one or the other. In the absence of such leadership, or in situations where there is political conflict or constant change, the existence of a central government mandate for reform can hold back deterioration in governance and promote some constructive administrative reforms. But the central government's inability to engage directly with the local private sector means that it cannot create the

embedded dynamic relationships that seem critical for serious reform. Nor can it encourage the coordination and common ground within the private sector that is essential for dialogue focussed on local issues.

Small enterprises found it difficult to engage in the reform process. There were exceptions, notably Dong Thap (as mentioned above) but also in Bac Ninh in an earlier stage of the reform, when a proactive SME association was the main driver of reform (for details see Schmitz *et al.*, 2012, pages 23-24). It was an example of good practice but not a typical case. Our discussion with informants that have country-wide expertise suggests that in most parts of Vietnam small enterprises are marginalised from the reform process. The reasons are several. First, in a small enterprise, the owner-manager has multiple roles. This makes it difficult to add a further role of engaging in policy advocacy. Business associations can help to give them more voice but often government hinders rather than helps the effectiveness of associations.<sup>7</sup> Small-scale entrepreneurs also feel that government officials pay more attention to large enterprises, because this provides opportunities for complementing their formal income with informal charges.

This raises the question of whether personal enrichment by public officials is a hidden driver of economic reform. There is a literature which suggests that it played a role in Chinese provinces (Francis 2001), but the evidence from our Vietnamese provinces is not clear. Most respondents in the public and private sector were reluctant to engage in discussions of this topic but those who opened up admitted that the families of public officials often gained financially from a prospering private sector. It is not possible for us to ascertain to what extent this is the case. We can, however, reflect on the relevance for the reform process which is our main concern. Does the financial gain by the families of public officials have an impact on the reform process? It is important to recognise that the potential for corruption could have a positive or a negative impact on reform. Where the financial gain is based on abusing a public position, the official concerned will want to maintain the old way of doing things rather than make the procedures easier and more transparent for business. In other words, gains based on corrupt ties are likely to lead to blocking reform. Where the financial gain is based on a family member prospering in business and this business benefiting from reform of regulations, the official is likely to support reforms enthusiastically.

Table 4 provides an overview of the different constellations of forces which help explain the progress (or lack of it) in the four provinces. There is, however, a dimension which the Table does not capture and which seems to have played a role in the reform process: unified support versus divisions amongst the provincial leaders. A mutually supportive relationship between the provincial executive (chairman and vice-chairmen of the People's Committee) and the provincial party secretary is particularly

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<sup>7</sup> For example, insisting that a retired government official run the association makes it more difficult for a small business to have a vigorous and authentic voice.

important. Government leaders and Party leaders tend to be the key people in the Provincial People's Committee (PPC) and forging an alliance seems critical for undertaking daring reform.

The Communist Party has thus political reach into the provinces and this matters for answering our central research question: who drives the reform process in the provinces? Playing a leading role in the reform process often means taking on controversial issues. It entails risks. The willingness and ability to take on risks is influenced by the position in the Communist Party and/or connections to key people in the Party. An insightful account of the first wave of reforms and the early fence breaking experiments suggests that 'the local leaders who launched this dynamic were actually high in the Party structure... Many of them were party secretaries at the provincial level' (Rama 2008: 27). The quality of relationships with(in) the Party continues to matter in the second wave of reform. They matter not in a day-to-day fashion but in terms of giving green or red lights for new initiatives. In this sense, the connection to the Party helps to understand where and why Provincial Government was a driver of the reform of the reform process.

This attention given to the role of provincial-level actors does not mean that central government is superfluous. Far from it. It plays an important role which is not captured in Table 4 but came out in the interviews: the influence of central government comes from providing incentives for provincial officials to undertake reforms. A good track record in accelerating and improving economic reform enhances the career prospects within government and the Party. Acknowledging this positive role of central government is as important as recognising its failures. Central government has failed to block off avenues for negative competition between provinces. Our interviews in the provinces and with key actors in Ha Noi have confirmed the urgent need for a stronger central framework to avoid a 'race to the bottom' in investment incentives. It is entirely rational for each provincial government to attempt to provide higher tax incentives than their neighbours to attract investment to their provinces. However, at a national level this does not make sense – it results in a substantial loss of tax revenue to the state and is increasingly seen as a negative feature of the reform process.

Following this initial overview of the drivers of the reform process, the remainder of the paper analyses in greater detail the key actors or alliances in the reform process.

