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ADB Economics Working Paper Series



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Liv Bjornestad

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Abstract

This paper provides an in-depth analysis of the relationship between fiscal decentralization and pro-poor outcomes based on the role of fiscal incentives. The literature on the relationship between fiscal decentralization and pro-poor outcomes is not well established in this area. A conceptual model is developed to explore in more detail this relationship, while endeavoring to illuminate the complexity of the issues involved for policy makers in developing countries. Four types of fiscal incentives are explored: namely, resources, responsibility, autonomy, and accountability. The paper then assesses the effectiveness of the Vietnamese system of fiscal decentralization for achieving pro-poor outcomes through a devolved system of fiscal incentives. The paper suggests that evidence from the Vietnamese case indicates that fiscal decentralization may contribute to poverty reduction outcomes, but does not provide evidence that fiscal decentralization is in and of itself inherently pro-poor. Rather, the lesson from Viet Nam is that if poverty reduction is an explicit objective for government, the system of fiscal decentralization should target pro-poor outcomes through an appropriate system of fiscal incentives. Since 2002, budgetary reallocation and income redistribution linked to poverty outcomes has been more strongly associated with equalizing fiscal transfers than with devolved finances in general. This represents a broadly correct approach to target poverty outcomes in a territorially unbalanced country like Viet Nam. Targeted transfers contribute to pro-poor outcomes by increasing the level of resources available to finance poverty spending. However, increasing the level of fiscal transfers for poverty spending will not ensure that fiscal transfers are then spent efficiently. In order to better realize these efficiency objectives, the government can promote greater fiscal and administrative decentralization of resources and responsibility to district- and commune-level governments. Further gains in this area must also be supported by greater levels of fiscal autonomy and fiscal accountability at the local government level.

I. Introduction

The classic argument for maximizing local discretion was made by Oates (1977), who posited that the greatest efficiency is achieved when budgetary choices are made by local officials elected by local citizens who have to meet the full cost of their decision through local taxes.¹ According to the fiscal federalism literature, fiscal decentralization should decrease transaction costs for the management of public funds, improve accountability² for the use of those funds, and provide a platform for local groups and communities to voice their demands through physical proximity to policy makers, thereby increasing the value of public services. More recently the theory has been extended to a number of areas of public policy; a particular area of interest for developing countries has focused on the efficacy of fiscal decentralization for realizing pro-poor outcomes.

The relationship between fiscal decentralization and poverty reduction is typically based on the tenets of fiscal federalism. Proponents would argue that increasing the efficiency of limited public resources in a developing country; strengthening the accountability for the use of those funds; and increasing the levels of engagement between the government and poorer segments of the population—thereby ensuring “voice” for the poor in policy development—can positively contribute to government efforts to reduce poverty. Fiscal decentralization also implies that local governments will be assigned functional responsibilities for a wide range of pro-poor public services, which fiscal federalists posit are best delivered by local governments. If poverty alleviation is a national concern, local governments should be involved in designing the poverty alleviation strategy, in contributing to financing the strategy through the collection of local taxes and user fees, and in lobbying for fiscal transfers for marginalized groups.

Yet, extension of the classically cited benefits of fiscal decentralization to the area of poverty reduction and pro-poor policy is not without controversy. Indeed some have suggested that fiscal decentralization could in fact be anti-poor. Why would this be so? A variety of arguments have been put forth relating to the following facts:

¹ In transitional countries (even with one-party systems) adherents still promote the benefits of bringing the government closer to the people even if the government has not been directly elected.

² The literature focuses on two aspects of accountability. The first relates to the degree to which institutions allow the government (or officials within the government) to divert rents: that is to transfer tax revenues away from productive expenditure on public goods, and to some other use that more directly benefits the government (such as campaign finance, or the outright use of these funds for personal consumption). The second relates to the degree to which institutions allow special interest groups to distort government decision making by *lobbying* (Ahmad and Brosio 2006, 45).

- (i) Fiscal decentralization could interfere with the capacity of the central government to implement its poverty reduction strategy since policy implementation will be devolved to lower tiers of government where preferences and priorities for public expenditure may not be homogenous with those of the central government.
- (ii) Public money already constrained by insufficient levels of public revenues may be misallocated as it travels through the system and fails to reach its targeted beneficiaries (in this case the poor).
- (iii) Fiscal decentralization tends to fortify the power of mid-level governments (provincial/regional) and therefore increases transaction costs for public expenditures, with limited actual impact at the local level.
- (iv) Decentralization is likely to exacerbate the already weak administrative and fiscal capacities of poorer regions, placing additional pressure on a system that is already unable to cope with existing financial management responsibilities.
- (v) There is no theoretical or empirical evidence that increasing proximity of the government to the people—even for the allocation of local public goods—is welfare-enhancing, especially since central government can reap economies of scale and scope in resource allocation.

In spite of the relevance of this discussion for many developing countries pursuing both fiscal decentralization and poverty alleviation programs, literature on the explicit nature of this relationship still requires further development. At present, there is no uniquely defined relationship between fiscal decentralization and poverty reduction (only for the more general theory of decentralization) and even this has its ambiguities. Limitations for theory development has arisen, since on one hand there is an issue of endogeneity of the relationship: it is possible that fiscal decentralization contributes to poverty reduction through financing to promote local development and improved service delivery, but that relationship is only indirect. Similarly, it is possible that fiscal decentralization leads to poverty reduction but the economic and/or social benefit was for all social groups (or at least not specifically beneficial to the lowest income quintile), and therefore was not explicitly pro-poor. On the other hand, owing to weaknesses in public expenditure data at the local level in many developing countries, there is a limited body of quality empirical evidence available for policy makers to assess the causality and impact of fiscal decentralization on the poor.

It is from this perspective that this paper explores in more detail the relationship between fiscal decentralization and pro-poor outcomes, while endeavoring to illuminate the complexity of the issues involved for policy makers in developing countries. In this paper, particular focus will be paid to the role of fiscal incentives under fiscal devolution

in affecting poverty outcomes since *ex ante* fiscal incentives are associated with local government promotion of economic development, reform in the local economy, improved service delivery outcomes and, by extension, poverty reduction.

The Vietnamese experience of fiscal decentralization is generally accepted as positive and so is its record of poverty reduction over the last two decades. However, to date, the nature and causality of the relationship has not been explored in adequate detail.³ For simplicity, this paper makes the following assumption: if a country has a defined national poverty reduction strategy, as does Viet Nam, and if the state budget is a relatively accurate budgetary interpretation of that policy, also broadly the case for Viet Nam, then public expenditures may be considered adequately pro-poor at the aggregate. Following from this assumption it is then possible to consider if decentralized expenditures and related institutional reconfiguration of government responsibilities have been used for the promotion of poverty outcomes at the subnational level. This can plausibly be achieved by assessing the effectiveness of the system of fiscal incentives in the context of budgetary redistribution, budgetary (re)allocations, and the role of fiscal transfers for achieving pro-poor outcomes. Given fiscal data paucity issues at the subprovincial level, a holistic conceptual methodology for analyzing the effect of fiscal devolution is developed. The methodological approach draws on available sources of both qualitative and quantitative information for analysis.

The remainder of this paper is structured as follows. Section II defines fiscal decentralization and poverty and undertakes an exploration of existing theories on the relationship between public policy, public expenditure, and poverty alleviation. Section III explores conceptually the role of fiscal incentives under fiscal decentralization in realizing pro-poor outcomes. Section IV introduces the Viet Nam case and describes Viet Nam's story of poverty reduction and central public expenditures. Section V assesses the effectiveness of the Viet Nam system of fiscal decentralization for achieving pro-poor outcomes through a devolved system of fiscal incentives. The paper suggests that fiscal decentralization may contribute to poverty reduction outcomes, but does not provide evidence that fiscal decentralization is in and of itself inherently pro-poor. Rather, the lesson from Viet Nam is that if poverty reduction is an explicit objective for government, then the system of fiscal decentralization should target pro-poor outcomes through an appropriate system of fiscal incentives. Since 2002, budgetary reallocation and income redistribution linked to poverty outcomes has been more strongly associated with equalizing fiscal transfers than with devolved finances in general. This represents a broadly correct approach to target poverty outcomes in a territorially unbalanced country like Viet Nam. Targeted transfers contribute to pro-poor outcomes by increasing the level

³ Nguyen (2008) published a paper exploring the effects of decentralized public expenditures created by Viet Nam's 2002 State Budget Law on poverty alleviation. He finds that an increase in the subprovincial expenditure has brought about a decrease in the income of the lowest-quintile average monthly income of the Vietnamese. Nguyen emphasizes the need to implement pro-poor allocation norms for provincial governments. See also the Vietnam Development Report (2008), which undertakes a correlation analysis between fiscal decentralization at the provincial level and provincial poverty levels for two periods (2002 and 2006). The report conversely finds a positive correlation between net fiscal resource transfers and pro-poor outcomes for this period.

of resources available to finance poverty spending. However, increasing the level of fiscal transfers for poverty spending will not ensure that fiscal transfers are then spent efficiently. In order to better realize these efficiency objectives, the government can promote greater administrative decentralization of resources and responsibility to district and commune-level governments. Further gains in this area must also be supported by greater levels of fiscal autonomy and fiscal accountability at the local government level. Section VI concludes the paper.

II. Exploring the Theoretical Relationship between Fiscal Decentralization and Poverty Reduction

A. Fiscal Decentralization: Concepts and Definitions

Decentralization and distribution of the public purse has a long history of discussion in politics and economics. The first notable economic theory of federalism was developed by Hayek (1945) who in the postwar period explored how knowledge was used by society. He emphasized that since local governments had better access to local information through proximity to users, this enabled them to provide public goods and services that were better aligned with local preferences than the central government. More than a decade later Tiebout (1956) proposed the idea of interjurisdictional competition. He asserted that competition between local governments created a mechanism to sort and match public goods and services with consumers' preferences. Applying these ideas in the area of public finance, Musgrave (1959) and later Oates (1972) built a theory of fiscal federalism, stressing the appropriate assignment of taxes and expenditures to the various levels of government to improve welfare (Jin et al. 2005). Oates in particular developed our current understanding of efficiency in the allocation of public goods by local governments as the most efficient method of service delivery for local goods and services.⁴

Fiscal decentralization is defined today as allowing lower levels of government to raise and/or spend an increasing share of the state budget (Fritzen 2006). Fiscal decentralization also determines the discretion given to regional and local governments to determine their expenditures and revenues (both in aggregate and detail). However,

⁴ Oates (1972) made the distinction between national and local public goods where a national public good should accrue in the same amount to all individuals in a country while local public goods only accrue to individuals of a particular subnational jurisdiction. He defines the rationale for defining the responsibility for the delivery of public goods in his Decentralization Theory, which argues that for a public good, "The consumption of which is defined over geographical subsets of the total population, and for which the costs of providing each level of output of the good in each jurisdiction are the same for the central or the respective local government—it will always be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions" (Oates 1972, 35).

fiscal decentralization is concerned with more than the physical allocation of public resources. It implies a rearrangement of the institutional configuration of government, the relationships and responsibility between and of different levels of government, as well as the reallocation of resources. Fiscal decentralization is therefore about empowerment⁵ over the management of public resources in a devolved setting. The objectives of fiscal decentralization in a developing country context are firstly *political*, i.e., to support poverty reduction and economic growth; secondly, *economic*, i.e., the need for responsiveness at the local levels to achieve allocative efficiency through the principle of subsidiarity, which states that services must be provided by the lowest sphere of government capable of efficiently providing these.

Decentralization or the distribution of administrative functions or powers of (a central authority) among several local authorities can be considered as four distinct areas of policy reform. Firstly, there is *political decentralization* where there is a transfer of political power and authority to subnational levels such as elected village councils and state-level bodies. If the local level of public authority is totally autonomous and fully independent from the devolving authority, this is referred to as *political devolution*. Secondly, there is *fiscal decentralization*, whereby some level of resource reallocation is made to allow local government to function properly, with arrangements for resource allocation usually negotiated between local and central authorities. Thirdly, there is *administrative decentralization*, which involves the transfer of decision-making authority, resources, and responsibilities for the delivery of selected public services from the central government to other lower levels of government, agencies, and field offices of central government line agencies. There are two basic types of administrative decentralization. On one hand there is *deconcentration*, which is the transfer of authority and responsibility from one level of the central government to another, with the local unit accountable to the central government ministry or agency that has been decentralized. *Delegation*, on the other hand, is the redistribution of authority and responsibility to local units of government or agencies that are not always necessarily branches or local offices of the delegating authority, with the bulk of accountability still vertical and to the delegating central unit. Fourthly, there is *divestment or market decentralization*, where transfers of public functions are made from the government to voluntary, private, or nongovernmental institutions by contracting out partial service provision or administration functions, deregulation, or full privatization (Work 2002, 3).