**Table 4 Actors and Drivers in Four Provinces**

<b>Drivers</b>	<b>Bac Ninh</b>	<b>Hung Yen</b>	<b>Dong Thap</b>	<b>Ca Mau</b>
<b>Central government</b>	Connections with central government and proximity to Ha Noi probably useful but not the dominant driver	Central government has been the only mainstay of reform, but without a local champion, reform has flagged	Central government has been supportive but not a major driver	Central government is a key driver, particularly of administrative reform
<b>Provincial government</b> - <b>Leaders</b> - <b>Bureaucracy</b>	Provincial leadership played a critical role in the later stages of reform	Provincial leadership has constantly changed leaving policy uncertainty and a lack of direction	Provincial leadership has been the critical driver	Provincial leadership has been mediocre and is not the key driver of change
<b>Large business</b>	Big firms play an important role throughout, working closely with provincial government	Large businesses have not played a key role in driving reform. Indeed, the lack of a leadership role from business may be one reason for the lack of governance reform	Big firms have focused on their own needs rather than on generalised reform	Big firms have been influential in driving reforms, but only for issues of concern to them
<b>Small business</b>	SME association was the main driver in the early stage but had less influence later on	SMEs have had very little influence over reform	Good SME/government relationships (and political links) have helped reform to be more broad-based	SMEs have had virtually no influence on reform

Source: Schmitz *et al.* (2012), chapters 5 - 9

## 5 The Role of the Private Sector in Enhancing Reform

Provincial government is by necessity involved in the economic reform process but who is actually driving it? In our research we found that in those provinces which are making most progress in economic reform (Bac Ninh and Dong Thap), the private sector played an important role. Not against government but with government. There was no formal public–private coalition but the dynamic was one of proactive government seeking the input from the private sector and the latter lobbying for and contributing to responsive and effective government. In Bac Ninh, the initial push came from the private sector; in Dong Thap the initial push came from the public sector. In both cases, there was a clear and open recognition that the two sides needed each other in order to bring about effective reform.

Malesky's (2004; 2008) earlier research showed that foreign enterprises had a considerable influence in helping provinces to increase their autonomy and engage in experiments in the 1990s and early 2000s. We sought to ascertain whether – in the period since 2005 – national enterprises have been able to exert influence. The answer is threefold:<sup>8</sup>

First, national enterprises have indeed exerted considerable influence. We noticed this in particular in the provinces which made greatest progress in reform, namely Bac Ninh and Dong Thap.

Second, the potential for influencing policy is much greater than actual influence. The reason is the lack of organisational capacity in the form of business associations. The experience of Bac Ninh in the 2005–08 period showed what can be achieved. At that time, the local SME association forced the pace of reform and organised regular meetings with reform-minded government leaders. In Dong Thap, local enterprises have only participated by invitation, relying on the initiative of the provincial government to consult with them. Their organisational capacity remains weak. In Hung Yen and Ca Mau, there are associations but without strong leadership and influence.<sup>9</sup> Local enterprises complain about government but do little to improve things. Of course individually there is little they can do. What is required is bundling their concerns and giving them organisational force. This is required not just in the provinces which we investigated but in many other provinces.

We recognise the main reason for the current weakness of associations.<sup>10</sup> Large enterprises find it easier to exert influence by contacting government leaders directly and individually.<sup>11</sup> We established

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<sup>8</sup> The evidence for this threefold answer is set out in chapters 5 – 8 of Schmitz *et al.* (2012).

<sup>9</sup> Ca Mau has a strong fishing association but it concentrates on the concerns of the large enterprises in the fishing industry.

<sup>10</sup> The problem of weak business associations has been recognised for some time (see, for example, Nguyen Dinh Cung *et al.* 2004: 12–16).

<sup>11</sup> In earlier years, policymaking tended to be a closed process (Tran Huu Huynh and Dau Anh Tuan 2007: 28–9). Government doors are now more open to allow business participation in this process.

in our interviews that this is the preferred route for leaders of big business. Participating in collective efforts is more time consuming. Leading collective efforts is more time-consuming still. Small enterprises need business associations to exert influence but their owners rarely have the clout – or time – to organise collective efforts. They also have the problem of being taken less seriously because of the large firm bias amongst many public officials.

Third, there is a way in which national enterprises have had a big influence on the reform but it is rarely acknowledged as such. The PCI which has been conducted since 2005 is based on the perceptions of domestic enterprises. The publication of the PCI scores and the ranking of provinces have attracted a lot of attention and triggered a range of responses:

- Business and central government have used the PCI as a source of information on the performance of provincial governments.
- Changes in PCI ranking have had an influence on whether provincial government officials were promoted or demoted – according to some observers.
- Provincial governments have sought assistance from VCCI to improve their ranking – as evidenced in the quantitative analysis.
- Poor performers have tried to learn from strong performers – confirmed in our interviews.

In short, the PCI scores, which derive from the views of domestic enterprises about their provincial government, seem to have had a considerable influence on the reform process.<sup>12</sup>

## **6 Learning in Provincial Government**

Tailoring economic reform to local conditions was a big challenge in Vietnam since the geographical, economic and cultural conditions within the country vary a great deal. Add to this that the country was embarking on the transition from central planning to market economy and that North and South had different political legacies. The challenge was enormous and the chosen way forward was decentralisation of some government functions, notably those relevant for improving the investment climate. This decentralisation occurred through a process of political negotiation in which provincial leaders played the key role and were supported by some leaders in the central Party. Formal decentralisation was the result of a process of experimentation characterised by breaking fences and learning step-by-step. We have concentrated on the process since then.

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<sup>12</sup> The evidence for this conclusion is set out in detail in chapters 10 and 11 of Schmitz *et al.* (2012).



Our research leads us to suggest that the reform process since 2005 is a continuation of the previous practice of learning by experimenting. The country's 63 provinces are a space to try out new things. Vietnam is learning by experimenting in 63 laboratories. Some provinces have used this space to the full, learnt a lot and built up their governance capacities in impressive ways. Others have been reluctant learners and reformed because they felt they had to. The differences in provincial state capacity which we have experienced – in the course of this research and in the course of visits to other provinces - are huge. Certainly the view of some interviewees (minority) that provinces are not capable of conducting effective economic policy is no longer valid as a generalisation.

Many factors have contributed to this learning and capacity building. The relative importance of these factors varies between provinces but it is important to see them working in conjunction. First, provincial leaders and officials have the ambition to make a difference to their career and to their province's growth. This came out clearly from the interviews. Second, provincial leaders who made the greatest progress learnt from working with the private sector. The comparison between our provinces makes this clear. Third, provinces learn from each other. A number of respondents confirmed that they sought to find out what has worked in other provinces although we cannot say how systematically such learning from each other is pursued. Fourth, central government contributes through its promotion decisions. Our interviews in the provinces confirm that promotion – decided by the Centre – plays a role. (Vice-) chairmen of the People's Committee and the heads of department seek promotion by implementing reforms which enhance economic investment and growth and thus raise tax income of their province.<sup>13</sup>

Finally, the PCI has become a driver of reform in its own right. The survey is conducted in a professional and impartial way; the indicators it generates have legitimacy. They can be compared across provinces and over time, enabling entrepreneurs, researchers, media, central government and provincial governments themselves to make broad judgements on both improvements and deterioration. It gives rise to numerous learning effects. It leads provincial governments to engage in positive competition with other provinces and emulate successful provinces.

In summary, in the course of examining the drivers of economic reform, a learning dynamic became apparent. It is uneven between provinces but it is strong. This finding deserves further analysis. There is a literature which suggests that decentralisation contributes to policy experimentation (Heilmann 2008), but Hongbin Cai and Daniel Treisman (2006, 2009) present counterarguments based on empirical and modelling work. It would be useful to specify in further research under what conditions decentralisation leads to the observed learning and experimentation.

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<sup>13</sup> Further confirmation comes from quantitative analysis: provincial leaders who were promoted tended to be in provinces that had performed well in improving the PCI; those that were disciplined were in provinces where the PCI had gone backward.

## 7 The Role of the Party

The role of the Communist Party in provincial-level reform also needs to be recognised. Reforming requires changing the *status quo*, often in controversial ways. Precisely because Vietnam changed so fast, issues kept coming up for which there was no officially recognised way forward. Experimenting was needed but this meant taking risks. Where government executives have good connections with Party leaders, they are more likely to take such risks. This came out clearly in the comparison between our two Southern Provinces: Dong Thap and Ca Mau. The consensus between government and party seems to have been more consistent in Dong Thap contributing to its greater progress in reform. The greater the experimentation, the greater the need to engage the Party in discussion.