According to international best practice, fiscal decentralization should ensure the following:

⁵ *Empowerment* as defined by Stern, Dethier, and Rogers (2005) refers to expanding economic activities, that is, one should have the ability to shape one's own life. The concept of empowerment covers a number of external and internal constraints, which can prevent individuals from taking advantage of economic opportunities and participate in the development process.

- (i) assignment of expenditure responsibilities to different government levels
- (ii) assignment of tax and revenue sources to different government levels: once subnational governments are assigned certain expenditure responsibilities, they determine which tax or nontax revenue sources will be made available to subnational governments in order to meet those responsibilities⁶
- (iii) intergovernmental fiscal transfers: in addition to assigning revenue sources, central governments often provide regional and local governments with additional resources through a system of intergovernmental fiscal transfers and/or grants
- (iv) subnational borrowing: local governments are legally allowed to borrow (from central government or from outside, i.e., national/international lenders) to finance revenue shortfalls.

B. Dimensions of Poverty Reduction: What is Pro-poor?

Poverty means different things to different organizations and is measured and assessed through a variety of methodologies and instruments. In the view of the Asian Development Bank (ADB), poverty is a deprivation of essential assets and opportunities to which every human is entitled⁷. Pro-poor is then most commonly defined by Ravallion's (2004) definition: if poor people benefit in absolute terms, as reflected in some agreed measure of poverty such as the headcount index then growth, distribution, whatever the measure we are analyzing is pro-poor. More specifically, pro-poor growth would compare changes in the incomes of poor people *with respect to changes in the incomes of the nonpoor*. Development would be pro-poor if the incomes of poor people grow faster than those of the population as a whole, i.e., if inequality declines. Thus growth is pro-poor when the distributional shifts accompanying growth favor the poor and poverty falls more than it would have if all incomes had grown at the same rate (Dethier 2004). The policy objective is to achieve the greatest amount of poverty reduction, hence, both growth and distribution policies matter.

⁶ The literature of fiscal federalism does not suggest that each tier of government should be self-sufficient.

⁷ ADB's (2008) definition can be further broken down into three categories. (i) human poverty: lack of essential human capabilities, notably literacy and nutrition; (ii) income poverty: lack of sufficient income to meet minimum consumption needs; (iii) absolute poverty: degree of poverty below which the minimal requirements for survival are not being met, a fixed measure in terms of a minimum calorific requirement plus essential nonfood components. While absolute poverty is often used interchangeably with extreme poverty, the meaning of the latter may vary, depending on local interpretations or calculations.

C. Theoretical Perspectives on Decentralization and Poverty Reduction

As discussed the relationship between decentralization and poverty reduction has received increasing attention as a research subject. Theories on this relationship are based on a number of different perspectives that can result from devolving political and administrative responsibility, and fiscal resources to lower tiers of government. Here we review the four most common approaches concerned with (i) proximity to the poor, information transfer, and transaction costs; (ii) voice and accountability; (iii) role of local capacity; and (iv) nonrelationship. What is clear from a review of these approaches is that the extent to which decentralization itself has an impact on poverty reduction outcomes is not a clear-cut or resolved issue, and there is definite disagreement as to the merit of undertaking fiscal decentralization in a context where a government prioritizes poverty reduction for political, economic, or development reasons. The categories are summarized in Table 1 below:

Table 1: Theories on the Relationship between Fiscal Decentralization and Poverty Reduction

Theory	Proposal	Authors
Proximity of decision makers, Information and transaction costs	Proximity of policy makers to the target group reduces information and transaction costs in identifying the poor.	Oates (1999)
	Proximity helps in designing potentially successful “capacity improving” and “safety net” policies.	
	In an economy with significant intercommunity (regional/local) variations in preferences, and when there are no significant economies of scale and scope, decentralized provision of public services can enhance efficiency in the provision of these services and result in welfare gains.	
	Intergovernmental competition and the mechanism of exercising choice by the citizen voters either through “exit” or “voice” helps to reveal preferences for public services.	
	Competition can also result in innovations in the provision of public services.	
	For quasi-public goods, it is possible to identify the beneficiaries and impose user charges on them. Thus, decentralized provision of such services can also help to link revenue–expenditure decisions at the margin. This can improve both efficiency and accountability in the provision of public services.	

continued.

Table 1: *continued.*

Theory	Proposal	Authors
	Centralized governments do not have an unlimited ability to collect information and monitor agents, and local authorities tend to be better informed on issues such as the revenue-generating capacity of local enterprises, or on the needs of local populations.	Stiglitz (1998)
	Forcing decision making to the lowest possible level of government where peer monitoring can take place and where people can more directly control agent efficiency and accountability are likely to increase efficiency.	
	Devolving responsibilities for expenditure management to the local level has advantages from the point of view of information. Putting decision making in the hands of those who have the information that outsiders lack gives them a strong incentive advantage.	Bardhan (2002)
	Local information can often identify cheaper and more appropriate ways to provide public goods. These incentives and information advantages make decentralization qualitatively similar to the advantages enjoyed by the market mechanism over the government.	
	Community groups are likely to have better information on who the poor are. However, only communities that have relatively egalitarian preferences, relatively open and transparent systems of decision making, or which have clear rules for determining who the poor are, will tend to be more effective than outside agencies in targeting programs to the poor within a given community.	Conning and Kevane (2002)
	Heterogeneous communities where people have multiple and conflicting identities may pose a particular challenge because of competing incentives.	
Local Government Participation	Participation and community involvement have impact on well-being through: community involvement in selecting the beneficiaries of anti-poverty programs, which improves targeting. This takes place through participation and other dimensions of decentralization to improve the delivery of public services and through outcomes shaped by inequalities and uneven distribution of resources within the community.	Mansuri and Rao (2004)
	Participation can also explain the links between decentralization, growth, and democracy. In static and poor societies, the fight for power is, in large measure, over a cake of fixed size and its control is in the hands of a narrow elite. Even if voting exists, participation may be limited to a few rich people; the ruling elite are part of a small group that exploits its political power to appropriate output.	Justman and Gradstein (1999)
	If dynamic forces arise leading to increased output, in the early phase of development, an increase in income may be accompanied by increased inequality as existing elites control the gains. When growth starts to affect a greater proportion of society and is driven by broader sections of society, then participation becomes broader and the political elite are recruited from a wider social spectrum.	

continued.

Table 1: *continued.*

Theory	Proposal	Authors
Local Government Capacity	Local government's lack of human, financial, and technical resources reduces the scope for them to provide the appropriate level of public services under decentralization, and financing and administrative authority should remain in the hands of the human, financial and technical rich, and central governments.	Shah, (1998), Wallis and Oates, (1998), Jutting et al. (2004 and 2005)
No Relationship	<p>Even if decentralization is effective in changing the relationship between local governments and their constituent's, decentralization is in and of itself not a sufficient condition for poverty reduction. Rather factors such as central government commitment to poverty reduction, effectiveness of central government institutions and functions, gender sensitivity in public financial management, etc, will be more determinative in whether or not the outcomes of decentralization will be pro-poor.</p> <p>Any form of decentralization by itself is not sufficient to truly empower local communities and to achieve pro-poor outcomes. For example while local power over the purse is important under fiscal devolution, successful fiscal decentralization goes hand in hand with political and administrative decentralization and vise-versa.</p> <p>Since local economies are highly open, the effect of any fiscal policy would tend to be small in their own jurisdiction.</p> <p>Redistribution does not work in a decentralized system because jurisdictions with aggressive redistribution strategies would attract poor people from, and repel rich people to, other jurisdictions. The mobility of people would thereby undermine any intended effect on poverty reduction.</p> <p>The theory that a country's central government has an informational disadvantage in the area of regional/local preferences has not been proven empirically or theoretically. The center may be just as efficient as local government in allocating a nonuniform level of public goods to different localities. Decentralization is therefore not necessarily welfare-enhancing. If the central government were able to provide different levels of local public goods, it could choose the welfare-maximizing level for each local jurisdiction. A centralized system would then always achieve at least a similar level of welfare for the population as a decentralized system and possibly more in the presence of positive externalities of scale or scope.</p>	<p>Crook and Sverrisson (1999)</p> <p>Sewell (1996)</p> <p>Musgrave (1969)</p> <p>Lockwood (2002), Besley and Coate (2000)</p>

Source: Author's compilation; see bibliography for full references.

D. Fiscal Devolution and Pro-Poor Outcomes

Pro-poor policies can target the poor in a number of ways. Analysis shows that in most countries, the poor are almost always concentrated in the poorer rural localities and regions. These areas tend to have lower standards of physical and social services, resulting in low levels of productivity of both capital (including land) and labor. Poorer

regions in many developing countries also tend to receive lower levels of general per capita fiscal transfers than their richer neighbors. Thus an effective strategy to alleviate poverty would require policy measures to accelerate growth as well as those that provide essential public services to improve human development of local citizens, who endowed with human capital assets such as health and education, increase their productivity and earning potential. Although redistribution has traditionally been associated with the role of central government, experience has shown that subnational governments can play an important role in designing and implementing poverty reduction strategies (Brown and Oates 1987). The role of the poor in determining their needs in this respect has also been considered. It is reasonable to assume that the poor will express heterogeneous preferences across localities for goods and services. The prevalence and causes of poverty vary substantially among different jurisdictions within a given country and each jurisdiction thus requires special policies for eradicating poverty (Steiner 2005, 17–8).

The role of local governments in the delivery of pro-poor public services is well documented. The fiscal federalism literature argues that many—if not most—public services that are closely associated with poverty alleviation are believed to be best delivered by local governments. Incidence studies (which examine who benefits from public services), for example, show that local sectors, such as education and certain public health services, are indeed among the most pro-poor areas of public spending (Martinez-Vazquez 2001). Yet, two things tend to vary greatly in fiscal decentralization policies and implementation across countries. The first is the extent of the local responsibility for the social sectors (health, education, and social assistance). If social sector delivery is not highly devolved to the local level it is very unlikely that fiscal decentralization can have a significant impact on poverty reduction. The second is that the link between local resource availability and service delivery outcomes is not necessarily uniform across regions and local governments (Hoffman and Guerra 2004). This is because some local governments use the resources at their disposal more efficiently than others, thereby highlighting the importance of local participation and local accountability⁸ in the realization of pro-poor outcomes (UNDP 2005).

The role of public expenditure in achieving pro-poor outcomes, be it through an indirect, long-term, growth-accelerating strategy or a short-term strategy to redistribute consumption, is similarly discussed in the literature. Poverty alleviation requires public expenditure programs to provide public and quasi-public services on one hand and targeted direct transfers to the poor on the other. In executing growth-enhancing spending programs, both allocative and technical efficiency in public expenditures is important in a resource-constrained economy. Thus, efficient allocation of public expenditures in the sense of both cost-efficient provision of public services, and delivery of these services matched to the diversified preferences of different sections of people, are important

⁸ The literature distinguishes between conditional and unconditional transfers and local accountability. Conditional grants lead to a more hierarchical system of accountability, with the center holding the subnational government accountable for the use of central funds. In unconditional transfers for discretionary resources, subnational governments plan local service delivery more effectively (Ahmad and Brosio 2006, 247).

components of an effective poverty alleviation strategy. Finally, to be cost-efficient, it is necessary that policies implemented to ensure consumption entitlements to the poor need to be well targeted. This requires identification of the poor and designing and implementing appropriate redistributive policies to enable targeting the poor for improving consumption entitlements (UNDP 2005).

III. Conceptual Framework

Assuming poverty alleviation is a national concern, this paper argues local governments should be involved in designing the poverty alleviation strategy, in contributing to financing such a strategy through the collection of local taxes and user fees, and in lobbying for fiscal transfers for marginalized groups. Fiscal decentralization implies that local governments will be assigned functional responsibilities for a wide range of pro-poor public services, and this paper supports that in principle, local governments are likely to be better placed to provide many of these services in an efficient and responsive manner than the central government.