This is not a finding specific to the recent second wave of reform. Rama (2008) showed that the same applied to the first wave of reform. Indeed, it helps to see our findings in historical perspective. Governance reform is difficult to do. There was no tested and successful role model, certainly not in the early years of this century when Vietnam decided to empower provincial governments to reform economic governance and improve the investment climate. This decentralisation seems to have worked and it is important to understand why.

The key reason was that Vietnam relied on its tradition of experimentation and allowed all provinces to find their own way of reforming in line with their endowments and preferences. From the national point of view, 63 (initially 64) provinces were unleashed to explore, to compete with each other and to learn from each other. Such learning dynamics seem to have contributed to the advances in economic reform. We know, however, from the PCI monitoring and from our own research that some provinces have been much more successful than others in using the space given to them. In spite of the tensions this has brought about, Vietnam has not fallen apart. Our discussions with a wide range of stakeholders indicate that the Communist Party has been the key force in holding the country together and providing the necessary glue for an increasingly complex political system.<sup>14</sup>

The Party has, however, failed to deal with two problems which endanger the entire edifice. Our research in the provinces highlights two corrosive issues: tax exemptions and land grabbing. There is evidence that granting excessive tax incentives continues in many provinces, that it undermines the financial capacity of their governments and leads to a race to the bottom.<sup>15</sup> And our interviews suggest that it undermines the legitimacy of provincial governments in the eyes of SMEs who rarely benefit. It

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<sup>14</sup> It is worth pointing out that the Vietnamese system has generated lower inequality than the Chinese system. Over the past two decades, no two economies have averaged more rapid economic growth than China and Vietnam. But China's inequality has risen more rapidly than that of Vietnam. Abrami, Malesky and Zheng (2008) suggest that this is because of the difference in Party organisation. Compared with China, Vietnam's institutions empower a larger group of insiders and place more constraints on the party leadership, both through vertical checks and semi-competitive elections. As a result, Vietnam spends a larger proportion of its revenue on transfers and has been able to achieve more equalisation between provinces and individuals.

<sup>15</sup> Granting tax incentives in the first wave of reform can be seen as a way of augmenting autonomy for provinces (Malesky 2008) but this political case for tax incentives no longer applies in the current phase.

even makes relationships between enterprises of different size difficult and thus makes it more difficult for the private sector to organise and develop a collective organisational capacity.

Land speculation also has a poisonous effect, in particular when land is sold at preferential prices to enterprises which then do not use it in the promised way. We have seen in the course of our interviews that this practice does much harm and we have also seen that provincial governments are struggling to deal with it effectively.<sup>16</sup>

Both practices have been known for some time but progress in dealing with them has been slow. Provincial governments on their own cannot resolve this, partly because there is a conflict of interest between what is good for Vietnam, for the province, for the enterprise and for the individual officials concerned. Addressing these conflicts of interest requires guidance and intervention from above. It is difficult to see how these corrosive practices can be stopped without substantial involvement of the Party. Recent Politbureau Resolution No. 9 (December 2011) provides a basis for doing this. The resolution is a political affirmation of the transformative role of enterprises and their social responsibilities. Paying taxes is the prime social responsibility of an enterprise. Equally, acquiring land on false pretences is not compatible with Party Resolution No. 9.

## 8 Lessons for other countries

The overriding lesson for other countries is that Vietnam was successful by finding its own way forward rather than relying on models advocated by international development agencies. This comes out clearly from Rama's (2008) account of the first wave of reform and from our account of the second wave of reform. Note that this is not an argument against learning from each other's successes and mistakes. It is, however, an argument for starting with one's own internal and external circumstances.

The same point was made a long time ago by the historian Alexander Gerschenkron. In his book *Economic Backwardness in Historical Perspective* (1962) he argued that latecomers have to plot their own distinctive path of development. Repeating what others have tried before is rarely possible because each country has its own specific internal conditions and because the rise of the early developer changes the external conditions for the latecomer. Analysis of early industrialisation in continental Europe led Gerschenkron to this conclusion. Analysis of the successful industrialisers in East Asia leads to the same conclusion. Japan, Korea, Malaysia, Taiwan and China did not follow models from elsewhere. In 'Institutions and Growth in East Asia', Stephan Haggard (2004) emphasised how East Asia succeeded through a long process of 'transition' that was highly experimental in nature. Similarly, Michael Hobday (2003), in a review of Asian industrial

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<sup>16</sup> See also the recent Tien Lang case in Hai Phong – [www.vnnnews.net/tag/tien-lang](http://www.vnnnews.net/tag/tien-lang) (accessed 15 March 2012).

development, concludes that it is diversity rather than uniformity in the institutional arrangements and development policy that characterises the innovation experience of the Asian Tigers.

We can add the case of Vietnam to this formidable list. Starting from desperate conditions less than 30 years ago, it has found its own way forward and transformed itself. While our research was not concerned with Vietnam's industrial development in general, the focus on reform in the provinces helped to understand three key features of the transformation: first, there was an alignment of interests of the newly-enabled decentralised actors with the reformers in central government; second, provinces had the space to experiment (what we called 'learning in 63 laboratories'); and third, the private sector engaged actively in these experiments.

Allowing all provinces to find their own way forward was central to Vietnam's progress in institutional and economic development. This is impossible to prove because we cannot examine the counterfactual.<sup>17</sup> We can, however, observe what happens in other countries where inappropriate recipes for governance reform are disseminated by central governments or foreign aid agencies. The history of governance reforms from outside includes many failures.<sup>18</sup> The conclusion drawn by critical analysts is to move away from ideas of global best practice and concentrate more on homegrown experiences (CFS 2010). 'Working with the grain' of local society is a perspective which is gaining increasing respect amongst researchers and policymakers (Crook and Booth 2011). The reform process in Vietnam's provinces supports this view.

The implication is not that international assistance agencies were superfluous. They could make useful contributions because they were feeding into a process of decentralised reform which was being driven forward from within Vietnam. They were active in 27 or so provinces. GTZ, DANIDA, IFC, ILO, UNIDO, SIDA, CIDA and others provided useful technical inputs for administrative reform and provided complementary tools for understanding and promoting local economic development. One of the most influential contributions was the financial and technical support by USAID, DAI and the Asia Foundation for the Provincial Competitiveness Index. As stressed earlier, the PCI provided critical capacity to monitor reform efforts and contributed to multiple learning effects within and across provinces. It thus enhanced Vietnam's capacity to find its own way forward.

While this research supports the case for decentralising authority for reforming the investment climate, it also recognises the pitfalls of decentralising. Provinces can be sucked into a race to the bottom by offering tax incentives which undermine their own future fiscal viability. This suggests that decentralisation needs to be accompanied by strong central regulation specifying what provincial

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<sup>17</sup> The Abadie Synthetic Control Method for Comparative Research tries to deal with such problems but applying it to our case would be difficult (Abadie *et al.* 2011).

<sup>18</sup> For example, the structural adjustment programmes imposed by donor agencies on African countries in the 1980s destroyed many of their state capacities (van de Walle 2001).

governments are permitted to offer investors and what they are not. These rules should apply equally to all provinces. The aim should be to encourage provinces to compete on their helpfulness to investors and the quality and timeliness of the services they offer, not on tax incentives or holidays.

A further problem exacerbated by decentralisation in Vietnam has been a tendency for local elites to push farmers off land to make way for development with very little compensation. This is a common problem in rapidly industrialising countries across the world. Here it is essential that the Centre acts as a counterweight to local development interests, providing a clear framework for the process which must be followed and ensuring that compensation is appropriate. In both this area, and in framing the tax regime, donors can play a useful role, bringing experience from other countries to the attention of policymakers and supporting their access to expertise in constructing regulatory frameworks which are suitable to the country's specific context.

Finally, there is a lesson for the private sector in Vietnam and in other countries. The research highlights the importance of both formal and informal spaces for communication and dialogue between the private sector and government. Reform has happened fastest in places where government has had a good understanding of the problems faced by the private sector and has been responsive to their needs. The capacity of government to do the right things depends to a considerable extent on the capacity of the private sector to engage. Governments and donors can support and challenge the private sector to develop such collective capacity but to do so is above all the responsibility of the private sector itself. Business people throughout the world excel in pointing out public sector failures. Few recognise that public sector failure often arises because the private sector is not sufficiently well organised to work with government in a constructive way. The comparison between provinces in Vietnam underlines the importance of developing the organisational capacity of the private sector. This is not a new point. The importance of well-organised and inclusive business associations has been recognised for a long time in Vietnam and elsewhere.<sup>19</sup> This point, however, needs to be made more forcefully because inadequate policies and regulations are usually associated with government failure. This, however, is rarely the full story. Behind public sector failure is often private sector failure.

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<sup>19</sup> See, for example, Tran Huu Huynh and Dau Anh Tuan (2007), Abdel-Latif and Schmitz (2010), Schneider and Maxfield (1997), Sen and Te Velde (2009).

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