As discussed fiscal decentralization is a much broader issue than simple resource reallocation from higher to lower levels of government. It involves changing the roles and responsibility of governments at different levels, and fiscal decentralization by nature entails the development of different institutional constructs, which are country-specific and which will have different outcomes in the common quest of poverty alleviation (Singh 2006). In some observed countries, the government may have decentralized fiscal resources, but fail to address other issues that affect the incentive structure of local governments to effectively manage those transfers.⁹ As Dethier (2004, 6) notes “because so many variables interact (degree of accountability and transparency, level of local capacity, degree of participation, skills level of the agents, etc), there is no recipe for success, no, universal law that can be inferred...on the effects of decentralization.” As such, fiscal decentralization will not be effective for the achievement of pro-poor outcomes unless fiscal incentives are established to ensure policy objectives and service delivery functions are applied in ways that will positively foster pro-poor outcomes (while actively avoiding regressive ones).

Fiscal decentralization is therefore about incentives; nevertheless, it is difficult to find a generally accepted definition of incentives in the literature. Here we use the definition of Sargent (1994, 155): “Incentives may best be thought of as signals. They may be negative—disincentives—providing an alert or deterrent, or they may be positive, motivating and indicating action.” A fiscal incentive would then come in the form of a policy measure(s) legislated by the central government to affect the behavior of

⁹ Intergovernmental fiscal transfers can take a number of forms: (i) shares of national taxes distributed by either a formula (per capita) or by origin (local, provincial, central); or (ii) through grants that are either targeted to support specific expenditure (e.g., health) or untargeted and used at the discretion of local governments (block grants).

subnational governments. It follows that this policy signal will enforce or restrain the policy outcome depending on the subnational governments' capacity to recognize the signal, be incentivized by this signal, be rewarded for responding to the signal, and be monitored for implementing the signal.

Fiscal incentives are thus considered more broadly in this paper than fiscal transfers only, from central to subnational levels, of government. Here we consider four types of fiscal incentives:

- (i) *Fiscal resources.* This pertains to the adequacy of fiscal transfers from the central government to fund pro-poor expenditures (offset poverty) at the vertical level and to balance horizontal inequities through the availability of additional fiscal grants for marginalized regions or segments of the population. Fiscal resources would also relate to the entitlement of subnational government to retain a progressive share of collected revenues to finance pro-poor expenditures.
- (ii) *Fiscal responsibility.* This derives from an increased responsibility for revenue collection and delivery of public services.
- (iii) *Fiscal autonomy.* This arises from fiscal decentralization, such that local governments are empowered to promote and respond to local needs/preferences for public spending. Autonomy may also be promoted by legislating entitlement for subnational governments to borrow to finance local revenue shortfalls.
- (iv) *Fiscal accountability.* Once fiscal autonomy has been achieved, an incentive structure that promotes fiscal accountability with regard to revenues and subnational public expenditures should be established. Local government accounts and transactions should be transparent¹⁰ and accountability mechanisms should be built into the system to ensure the holding of decision makers to account by their tax paying constituents.

Table 2 reviews the categorization of fiscal incentives in more detail.

¹⁰ Transparency in government provides an incentive for decision makers to act in a spirit of compliance. The capability of the public to easily examine and review the full performance and financial statements of government entities can lead to confidence and trust in the public sector (McTigue 2008).

Table 2: Typology of Fiscal Incentives

Type of Incentive	Description of Incentive
Fiscal Resources	<p data-bbox="492 348 1365 457">Fiscal transfer system ensures that poorer localities have adequate resources to deliver the desired package of services. The size of the overall fiscal transfer is a significant determinant of the ability of the local government to engage in pro-poor spending (vertical equalization).</p> <p data-bbox="492 491 1377 600">Design intergovernmental transfers to offset fiscal disability of poorer regions to enable them to provide comparable levels of public services and ensure certain key services enforced by central government to affect poverty outcomes in marginalized regions (horizontal equalization).</p> <p data-bbox="492 634 1386 686">Fairness of revenue sharing arrangements between central and local government should promote local discretionary spending on pro-poor services.</p>
Fiscal Responsibility	<p data-bbox="492 749 1409 802">Increase share of budget responsibility for service delivery to lower tiers of government for social sectors (health, education, and social assistance).</p> <p data-bbox="492 835 1333 888">Increase responsibility for revenue collection to fund own local budgets in line with increased responsibility of delivery of public services.</p> <p data-bbox="492 921 1382 1089">(Arguably, a high degree of revenue decentralization [autonomy] may not be associated with improvements in equitable distribution of resources, particularly for rural governments with a limited capacity to raise own revenues as poverty spending may not be a priority if resources are limited.) However, balancing low revenue capacity with performance-based equalization transfers could ensure a poverty-oriented allocation of spending of local resources).</p> <p data-bbox="492 1123 1414 1318">A degree of revenue responsibility can provide local governments with incentives to attract private sector investment (and thus stimulate economic growth) because they will benefit from any revenue increases associated with a growing economy (insofar as economic growth is seen to be pro-poor). Also own revenues tend to be untied (unlike fiscal allocations that are tied to specific budget lines). As such this “discretionary” revenue can be used to respond to specific pro-poor issues that could be rewarded at the local level through such mechanisms as reelection.</p> <p data-bbox="492 1352 1328 1404">Local governments have assigned responsibility to participate in local and national planning and budgeting processes.</p>
Fiscal Autonomy	<p data-bbox="492 1467 1409 1520">Local governments are empowered to promote and respond to local needs/preferences for public spending through fiscal discretion.</p> <p data-bbox="492 1554 1393 1633">Legislation for local government autonomy to borrow (subnational borrowing) to finance local revenue shortfalls should be reviewed and considered based on local government revenue-generating capacity and commitment to finance pro-poor outcomes.</p>

continued.

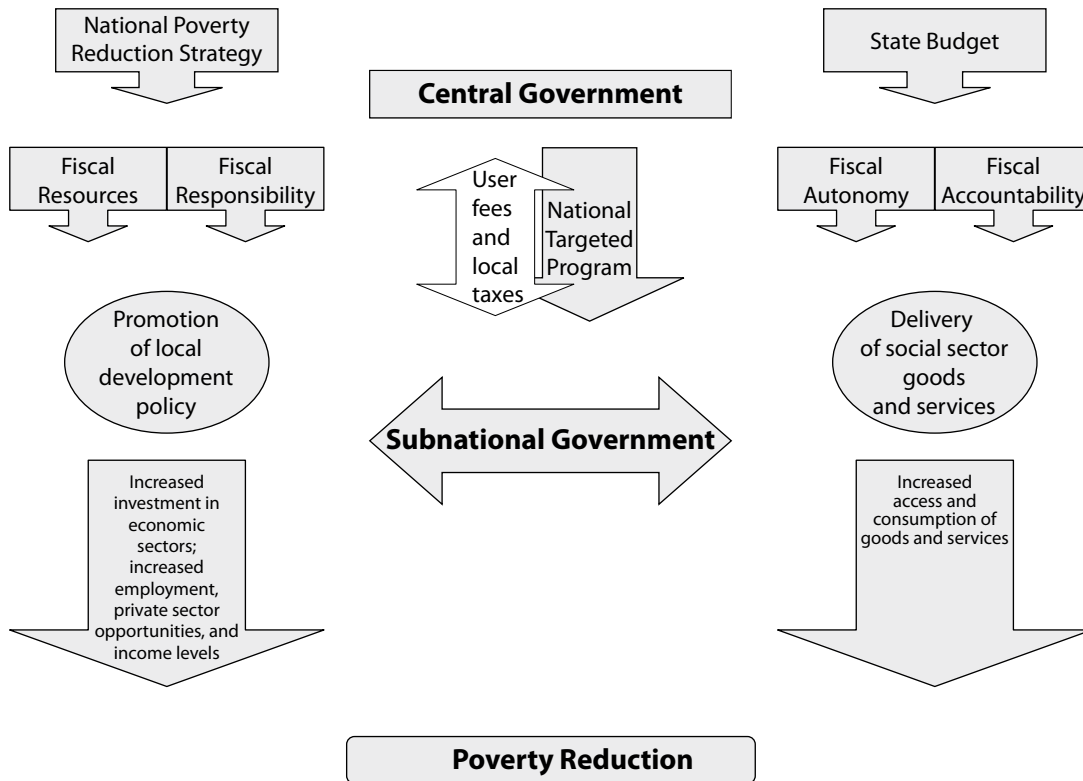
Table 1: *continued.*

Fiscal Accountability	<p>Fiscal transfer schemes should ensure that funds directed for poverty alleviation spending at the local level are de facto spent on poverty reduction and in a pro-poor manner. Central governments may try and regulate the use of local funds through fiscal conditionalities, budget guidelines, or minimum service standards but this could limit local government capacity to address poverty issues. Thus a system of local budget processes and participatory and inclusive planning procedures can help to foster pro-poor local government spending.</p> <p>Design performance measures for fiscal transfers particularly for additional top-up grants allocations for marginalized groups to the extent that local government meets broader policy goals of government.</p> <p>Publish quarterly/annual budget execution reports of local governments and conduct annual audit of local government budget execution reports.</p>
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Source: Author's own with contributions from the UNDP primer on fiscal decentralization and pro-poor.

Figure 1 below sets out a framework for the promotion of pro-poor outcomes under fiscal decentralization, based on the efficacy of fiscal incentives designed within the financial management system. It is assumed that the country has a national strategic poverty reduction strategy in place and that the state budget is broadly representative of this strategy. We consider that there are two main actors in our framework, the central government and the subnational government. As described there can be four types of fiscal incentives promoted by the central government, which should in theory positively affect the behavior of the subnational government through signals that address fiscal resources, fiscal responsibility, fiscal autonomy, and fiscal accountability.¹¹ These incentives when properly employed should lead to the promotion of two spheres of policy action to target the poor by the subnational government. The first is the promotion of local development policy (reforms) in line with the objectives defined in the national poverty strategy, and the second would be increased and improved delivery of social goods and services to the local population. The promotion of local development policies should increase investment in the economic sectors, and create new employment and private sector opportunities for the local population thus increasing income levels of the poor. The increased levels and improved quality of social sector goods and services improves access rates and local consumption levels of social goods affecting a country's levels of human capital and quality of life. In theory, the combined effect of these two policy actions in turn reduces local income and nonincome poverty rates.

¹¹ Fiscal incentives for the subnational government can also promote their own secondary incentives for central governments. That, is the amount of fiscal resources leveraged by a country could actually increase under fiscal decentralization if tax collection rates are improved. On one hand fiscal incentives should promote an improvement in subnational revenue mobilization efforts in the area of local taxes and local user fees. On the other hand, the size of the national tax base could be enlarged as a result of fiscal decentralization, through the promotion of local development policies for local private sector development.

Figure 1: Framework for Incentives for Pro-Poor Outcomes under Fiscal Decentralization

Source: Author's own.

IV. Case Study: Poverty Reduction and Public Expenditure in Viet Nam

A. Overview of Viet Nam's Poverty Reduction Story

Viet Nam has experienced notable success in achieving rapid and sustained economic growth and poverty reduction since the early 1990s. Two decades of *Doi Moi* (renovation) have promoted a transformation of the Viet Nam economy from a primarily agrarian, centrally planned state economy to a market- and export-oriented emerging market with an increasingly strong base in the secondary and tertiary sectors. Real gross domestic product (GDP) growth averaged 7.6% per annum between 1991 and 2007 and grew at 6.2% in 2008. At this rate the size of the economy will almost double each decade. The key to Viet Nam's development has been its success as an exporter of (i) primary goods such as rice, coffee, fish, pepper and rubber; (ii) light manufactures such as garments, shoes, and furniture, which accelerated after 2000; and (iii) petroleum-based products. Most of Viet Nam's non-oil exports are produced by small private firms and by foreign

and joint owned companies. Two decades of rapid growth have resulted in overall poverty rates declining to an estimated 14.8% in 2007 compared to 28.9% in 2002, and 58.1% in 1993.¹²

Viet Nam's last household survey was conducted in 2006. The data confirms continued poverty reduction in Viet Nam. However, progress has been uneven. Poverty remains much higher and increasingly concentrated in the ethnic minority communities. The majority of the poor are based in rural areas, though rural poverty is also declining. From Table 3, it can be seen that regional differences remain wide. Mountainous areas are much poorer than the lowlands and the Southeast region. The poorest region in the country, the Northwest, has reduced poverty by 19 percentage points between 2002 and 2006, and the Central Highlands region by 23%. On the other hand, the least poor regions, the Red River Delta and the Southeast, are observing stagnating declines in their poverty rates. The combination of rapid rates of falling poverty in poorer areas of the country and slower declines in the richer areas has contributed to reduce poverty and income inequality between the rich and poor areas. There is some evidence of convergence whereby poverty has fallen more rapidly in areas where poverty incidence was initially the highest. The picture is similar when provincial poverty rates instead of regional poverty rates are considered.

Table 3: Poverty Rates by Selected Classification

	1993	1998	2002	2004	2006
Poverty Rate (Viet Nam)	58.1	37.4	28.9	19.5	16
Urban	25.1	9.2	6.6	3.6	3.9
Rural	66.4	45.5	35.6	25.0	20.4
Kinh and Chinese	53.9	31.1	23.1	13.5	10.3
Ethnic Minorities	86.4	75.2	69.3	60.7	52.4
Northern Mountains	81.5	64.2	43.9	35.4	30.2
Northeast	n.a	n.a	38.4	29.4	25.0
Northwest	n.a	n.a	68.0	58.6	49.0
Red River Delta	62.7	29.3	22.4	12.1	8.8
North Central Coast	74.5	48.1	43.9	31.9	29.1
South Central Coast	47.2	34.5	25.2	19.0	12.6
Central Highlands	70.0	52.4	51.8	33.1	28.6
Southeast	37.0	12.2	10.6	5.4	5.8
Mekong Delta	47.1	36.9	23.4	15.9	10.3

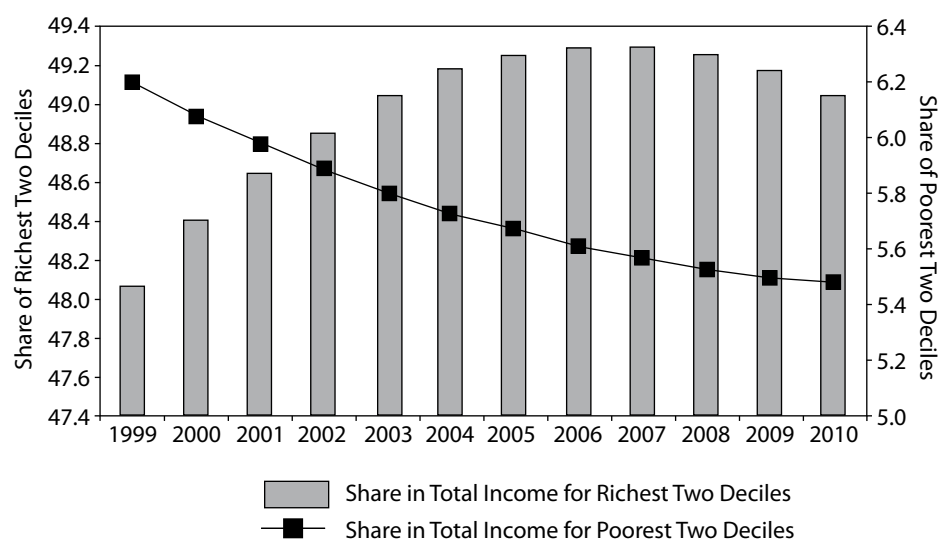
Source: Government Statistics Office data.

¹² Within a Southeast Asian context, Viet Nam remains a poor country in comparison to majority of its Asian neighbors. Recent ADB estimates put the average Vietnamese citizen's purchasing power parity income per capita at two thirds that of the average Indonesian, and one third that of the average Thai.

Viet Nam's track record in the area of poverty reduction is notable. However, recent evidence suggests that eliminating poverty rates for the remaining 13.5 million Vietnamese living below the poverty line—6 million of which are food-poor (Vietnam Development Report 2008)—will be a significant challenge for government in the years to come. Indeed, there is now a growing concern among observers that urban poverty rates have actually stagnated and may be on the increase for the first time in decades. At the same time, data analysis suggests that although the distribution of Viet Nam's income over this growth period had remained relatively stable, it increased fairly sharply in 2005/2006 (the Gini index for per capita expenditures has shown an increase of 0.345 in 1990 to 0.37 in 2004 and 0.432 in 2006). Other measures of income inequality paint an even more disconcerting picture; the absolute income/expenditure gap between the richest and the poorest, as proxied by the gap between top and bottom expenditure quintiles (or deciles), has actually grown considerably between 1993 and 2006 (VASS 2007, 14).¹³ A key reason that income gaps may be widening relates to the country's ongoing structural transformation from an agricultural economy to a manufacturing- and services-based one. Contribution to GDP from the agricultural sector fell from 25.7% in 1997 to 20.3% by 2006. The share of manufacturing to GDP meanwhile rose from 16.5% to 20.9% over the same period. Figure 2 below presents a breakdown of Viet Nam's income distribution by contrasting the share in total income for the richest two deciles and the poorest two decades for the period 1999–2010.

¹³ The gap in income is widening between the richest and poorest deciles of total income in Viet Nam. The poorest two deciles of households accounted for 8.0% of total income in 1990. Their share fell to 5.6% in 2006. The richest two deciles accounted for 42.7% of total income in 1990, increasing to 49.3% in 2006. Income variation is also large across regions. Data from national statistics show that between 1999 and 2004 the average monthly income per capita rose by VND 45,500 in the Central Highlands, while it rose by VND 305,200 in the Southeast region.

Figure 2: Share in Total Income of Richest and Poorest Deciles, 1999–2010 (percent)



Note: Figures for 2007 onward are projections. Income deciles divide the total income data into 10 equal subsets each accounting for households with the lowest 10% to the highest 10% of total income.

Source: Euro Monitors International from national statistics/United Nations.

B. Poverty Reduction Strategy and Public Expenditure

Viet Nam's success in poverty alleviation was the result of the successful pursuit of high growth rates in the context of an economic and social structure that was conducive to spreading the benefits of growth in the 1990s. Poverty reduction achievement during that decade cannot be said to be the result of focused efforts to reduce poverty during this period, "but rather significant poverty reduction achieved during the 1990's happened in spite of an explicit poverty alleviation strategy or program" (Van Arkadie and Mallon 2003, 224–5). This experience is in contrast to developments since 2002, when the government unrolled an explicit poverty strategy, the Comprehensive Poverty Reduction and Growth Strategy (CPRGS), which today influences the allocation of substantial national and donor funds for poverty alleviation purposes in Viet Nam.

Since 2002 Viet Nam's poverty strategy has been to continue to rely on economic growth to improve the living standards of the population, but with more focused interventions on increasing expenditures on health and education and on land redistribution programs to lift the population out of poverty. On the positive side, the Viet Nam government recognizes that poverty alleviation results from a combination of high levels of economic growth, policy actions to redistribute consumption entitlements from the rich to the poor, and delivery of targeted programs that increase social sector allocations to the

population. On the down side, poverty and development policies and targets are based on territorial patterns of development, separating somewhat artificially the poor from the nonpoor through geographically based patterns of income and nonincome poverty. The Viet Nam government uses concepts of “poor areas and poor communes” to identify the places where the percentage of poor households is much higher and living standards are much lower than the national average level, areas typically characterized by unfavorable natural conditions (poor land, frequent natural disasters) and underdeveloped infrastructure). The government then seeks to support the countries most vulnerable by introducing both small- and large-scale targeted poverty alleviation programs to help the neediest households cope with the costs of social services and to increase their access to credit, and other schemes to increase employment opportunities. The targets are then aggregated for distribution based on provincial/regional lines. That is, transfers are targeted to provinces or regions and not to poor households specifically. A poor household in a wealthier province will find access to these types of pro-poor funds less accessible than would poor households in poor provinces.

In terms of the quality and usability of the instrument itself, the CPRGS was considered innovative, in that it changed the *modus operandi* of the government approach to policy planning and budgeting for development outcomes. The new outcome-oriented nature of the CPRGS also required deeper analysis of the impact of government policies, which resulted in greater use of empirical evidence for policy making and increased consultation with key stakeholders. In a break with past practice, consultations with poor communities and local officials in six sites around Viet Nam were held while the document was being drafted. On the down side, the different approach of the CPRGS meant that it was not well mainstreamed with the government’s other main policy tool, the Socio-Economic Development Plan (SEDP) 2001–5 (World Bank 2009).

By 2004, the government had acknowledged that policy integration of the CPRGS and the SEDP was an area of weakness, as was institutional recognition of the document outside of Hanoi. Actions were initiated to mainstream the CPRGS with other policy tools and to roll out the CPRGS to the provincial level. This resolution again resulted in policy innovation—guidelines for realizing the mandate were issued by the Ministry of Planning and Investment in 2004. Since then over two dozen provincial governments have experimented with the preparation of strategic plans. Interestingly, each local government chose its own approach to bring together the various departments involved and to come up with a renovated provincial strategic plan (World Bank 2009). The experience was quite diverse across the different provinces in terms of policy quality and instrument usability. Even so the benefits from learning by doing at the provincial level were considerable.

In the end the government decided that it was better to create one single strategy to support government objectives than to try to streamline a second CPRGS with the SEDP. Thus after 2005, the government opted not to roll out a second generation poverty

strategy. The government adopted the SEDP 2006–10 as the main policy tool to address pro-poor growth, employment generation, and poverty reduction in 2006. The SEDP 2006–10 was notably prepared in a fairly open and participatory manner, also involving fairly extensive consultations with civil society, business, and development agencies. This experience shows continuity by the government in its approach to policy development, especially where issues of income and social security are concerned. In line with the first CPRGS, the SEDP is oriented toward attaining development outcomes (including poverty reduction) and less toward achieving production targets. The SEDP goal is to reduce poverty further from 18% in 2005 to 10–11% by 2010.

The development of the CPRGS in terms of the process of formulating, implementing, and monitoring implementation of poverty reduction objectives led to permanent changes in the government's approach to socioeconomic planning. The result is now a policy instrument that is better linked to budgets and that is more poverty-focused and results-oriented than the previous SEDPs/CPRGS. The most recent SEDP goes beyond the standard mainstreamed approach to poverty reduction, moving away from targeted assistance to tackle budget allocation norms and sectoral policy priorities within levels of government.

Notwithstanding this achievement, the government's approach to the CPRGS/SEDP has not been without its critics. First, there are concerns over the allocational efficiency of the state budget. On one hand the government still expends significant resources on the traditional state-owned sector, which has not been successful in creating new labor-generating opportunities for the population as the country shifts its population and resources from the traditional to the modern sectors. The contribution of the state sector to poverty reduction, despite receiving the lion's share of investment for decades is thus seen to be minimal, and this remains an area of inconsistency with social and poverty considerations established in the CPRGS and the SEDP 2006–10. By contrast, the government has tread relatively slowly to date in increasing physical allocations for its targeted social protection programs; in 2008 they still represented a small fraction of central budget outlays (less than 1% of the budget). Given the breadth of the problem, it is unlikely that this level of resources can totally offset nonincome poverty levels.¹⁴ Secondly, concerns have been expressed as regards the government's tendency to focus its poverty alleviation efforts on poverty in regions that are backward and therefore easier to identify, since this may actually be contributing to the recent rise in urban poverty. The focus on poorer regions has led to an overly homogenous policy to tackle development of the country's poor as a whole, given the fact that roughly one third of Viet Nam's poor are actually located in the wealthier areas of the country, namely in the Red River and Mekong Delta regions. The extent to which the poor in these regions are being left out of the development process because of their proximity to richer localities is a serious

¹⁴ This view does not take into account that funding from development partners for poverty alleviation programs are similarly allocated to the three regions that have the highest poverty incidence, namely, the Northern and Central Uplands, which have a concentration of ethnic minorities; and the North Central Coast, which suffers from a poor agricultural environment. The actual level of financing for these initiatives is much higher.

issue for Viet Nam's policy makers. Tackling poverty in these areas requires a different approach to those who are poor because they reside in poor areas. Failure of households to benefit from growth in high-growth areas may be an even more difficult task for the government in the coming years (Vietnam Development Report 2008).

C. Central Government Financing of Poverty

Total government expenditures in Viet Nam is not large by international comparison; it accounted for 28.8% of GDP in 2008 for on-budget revenues and 31.7% if off-budget expenditures and on-lending for nonsovereign borrowing is included (see Table 4 below). The share of public expenditures did increase over the 1990s but since 2003 has remained relatively unchanged.¹⁵ Like most developing countries, Viet Nam has a limited resource base, and in order to meet the country's growth and poverty objectives, the government is determined that the efficiency of the public system for both revenue management and public expenditures be improved. In particular, Viet Nam has a large and increasing need for investment in infrastructure, education, health, and other areas of public investment. In spite of pressing fiscal needs and a relatively large fiscal deficit (estimated to rise between 8% to 10% in 2009), the government's policy has been to improve tax administration collection, but not to increase overall tax rates on export goods (the main source of government income) with Viet Nam's accession into the World Trade Organization.

Table 4: Central Government Finances as a Percentage Share of GDP, 2003–2008

	2003 Actual	2004 Actual	2005 Actual	2006 Actual	2007 Actual	2008 Estimate
Total revenue and grants	25.77	27.77	28.44	29.68	27.61	26.98
Current revenue	23.77	25.19	26.15	27.08	24.70	25.08
Tax revenue	20.86	21.75	22.85	24.26	23.24	23.94
Nontax revenue	2.91	3.44	3.30	2.83	1.46	1.15
Grants	0.48	0.40	0.45	0.81	0.37	0.34
Total on-budget expenditure	26.43	26.19	27.30	27.55	29.84	28.76
Off-budget expenditure and on-lending	4.37	2.91	4.78	3.35	3.22	2.94
Current expenditure	16.71	16.95	17.86	18.48	20.04	20.79
Capital expenditure	9.72	9.24	9.44	9.07	9.80	7.97
Overall fiscal balance	-5.04	-1.34	-3.64	-1.22	-5.45	-4.72

Source: Based on Viet Nam Ministry of Finance estimates.

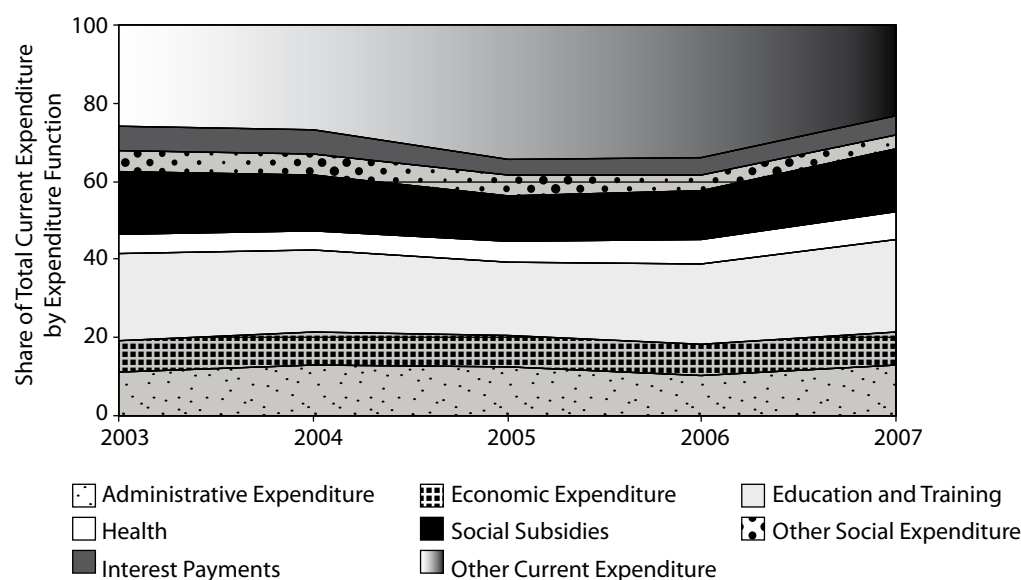
D. Sectoral Budget Allocations

Since Viet Nam published its first poverty reduction strategy in 2002, social sector expenditures have increased in line with policy objectives expressed in the CPRGS /SEDP. The overall level of social sector expenditures is broadly in line with that of

¹⁵ Although off-budget expenditures have decreased since 2003, on-budget expenditure has been increasing, leaving the average total public expenditure figures unchanged as a share of GDP between 2003 and 2008.

other developing/transitional countries. Overall current budget social sector expenditures increased from 8.2% to 10.1% of GDP over the period. Education and social sector expenditures increased by 3.7–4.7% and by 3.6–4% GDP respectively, while health sector expenditures increased by 0.9–1.4% over the period (see Figure 3 below expressed as share of the total current budget).

Figure 3: Distribution of Current Expenditure by Sector, 2003–2007



Source: Ministry of Finance.

The next section assesses whether or not Viet Nam's government expenditure has been redistributed and allocated more equitably between levels of government and in territorial terms (the geographical pattern of expenditure has been directed to redress historical disparities in access to public services and infrastructure) in support of pro-poor outcomes.

V. Case Study: Fiscal Decentralization and Pro-Poor Outcomes in Viet Nam

A. Overview of Fiscal Decentralization in Viet Nam

Irrespective of the policy at hand, in a country as decentralized as Viet Nam, the amount of budgetary resources available to a province has a decisive influence on its capacity

to deliver social services, implement social and development policies, and finance infrastructure development (Vietnam Development Report 2008, iii).

Decentralization has been ongoing in Viet Nam since the *Doi Moi* policy implementation of 1986.¹⁶ In fiscal policy, the first attempt to decentralize was Resolution 186 by the Council of Ministers, effective 1990, which stipulated two budget layers of central and provincial governments. The first budget law was introduced in 1996, amended in 1998, and resulted in some major steps in furthering fiscal decentralization. However, it was the latest and active version of the State Budget Law passed in 2002 that came into effect from 2004, which resulted in a shift from line budgeting distribution to allocative redistribution at the provincial level. Since 2004, the mechanisms used to allocate budget resources to lower levels of government have substantially changed the nature of the budget system. In addition to the law on state budget, ongoing reform efforts in public administration have also had a positive effect on fiscal management.

The government of Viet Nam is a unitary system with four layers: central, provincial, district, and communal governments. The subnational public administration operates in a system of dual subordination. The local executive government, known as People's Committees, at all subnational levels are accountable to the respective legislative body, known as People's Council, at the same level and the upper level of government. The People's Council consisting of elected members from the local jurisdiction is accountable to the upper level legislative body.

B. Fiscal Resources and Fiscal Transfers

This section assesses in more detail Viet Nam's experience of fiscal decentralization as it relates to redistribution, allocation of budgetary resources, and fiscal transfers for pro-poor outcomes. Once an appropriate understanding of these three issues is established, an application of this analysis is applied to the four areas of fiscal incentives for the promotion of pro-poor outcomes in the concluding section of the paper.

Redistribution of the public purse takes place on the one hand through decentralized expenditure. The State Budget Law passed in 2002 and implemented in 2004 has resulted in a profound transformation of Viet Nam's national system of budget distribution. Provincial minimum expenditure needs are now calculated on the basis of the expenditure norms determined by the national government (Martinez-Vazquez 2005). The difference between expected revenue and minimum expenditure needs for each subnational region determines the retention share rates for total state revenues. If the expected revenue (revenue from both own sourced and shared taxes) is less than the minimum expenditure needs, the region is allowed to keep all proceeds from shared taxes for its local budget. For richer provinces, if expected revenue is greater than minimum expenditure needs, revenue from shared taxes must be transferred to the national budget at a rate determined by the central government.

¹⁶ See Vo (2005) for an in-depth analysis of fiscal changes and economic growth in Viet Nam since 1976.

1. Budgetary Allocations and Fiscal Transfers

The government has established a new set of budget allocation norms to transfer resources from richer to poorer provinces. Today almost half of budgetary expenditures are decided at the provincial level and below. In some of the smaller provinces, budgetary resources may be equivalent to 50% or more of provincial GDP in equalization grants. Such availability of resources bears the potential to lift people out of poverty and to reduce their vulnerability. The main challenge is however, to use these monies effectively. Importantly, transparent formulas have been introduced to allocate budget resources to the provinces. In an effort to increase fiscal transparency, transfers are now based on numerical formulas involving a series of measurable indicators at the province level. Initially, allocation norms were applied to recurrent expenditures only, with the introduction of 11 formulas by policy areas. Since 2007 the same principle has been adopted for capital expenditures. Formulas for budget transfers are developed based on indicators such as provincial population and level of development, and also take into account geographic conditions and the organization of government administration (Vietnam Development Report 2008). Positively, the new budget allocation mechanism aims to increase the coherence between recurrent and investment expenditures as well.

As discussed, Viet Nam is quite fiscally decentralized at least to the provincial level. The Appendix shows the breakdown of expenditure responsibilities by level of government (central, provincial, district, and commune levels). It is the case that the current arrangement has fundamentally devolved the responsibility for service delivery to the provincial level from the central level; however, it essentially leaves the organization of expenditures at the subnational level up to the provincial government. This provides a large amount of discretion to the provincial government to adapt to their specific conditions (Martinez-Vasquez 2005), but less so for subprovincial level governments. The exception as mandated by Article 34 in the new budget law requires that townships and cities under a province must be assigned responsibility for the construction of public schools, lighting, water supply and sewerage, urban traffic, and other public infrastructure. In this sense fiscal decentralization has changed the expenditure assignment relationship between the central government and the provincial government; however, the effect at the district and commune level has been much less pronounced.

2. Are Budget Allocation and Fiscal Transfers Pro-Poor?

The formula for budget allocation still use population as one of the main determinants of budget allocations; however, they are now moderated based on the level of development of the province, the difficulty of its terrain, its administrative organization, or the presence of a regional development pole (see Table 5 below). Other redistribution mechanisms have also been designed for budgetary outlays. There are targeted programs for the exemption of education fees for poor households, distribution of health insurance cards for disadvantaged people, or support to communes facing extreme difficulties. Each

program has its own formula mapping resources to locations with an increasing trend toward transparency (Vietnam Development Report 2008, 65).

Table 5: Budget Allocation Norms for Provinces, 2007–2010

Category	Criterion	Recurrent Expenditures	Capital Expenditures	
			Equalization Transfers	Targeted Transfers
Population	1) Total	+	+	+
	2) School-age children	+		
	3) Ethnic minorities		+	+
	4) School-age children in P135 communes	+		
Development	5) Poverty rate	+	+	+
	6) Local revenue		+	
	7) Revenue transferred to state budget	+	+	
	8) Industrial output	+	+	
Geography	9) Total surface		+	+
	10) Disadvantaged location	+	+	
	11) Growth pole			+
Administration		+	+	
	12) Administrative units at district level		+	+
	13) Districts in disadvantaged locations		+	
	14) Civil servants	+		

Note: This table is based on Decision 151/2006/QĐ-TTg for the allocation of recurrent expenditures in 2007 and Decision 210/2006/QĐ-TTg for the allocation of capital expenditures in 2007–2010. The former does not include National Target Programs, Health Care Fund for the Poor, and Program 135.

Source: Vietnam Development Report (2008).

According to the Vietnam Development Report (2008), budget allocation norms combined with the authority of People's Councils to decide how to appropriate the resources allocated to them could be a powerful tool for social inclusion. Unlike targeted programs, these norms transfer to local levels of government not only the funding but also the responsibility for its use, provided that the norms actually redistribute resources from richer to poorer provinces. As the formulas for distribution refer to the provincial poverty rate, the formula underlying the norms should be pro-poor. For instance transfers for investment purposes are increased by 50,000 Vietnamese Dong (VND), or about US\$3, for each ethnic minority person living in a province. Similarly the allocation of recurrent health expenditures per capita is 72% higher in the uplands and in low areas of the population by ethnic minorities than in urban areas (Vietnam Development Report 2008).

Notwithstanding the progressive nature of Viet Nam's approach, the Vietnam Development Report has also pointed out some weaknesses in the system. First, not all the criteria considered in budget allocation formulas are progressive. Second, the pro-poor nature of budget allocations from the center to the provinces is only now starting to be replicated for transfers from provinces to districts and below. Third, progress has been

somewhat slow in implementing the new system, particularly in poorer regions, and has resulted in gaps between demand and supply for local funding. Fourth, grassroots level participation is still needed to improve local participation in the budget process. Fifth, the sheer number of provinces (64) and the relatively small size of most provinces raise important coordination problems in relation to public investments. Finally, although the budget law indicates responsibilities for expenditure between national and subnational governments, the regulations managing these expenditures are not always clear and overlaps in goods and services provision by different levels of government is not uncommon (Vietnam Development Report 2008, 63).

The government focuses on two different types of equalization policies. The first is to affect vertical equalization, being the correction of disparities between the cost of services devolved to local government and the potential yield of its direct revenue. The second is to affect horizontal equalization, being the correction of disparities between the per capita revenue bases and spending needs of individual local governments. Like most countries, Viet Nam suffers from both types of fiscal imbalances. In order to address these deficiencies the government provides two types of fiscal transfers:

- (i) *Balancing transfer*. This includes capital as well as recurrent expenditures, however there is no poverty mandate.
- (ii) *Conditional grants*. These are from National Programs, are focused, and small-scale. Norms are differentiated in favor of disadvantaged and remote provinces.

In Viet Nam, the size of the actual fiscal transfer is large in relative terms between the poorest and richest provinces. The poorest provinces, for example in the Highlands, receive much higher levels of equalization grants from the central government than do richer provinces in the Red River Delta and the Southeast. Subnational budgetary accounts are not wholly reliable in Viet Nam; however, even employing a cautious approach, the fact that equalization grants exceed 50% of provincial GDP in some poorer provinces is illustrative of the magnitude of the intervention.

Balancing transfers from the central to provincial government is based on both a formula and on negotiations between the central and provincial government. As noted, a distinction is now made between funds for recurrent and capital expenditures. Transfer arrangements are decided for a stability period of 3–4 years. Conditional grants under “National Programs” are actually passed down through the subnational government to targeted recipients. District governments are now starting to emulate the national formulas for their budget transfers to districts and communes. As of August 2007, 21 provinces had approved budget allocation norms similar to those used by central government. Encouragingly, more than 30 others have submitted proposals in this direction to their respective People’s Councils (Vietnam Development Report 2008, 70). Prohibition of passing down service responsibilities without resources transfer should in theory prevent

fiscally irresponsible instructions of delegation, through this is not necessarily the case on the ground in some provinces.

Viet Nam also has a range of targeted programs whose objective is to alleviate/target poverty either directly or indirectly. The list is not exhaustive, but the main targeted programs consist of cash transfers to vulnerable groups, while others support households through access to credit or through subsidies to participate in mainstream social programs. Still others are focused on helping disadvantaged communes, financing local infrastructure development, and initiatives to improve livelihoods.

3. Data Analysis

In order to assess in more detail whether fiscal decentralization (aggregate and transfers) have indeed been pro-poor in nature, a correlation analysis is undertaken. Owing to data limitations, the period covered is 2002–2006 and therefore does not take account of recent changes to link the capital budget to nonpopulation parameters such as poverty levels. The years 2002 to 2006 are the years for which the final accounts were published by the Ministry of Finance at the provincial level. Provincial poverty headcount ratios are only available for the years 2002 and 2004. 2006 provincial poverty headcount ratios were therefore estimated using the percentage change between 2002 and 2004 to forecast the poverty headcount for 2006. It is assumed that the percentage change is constant for the period 2002–2004 and also 2004–2006. The year 2002 represents the base point for the analysis since it was the first year of implementation of the CPRGS. However, in 2002, the government was still using the old budget allocation system. For this data year, resources are still channeled to the provinces on the basis of allocations by line ministries, and for investment projects approved by the Ministry of Planning and Investment. 2004 is then the first year that the new budget law was put into effect and although still relying on targeted programs, they were mainly based on quantitative formulas for recurrent expenditures. Finally the year 2006 is also the first year of implementation of the new SEDP 2006–2010. The time period for analysis is not extensive; however, the period of analysis captures important changes in public policy and budgetary allocations within a system of fiscal decentralization.

The poverty headcount value is used since it is the most simple and available method of assessing provincial poverty rates in Viet Nam. The poor are those whose incomes fall below a stipulated poverty line. In Viet Nam this is calculated by adding the nonfood component to the food poverty line (minimum food required to generate 2100 calories a day). The poverty line was equivalent to roughly 260,000 Vietnamese Dong for urban dwellers, and 200,000 Vietnamese Dong for rural dwellers in 2006. Per capita provincial expenditure is calculated by dividing provincial expenditure by the provincial population. Net provincial fiscal transfers are calculated by dividing total provincial transfers by provincial population. Per capita fiscal revenues are captured by dividing total provincial revenues collected by provincial population.

Table 6: Correlation Matrix

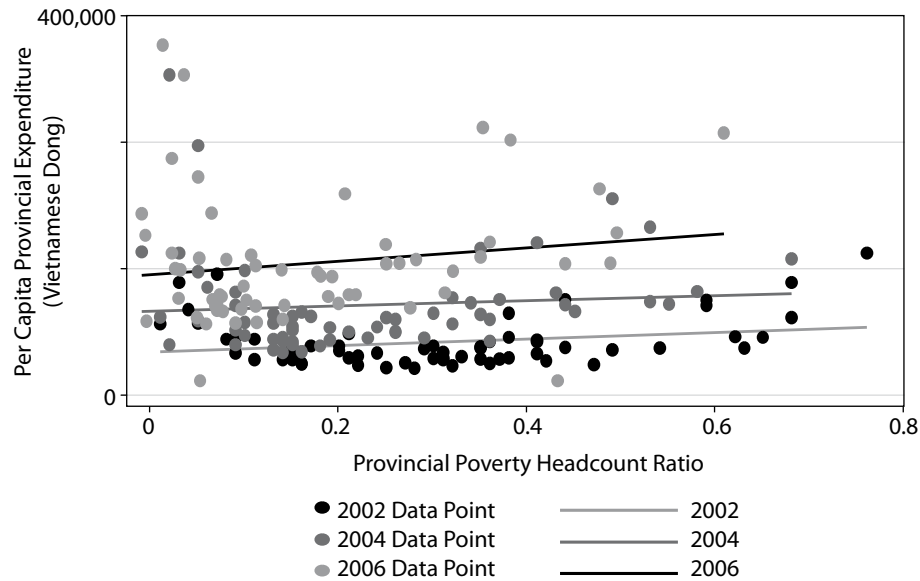
	Per Capita Provincial Expenditure	Poverty Headcount	Per Capita Revenue	Per Capita Fiscal Transfers
Per capita provincial expenditure	1			
Poverty headcount	–0.0778	1		
P-value	0.2964			
Per capita revenue	0.3953	–0.3533	1	
P-value	0	0		
Per capita fiscal transfers	0.5014	0.5169	–0.2279	1
P-value	0	0.00000	0.0015	

Source: Vietnam Household Living Standards Survey (Ministry of Finance, various years).

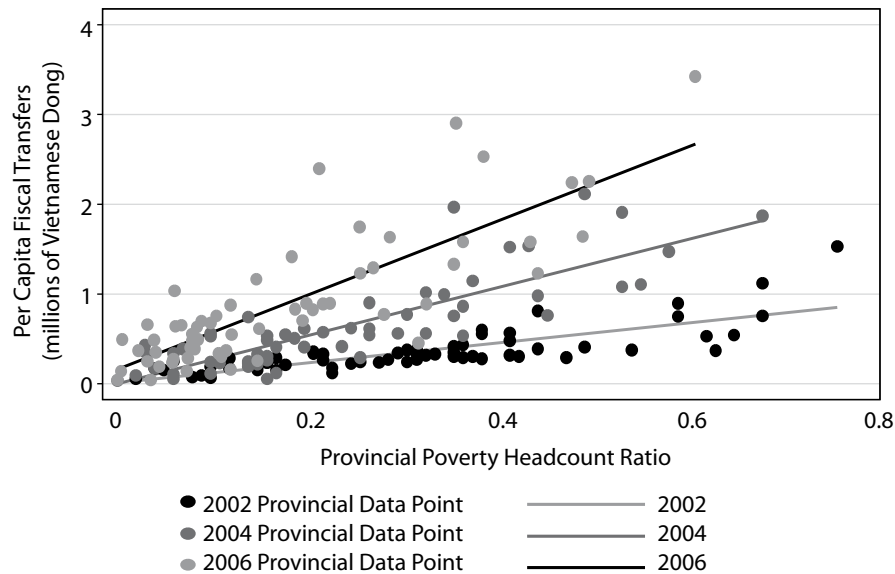
On the expenditure side, it can be seen that overall, the correlation between decentralized public expenditures¹⁷ represented by per capita provincial expenditure has increased in value across all provinces—a level effect—but pro-poorness of aggregate provincial expenditures has not increased over the period. Put another way, provincial expenditure per capita has not changed proportionally in favor of poorer provinces over time (see Table 6 for statistical reference). This is captured by the lack of statistical significance between per capita public expenditure and poverty headcount, i.e., the slope effect. This pattern is also easily observable in the graph represented in Figure 4 below. The graph maps per capita provincial expenditure on the y-axis and poverty headcount ratios on the x-axis for the years 2002, 2004, and 2006.

Turning to fiscal transfers, the results differ from the aggregate pattern of provincial expenditures. The relationship between per capita fiscal transfers and provincial poverty rates is graphed in Figure 5. In this relationship there has been both a level effect and a deepening of the relationship between fiscal transfers and pro-poor outcomes (slope effect). Note how the trend line both rises and shifts up as the time horizon shifts in Figure 5. This is also confirmed by the correlation analysis in Table 6, which shows that the relationship has become significantly stronger over time, for both the level and deepness, in favor of pro-poor outcomes (the relationship between per capita fiscal transfers and provincial poverty headcount ratios is significantly different than zero, and there is an expected positive sign for the relationship). Poorer provinces are receiving larger fiscal transfers from the government in 2006 than they were in 2002.

¹⁷ The adequacy of fiscal transfers to fund pro-poor expenditures in Viet Nam at the provincial and subprovincial level is subject to an aggregate level budget constraint. Public transfers cannot exceed the level of taxes and grants collected plus some sustainable level of public borrowing. At the same time even with an identified budget constraint, the Vietnamese government has not identified a formal measure at which to expend pro-poor expenditures versus regular expenditures for the nonpoor. To do so now would be beyond the scope of analysis in this paper.

Figure 4: Provincial Expenditure and Poverty Headcount: 2002, 2004, and 2006

Source: Vietnam Household Living Standards Survey (Ministry of Finance, various years).

Figure 5: Fiscal Transfers and Poverty Headcount: 2002, 2004, and 2006

Source: Vietnam Household Living Standards Survey (Ministry of Finance, various years).

A comparison of Figure 4 and Figure 5 is therefore telling. As discussed, budget allocation norms do in principle favor poorer provinces. However, this has resulted in a level effect change only over the period for the aggregate data. Put another way, overall

levels of aggregate expenditure have increased to all provinces over time but they have not become more pro-poor over the period of analysis. Fiscal transfers however, have become both larger and more pro-poor. Though the time period is not long enough to make definitive conclusions, it is possible to infer that fiscal decentralization has not been inherently pro-poor in Viet Nam from the expenditure perspective. However, decentralization has been responsive to pro-poor outcomes, by making use of fiscal transfers to compensate and target development outcomes in poorer provinces over time. From the previous section's discussion of Viet Nam's poverty strategy and budgetary allocations, the results fit the Vietnamese model. That is, the government has sought to tackle provincial/regional variation in poverty rates by increasing central government transfers to poorer provinces, and these transfers represent a higher share of aggregate provincial expenditures than in richer provinces.

What is not captured by these figures is the increased participation in the planning and budget process, which include qualified efforts established in recent years by the central government to increase the role of civil society, private sector, and local government in both the preparation of national development strategies and provincial strategic plans and budgets. Participation in planning for public expenditures, including targeting poverty outcomes with fiscal resources, is a clear incentive or signal to subnational governments to focus efforts and outputs on Viet Nam's development targets. However, as discussed in previous sections, local government responsibility in planning for poverty outcomes has to be directly linked to local government autonomy to finance these policy objectives. If allocations and transfer targets are still going to be decided at the central level (with limited local participation) then a disconnect between local policy planning and actual budget allocations at the local level will result.

4. Revenue Sharing Arrangements, Revenue Autonomy, and Pro-poor Outcomes

Redistribution of resources also takes place through taxation in Viet Nam.¹⁸ The country's sources of provincial revenues include: (i) local taxes, (ii) fees, and (iii) transfers and grants from central government. The provincial share of total government revenue was under 30% in 2008. The distribution of revenue sources according to level of government is outlined in Box 1. The national government sets all tax bases and rates. Expected revenues for subnational governments are determined by the subnational tax administration on the basis of actual revenue for the previous year, taking into account

¹⁸ Overall, household taxes are progressive in Viet Nam, but this is not true of user fees. Taxes paid by enterprises are seen to be large-enterprise-friendly, that is smaller firms are taxed more heavily in relative terms, which provides incentives for tax evasion by remaining informal businesses and which impedes growth and employment creation opportunities in small and medium enterprises. Compliance costs are also seen to be quite high. Currently attempts are being made to redistribute resources through Personal Income Tax but some critics of Viet Nam's approach suggest that this scheme runs the risk of penalizing the formalization of private sector activities with a high opportunity cost, since actual revenue mobilization potential is limited. Rather taxes on valuable land in urban areas would produce a much higher potential to redress inequality and raise resources for local infrastructure development, without distorting incentives. However, such a scheme would require administrative reforms for both land and tax management.

tax policies in the year and expected annual growth rate. Sharing of tax revenue between the central and provincial government is stipulated in the State Budget Law. Taxes are divided into three categories: (i) 100% retained by provincial government, (ii) a certain ratio shared between the two levels, and (iii) 100% retained by the central government.

Box 1: Revenue Sharing Arrangements between Central, Provincial, and Local Government

Central government: Tax revenues (of which 100% is assigned to the central government) include export tax and import duty, value added tax (VAT), and excise tax on imported goods; corporate income tax on corporations implementing a uniform accounting system; tax and other revenue from crude oil; proceeds collected from government lending; capital contributions, etc.

Shared taxes between the central and provincial government: Includes all VAT except that on imported goods; corporate income tax except that on imported goods; income tax on high income earners; profit remittance tax (which was abolished in January 2004); excise tax on domestic goods and services; and petroleum fees. Two revenue sources, including the excise tax on domestic goods and services and petroleum fees were added to the list of sharable taxes under the 2002 State Budget Law. The shared tax rates are uniform for all shared taxes for each province and can differ by province. These rates are calculated as part of the budgetary process at the start of each stability period of at least three years (Martinez-Vazquez 2005).

Local government tax revenues: These are 100% assigned to the local government level and include housing and land tax; natural resources tax (except that on crude oil); license tax; land transfer tax; agricultural land use tax; land use fees; rental of land; proceeds from the sale and lease of state-owned houses and buildings; and registration fees; proceeds from lottery activity; and other fees and charges.

Bonus mechanism: This scheme for revenue collection by the regional taxation office is also prepared based on excess revenue collection. The 2002 State Budget Law specified that should the actual revenue collection of shared tax exceed the targeted plan, the government could allocate up to 30% of the excess revenue to the provincial budget to invest in infrastructure development and other expenditure responsibilities. However, this amount must not exceed the difference between the actual and planned budget collections of the previous years.

Source: Ministry of Finance.

According to the conceptual framework, the fairness of revenue sharing arrangements between central and local government could promote local discretionary spending on pro-poor services. In Viet Nam, sharing ratios are different for different provinces, but apply consistently across all sectors. Ratios are determined by the National Assembly and apply for stability periods of 3–4 years. In spite of capacity to collect local revenues and the high level of shared revenues, most provinces have fiscal imbalances, and fiscal transfers remain a significant source of subnational spending.¹⁹ In Viet Nam, the sharing rates for majority of the provinces and certainly all poor provinces is already nearly 100%,

¹⁹ This is not a weakness of the Viet Nam system; the literature on fiscal federalism does not suggest that subnational governments should be self-sufficient from a revenue perspective.

and this has not changed drastically since 2002. This suggests a progressive approach toward decentralization from the outset. However, the extent to which sharing rates have promoted pro-poor expenditures at the provincial level and whether or not the system is replicated between the provincial and district level requires further analysis.

Disadvantaged provinces in Viet Nam get preferential norms for revenue retention. However, formulas for the allocation of budget resources still favor provinces with a stronger capacity to raise revenue. As such, poorer provinces will experience a slower growth in their level of transfers. At the same time, it is the provincial government that has discretion to assign authority to collect revenues at lower levels, following minimum requirements set by the State Budget Law. Local governments are only allowed to autonomously set fees and charges for revenues that comprise an insignificant share of their budget, and tax collections are centralized with local tax authorities only collecting revenues arising within their administrative regions, on the national government's behalf. Thus it remains the case that more resources are still transferred to provinces with greater capacity for revenue collection or that have regional development poles. Moreover, given the limited autonomy associated with collection of these resources at the local level, the relationship between subprovincial revenue mobilization and poverty spending would be expected to be insignificant at this stage of the decentralization process.

Indeed, this viewpoint is confirmed by the data analysis. The same exercise was conducted as above to examine the relationship between per capita revenue collection (assuming that retention rates are almost universally 100% across provinces), fiscal transfers, and poverty headcount ratios. At the provincial level per capita local revenue collection was found to be weakly negatively correlated with the level of fiscal transfers for the period 2002–2006; the result however, was not found to be statistically significant. Per capita fiscal transfers are also not correlated with poverty headcount ratios (see Table 6). Notwithstanding that this relationship is not yet developed in Viet Nam, it remains as noted above that the overall system of revenue decentralization is moderately progressive, at least as represented by the fairness of the revenue sharing agreements. The overall framework on the other hand does not appear to be oriented to leveraging greater levels of resources for poverty spending or otherwise.

C. Fiscal Autonomy and Accountability Systems

The issue of fiscal autonomy has been discussed indirectly in previous sections of this paper. The degree to which local governments have been empowered to promote and respond to local needs/preferences for public spending through policy and spending discretion is a promising area in Viet Nam. Notable progress has been made to involve subnational governments in the planning process for poverty alleviation and other types of development policies, through the development of provincial strategic plans. However, the mandated autonomy of local government to develop their own policy initiatives and how

these relate to national level policy plans is still an area for development. Fiscal autonomy for public spending, particularly at the district and commune level, would also be required to support policy initiatives that require decentralization of resources to the local level. As it stands, transfers from provincial to lower levels remains largely within the discretion of the provincial government, following some minimum requirements. Norms are optional and for planning purposes, they are not obligatory for subnational transfer to lower levels. In sum the planning framework has become more bottom-up, though it is still unclear how local policy initiatives for poverty reduction if different from national policy plans can be mandated.

A further example where fiscal autonomy could be enhanced is related to the issue of subnational borrowing since the availability of additional funds could be used to promote and respond to local needs/preferences for public spending. According to Ahmad (2006) the question of whether or not subnational governments should be empowered to borrow (access financial markets) may determine the extent to which such markets will influence the overall health of the subnational government and its ability to ensure good service delivery. Access to finance can be achieved through the central government where the central government borrows on behalf of the subnational government, or the subnational government can raise funds directly through commercial bank borrowing or bond operations. In theory, access to capital markets has the potential to create a more market-based relationship for public administration, could increase expansionary spending in resource constrained environments, and could enhance a hard budget constraint on local governments. However, subnational lending is subject to moral hazard for decentralized borrowing, which could create fiscal and macro stability issues for central governments and also lead to crowding out effects for private sector initiatives.

In Viet Nam, domestic borrowing can only be for infrastructure investment in the form of either bond issuance or institutional loans not exceeding 30% of the provincial capital budget. Repayment of both the principal and the interest is the responsibility of the provincial government, and subnational borrowing must be in the local currency, requiring central government approval for any foreign exchange borrowings. A few large cities have issued domestic bonds to fund infrastructure investment, but this remains an area for development and policy consideration. Such type of developments will still require support to create a sound borrowing and monitoring framework that will underpin the sustainability of local finances.

Fiscal accountability in Viet Nam remains as an area for further analysis and discussion as there are still rather limited developments in Viet Nam to date, and as the decentralization process deepens in coming years. Briefly touching on the three areas of concern for the fiscal incentive framework, namely, (i) that fiscal transfers are used for poverty purposes (no leakages); (ii) that transparency and accountability are promoted including for the areas of audit and oversight functions of government; and (iii) that performance measures are in place to promote good fiscal practice and value for money in the use of public spending for the promotion of pro poor outcomes, a few issues are identified here.

In Viet Nam internal control of public finances is undertaken systematically, however, that is, at the central level only, by the Treasury and the external audit authority under the National Assembly. Provincial budgets are not directly subject to the People's Council authority and so *ex post* controls at the local level by the central level are seen to be relatively weak. Subprovincial level audit and budget scrutiny likewise remain fairly undeveloped areas in Viet Nam. As outlined in Section III, accountability in public finances is closely linked with fiscal autonomy and so progress in this area may only be realized once greater levels of fiscal autonomy at the subprovincial level are established. As regards the issue of performance management measures to promote good fiscal practice and value for money at the subnational level, this also remains an untapped but potentially large and encouraging area for Viet Nam.

In sum, fiscal autonomy and accountability are areas that require further evolution in line with future administrative decentralization to frame incentives in Viet Nam. In other countries, accountability at the local government has level tended to evolve in line with prospects for grassroots democratization, since this will directly affect the capacity of the populace to reorient accountability relationships at the local level. It is beyond the scope of discussion for this paper, but how exactly this type of process can work in a one party state should be an area for discussion. At this point the likelihood of political reconfiguration including the direct election of local officials is unlikely and therefore further administrative decentralization may be politically impossible. According to Fritzen (2006, 10):

Viet Nam's current constitutional framework and Vietnamese idioms emphasize the need to maintain state control of public resources and public information about resources. This approach suggests efforts to move towards devolution within the current governance structure will face conceptual as well as practical difficulties in future. The net effect of all of these governance arrangements is to reinforce a system in which accountability is primarily directed upwards (towards higher levels of government) and is, at the same time, somewhat blurred by overlapping spheres of authority and habits of intervention. Accountability, when blurred in this way, tends to preclude the shifting of power from *more* to *less* powerful actors and levels of government, since meaningful decentralisation of any kind rarely happens (or remains precarious, as at present in Vietnam) except when backed by enforceable recourse to the rule of law.

VI. Conclusions

The issue of how local governments can best be incentivized to ensure policy objectives and service delivery functions are applied in ways that will positively foster pro-poor outcomes—while avoiding incentivizing regressive outcomes—is of key importance for countries pursuing both fiscal decentralization and poverty reduction strategies. As Dethier (2004, 2) notes: “even when resources are (re)allocated correctly, they may not reach their intended destinations if organizational and incentive problems in public agencies lead to corruption, misappropriation or theft; and because even when resources reach a school or a health clinic, providers may have weak incentives ... motivations ... to deliver services effectively.”

This paper has reviewed the literature on the relationship between fiscal decentralization and pro-poor outcomes. The paper takes the view that fiscal decentralization does not automatically contribute to pro-poor outcomes; however, if positive fiscal incentives are introduced within the process of fiscal decentralization, the relationship has potential be positive in nature. While central governments may have an explicit poverty reduction strategy, and may generally expect that local governments should have a hand in achieving policy objectives identified in this strategy, the system of fiscal incentives, including resources, responsibility, autonomy, and accountability are what actually guide or motivate local government behavior. Fiscal incentives are an effective management tool that can be used to improve the likelihood of achieving pro-poor outcomes. As such, institutional incentives should form an explicit part of the design of a program of fiscal decentralization (and if appropriate should be addressed in the PRSP) in countries that prioritize poverty reduction so that policy reforms can ensure a more targeted, effective, and efficient service delivery system and a more development-oriented economy.

Notwithstanding the key importance attached by this paper to the role of fiscal incentives under fiscal decentralization for achieving pro-poor outcomes, it is widely acknowledged that the effectiveness of fiscal incentives under fiscal decentralization will also be determined by the existing institutional and organizational structure. First, the capacity of subnational governments to deal with increased responsibility and autonomy for fiscal and revenue management (revenue administration, expenditure planning, budgeting, execution, reporting and monitoring), determine whether or not results from fiscal decentralization will be optimal or suboptimal. Second, fiscal decentralization has been shown to be relatively ineffective if undertaken without some kind of political and administrative decentralization, since this is necessary to change the power sharing structure between the central and the subnational governments. Third, successful fiscal decentralization requires a functional communication mechanism to exist between local and central governments to ensure information exchange and coordination. Finally, there must be an appropriate set of legal and regulatory arrangements in place (or at least being developed) that are recognizable to government cadres for fiscal decentralization to be effective.

The paper finds that the fiscal decentralization and poverty reduction experience in Viet Nam is positive. Decentralization has been ongoing in Viet Nam since the mid-1990s and significant progress has been made in devolving resources to lower levels of government by increasing the level of fiscal resources and fiscal responsibility in provincial governments on the revenue and expenditure side. The government has been implementing an explicit poverty reduction strategy since 2002. Since 2002, budgetary reallocation and income redistribution linked to poverty outcomes have been more strongly associated with equalizing fiscal transfers than with devolved finances in general. This represents a broadly correct approach to target poverty outcomes in a territorially unbalanced country such as Viet Nam. Targeted transfers contribute to pro-poor outcomes by increasing the level of resources available to finance poverty spending. However, increasing the level of fiscal transfers for poverty spending will not ensure that fiscal transfers are then spent efficiently. In order to better realize these efficiency objectives, the government can promote greater fiscal and administrative decentralization of resources and responsibility to district and commune-level governments. Further gains in this area must also be supported by encouraging fiscal autonomy and fiscal accountability for the local government level, though this may prove to be politically unfeasible in Viet Nam's current political environment.

A. Summary of Results for the Case Study

Based on the analysis developed in Section V, Table 7 summarizes Viet Nam's experience of fiscal decentralization as they relate to the four areas of fiscal incentives, namely, (i) resources, (ii) responsibility, (iii) autonomy, and (iv) accountability for achieving pro-poor outcomes.

Table 7: Application of Fiscal Incentives to the Viet Nam Case

Type of Incentive	Description	Viet Nam Experience	Effectiveness of Incentive
Fiscal Resources	Adequacy of fiscal grants and transfers from the central government	Fiscal transfers from center to provincial level are large in both relative and absolute terms.	Overall levels of decentralized expenditures increasing in the aggregate but not becoming more pro-poor over time
	Availability of additional fiscal grants for marginalized regions or segments of the population	Fiscal transfer from provincial to lower levels is at the discretion of provincial government, following minimum requirements	Fiscal transfers increasing over time and positively correlated with poverty rates
	Fairness of revenue sharing arrangements between central and local government should promote local discretionary spending on pro-poor services	Balancing transfer from central to provincial government is based on both formula and negotiations between the two levels; distinguishing between recurrent and capital expenditures is a recent phenomenon	Require further administrative decentralization to increase autonomy and accountability in spending at the district and commune level
		Transfer arrangements are decided for a stability period of 3–4 years	There is no observable incentive for leverage of conditional grants to achieve pro-poor effectiveness
		Conditional grants under “National Programs” are “passed” down through the subnational government to targeted recipients	Subnational government has limited authority to raise its own revenue, only through (i) surplus collection and (ii) certain fees and tolls
		Provincial government revenue comes from: (i) 100% retained taxes, (ii) shared taxes from the central government, and (iii) local tolls and fees	Fiscal system favors provinces that collect higher levels of taxes, even when provinces are differentiated by pro-poor norms
		Surplus from (ii) can also be retained as incentives for collection; sharing rates of (ii) is the same across tax types	The stability period gives relatively stable revenue assignment to provincial governments May be a negative incentive for local revenue collection resulting from revenue-based transfer calculation

continued.

Table 7: *continued.*

Type of Incentive	Description	Viet Nam Experience	Effectiveness of Incentive
Fiscal Responsibility	Increased responsibility for local revenue collection	Centralized revenue collection, but <i>de facto</i> dual subordination of local tax collecting agencies	Disadvantaged provinces get preferential norms for revenue and expenditures.
	Delivery of local public services	Service delivery responsibility has been devolved to the subnational level but decisions for expenditure remains on balance at the provincial and not district and commune levels	Weak incentive to increase revenue collection since additional funds over the negotiated level are retained by the center
	Local governments have assigned responsibility to participate in local and national planning and budgeting processes	Article 34 in the 2002 State Budget Law requires that townships and cities under a province must be assigned responsible for construction of schools, lighting, water supply and sewerage, urban traffic and other public infrastructure	Strengthened expenditure responsibility at the provincial level including more flexibility to respond to the locality's specific needs/priorities
		Qualified efforts have been rolled out in recent years to increase the role of civil society, private sector, and local government in both the preparation of national development strategies and provincial strategic plans and budgets	Social services are assigned to the lowest possible level to ensure delivery; however, there is often lack of clarity about aggregate responsibility for delivery, and overlap of responsibilities between the provincial and subprovincial government
		Limited actual responsibility in planning and budgeting: top-down; optional "budgeting norms" at the local level	Expenditure assignment could be more explicit, especially in coordination of items requiring both central and provincial levels
		Expenditure responsibility: relatively clear assignment of responsibilities between central and provincial governments, with flexibility for provinces to assign to lower levels; strengthened restriction on passing down unfunded expenditure mandates	

continued.

Table 7: *continued.*

Type of Incentive	Description	Viet Nam Experience	Effectiveness of Incentive
Fiscal Autonomy	Local governments are empowered to promote and respond to local needs/preferences for public spending through fiscal discretion	Limited autonomy in budgeting and revenue estimates at the subprovincial level	Inadequate autonomy to raise revenue of subnational governments Administrative regulation rather than incentive-driven resource allocation across sectors
	Autonomy to borrow to finance local revenue shortfalls	With certain flexibility (meeting minimum requirements), provincial governments can assign expenditure responsibilities to lower levels to respond to its specificities, but not vice versa	Unclear effects: actual allocation at subnational levels has not been universally pro-poor
	Degree of revenue autonomy for discretionary spending for poverty-related interventions and as an incentive to attract private sector investment to increase local development and in turn the tax base	Increasing participation of the local and provincial governments in policy making on poverty-related issues including in the development of national and provincial strategic plans	Participation is linked to increased levels of accountability for public spending in many countries. However this effect may be more strongly linked in Viet Nam to central and provincial level budgets. Currently at the local level there is in reality limited participation of civilians in the budget process, since budget allocations are assigned for the most part by the provincial government.
		Provincial governments empowered to develop provincial planning instruments; however this process is only replicated at district commune level	
		Only domestic borrowing for capital spending in <i>infrastructure</i> allowed, with 30% total capital spending ceiling	
		Domestic borrowing can only be in the form of either bond issuance or institutional loans, not exceeding 30% of provincial capital budget. Repayment of both principal and interest must be from the provincial future budget.	Additional funds made available through subprovincial borrowing could promote and respond to local needs/preferences for public spending

continued.

Table 7: *continued.*

Type of Incentive	Description	Viet Nam Experience	Effectiveness of Incentive
Fiscal Accountability	Fiscal transfers used for poverty reduction purposes, leakages minimized	Publicity of budget-related activities: planning, final accounts, auditing results at all levels	Increased publicity improves transparency in budget processes
	Performance measures are in place to promote good fiscal practice and value for money	National Assembly and People's Councils have authority to approve the budget and monitor execution	Authority of National Assembly and People's Councils in budget approval and monitoring enhanced; external audit becomes independent from the government
	Transparency and accountability is promoted including audit and oversight functions	Internal control authority is given solely to the Treasury, and external audit authority is given to the State Audit Agency under the National Assembly for the whole state budget	Limited participation at lower levels in budget planning and monitoring to ensure accountability in the use of public resources External audits are not systematically conducted for provincial and district level expenditures; audits conducted are not under the mandate of the respective People's Council Lack of budget performance evaluation at all levels

Appendix: Assignment of Expenditure Responsibilities in Viet Nam

	Central Government	Provinces	Districts	Communes (and Precincts)
Health	<ul style="list-style-type: none"> - Central facilities - Research 	<ul style="list-style-type: none"> - Provincial services 	<ul style="list-style-type: none"> - District services as assigned by the provincial government 	<ul style="list-style-type: none"> - Commune health activities as assigned by the provincial government
Education	<ul style="list-style-type: none"> - National health programs - Postsecondary - National programs 	<ul style="list-style-type: none"> - Provincial services 	<ul style="list-style-type: none"> - District services as assigned by the provincial government 	<ul style="list-style-type: none"> - Commune activities as assigned by the provincial government
Economic Activities	<ul style="list-style-type: none"> - Economic services, managed centrally 	<ul style="list-style-type: none"> - Provincial services 	<ul style="list-style-type: none"> - District services as assigned by the provincial government 	<ul style="list-style-type: none"> - Commune activities as assigned by the provincial government
Culture and Sports	<ul style="list-style-type: none"> - National programs 	<ul style="list-style-type: none"> - Provincial activities, supporting individuals 	<ul style="list-style-type: none"> - District services as assigned by the provincial government 	<ul style="list-style-type: none"> - Commune activities as assigned by the provincial government
Social	<ul style="list-style-type: none"> - National programs - Social security 	<ul style="list-style-type: none"> - Provincial activities 	<ul style="list-style-type: none"> - District services as assigned by the provincial government 	<ul style="list-style-type: none"> - Commune activities as assigned by the provincial government
Defense	<ul style="list-style-type: none"> - National defense 	<ul style="list-style-type: none"> - Military conscription - Other defense activities 	<ul style="list-style-type: none"> - District services as assigned by the provincial government 	<ul style="list-style-type: none"> - Commune activities as assigned by the provincial government
Police and Security	<ul style="list-style-type: none"> - National police 	<ul style="list-style-type: none"> - Local security and social order 	<ul style="list-style-type: none"> - District services as assigned by the provincial government 	<ul style="list-style-type: none"> - Commune activities as assigned by the provincial government
Political Organs	<ul style="list-style-type: none"> - Central organs of CP and other central organizations 	<ul style="list-style-type: none"> - Provincial organs of CP and other organizations 	<ul style="list-style-type: none"> - District organs of FP and other organizations 	<ul style="list-style-type: none"> - As assigned by the provincial government
Price Subsidies	<ul style="list-style-type: none"> - Central Programs 	<ul style="list-style-type: none"> - Subsidies conforming to national policies 	<ul style="list-style-type: none"> - As assigned by the provincial government 	<ul style="list-style-type: none"> —
Interest	<ul style="list-style-type: none"> - National debt service 	<ul style="list-style-type: none"> - Service of provincial debt 	<ul style="list-style-type: none"> — 	<ul style="list-style-type: none"> —
Other Expenditures	<ul style="list-style-type: none"> - As stipulated by law 	<ul style="list-style-type: none"> - As stipulated by provincial budgets 	<ul style="list-style-type: none"> - As stipulated in district budget by the provincial government 	<ul style="list-style-type: none"> —
Capital Investments	<ul style="list-style-type: none"> - Programs in infrastructure - Support of state enterprises and joint enterprises - National investment and development programs - Transfers to subnational governments 	<ul style="list-style-type: none"> - Construction of basic economic infrastructure - Support of state enterprises according to the law - Transfers to lower budget 	<ul style="list-style-type: none"> - Public schools power - Water supply - Sanitation - Transport (Art. 3.4) 	<ul style="list-style-type: none"> - Health centers, schools, local roads - Water supply systems (Art. 34)
Transfers			<ul style="list-style-type: none"> - Transfers to lower budget as stipulated by the provincial government 	<ul style="list-style-type: none"> —

CP = Central Program, FP = Federal Program.
Source: Martinez-Vasquez (2005).

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About the Paper

Liv Bjornestad writes that the key to achieving pro-poor results under fiscal decentralization is to introduce an appropriate system of fiscal incentives. While central governments may have an explicit poverty reduction strategy, and may generally expect that local governments should have a hand in achieving policy objectives identified in this strategy, the system of fiscal incentives, including resources, responsibility, autonomy, and accountability are what actually guide or motivate local government behavior. This paper documents how fiscal incentives including resources and responsibility have been used as effective management tools by the Government of Viet Nam to improve the likelihood of achieving pro-poor outcomes; however, further gains in this area must also be supported by encouraging fiscal autonomy and fiscal accountability at the local government level.

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