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# Socialist Republic of Vietnam

# ASSESSMENT OF FINANCING FRAMEWORK FOR MUNICIPAL INFRASTRUCTURE

## Assessment of the financing framework for municipal infrastructure in Vietnam
## Final Report

September 2013

Public Disclosure Authorized

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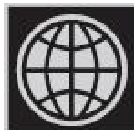

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# ASSESSMENT OF THE FINANCING FRAMEWORK FOR MUNICIPAL INFRASTRUCTURE IN VIETNAM

*FINAL REPORT*

THE WORLD BANK

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# Assessment of the Financing Framework for Municipal Infrastructure in Vietnam

*Final Report*

September 2013

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This work was carried out under the overall guidance and direction of Victoria Kwakwa (World Bank Country Director, Vietnam), Jennifer Sara (Sector Manager, EASVS), Abhas Jha (Sector Manager, EASIN), and Parameswaran Iyer (Urban and Water Cluster Leader, EASVS). A multidisciplinary World Bank team that included staff based in Hanoi and Washington, DC was involved in the preparation of the report. The team was led by Cuong Duc Dang (Senior Urban Development Specialist, EASVS), and included Quang Hong Doan (Senior Economist, EASPV), Cung Van Pham (Senior Financial Management Specialist, EASFM), and Kien Trung Tran (Senior Procurement Specialist, EASR2). Cledan Mandri-Perrott (Lead Financial Officer, TWISI) and Daniel Pulido (Young Professional, LCSTR) contributed to the first phase of the analytical work. Marcus Lee (Urban Economist, EASIN) and Nozomi Tokiwa (Jr Professional Officer, PPIAF) were the main authors of the final report, with support from Phoram Shah (FEUCA). The consultants, Vision Associates and Vietbid, contributed to the three case studies and the Diagnostic and Action Plan report. Valuable comments were received from the peer reviewers: Aldo Baietti (Lead Infrastructure Specialist, EASWE), Vickram Cuttaree (Senior Infrastructure Economist, ECSTR), Peter Ellis (Lead Infrastructure Economist, SASDU), and Deepak Mishra (Lead Economist, EASPR). Giang Thi Huong Nguyen (Program Assistant, EASVF) provided logistical support to the team.

# Acronyms and Abbreviations

| | |
|---|---|
| AFD | Agence Française de Développement (French Development Agency) |
| AMC | Ahmedabad Municipal Corporation (India) |
| BOO | Build-operate-own |
| BOT | Build-operate-transfer |
| BT | Build-transfer |
| BTO | Build-transfer-operate |
| CPSCL | Caisse de Prêts et de Soutien des Collectivités Locales (Tunisia) |
| EAAIG | East Asia and Pacific Australian Government Infrastructure for Growth Trust Fund |
| EZ | Economic zone |
| FDI | Foreign direct investment |
| FINDETER | Financiera de Desarrollo Territorial (Colombia) |
| GDP | Gross domestic product |
| GNI | Gross national income |
| GOV | Government of Vietnam |
| HCMC | Ho Chi Minh City |
| HFIC | Ho Chi Minh City Finance and Investment State-owned Company |
| HIFU | Ho Chi Minh City Investment Fund for Urban Development |
| IIGF | Indonesia Infrastructure Guarantee Facility |
| INR | Indian rupee |
| IP | Industrial park |
| LDIF | Local Development Investment Fund |
| LGUGC | Local Government Unit Guarantee Corporation (Philippines) |
| MDF | Municipal Development Fund |

| | |
|---|---|
| MDG | Millennium Development Goal |
| MOF | Ministry of Finance |
| MPI | Ministry of Planning and Investment |
| MUFIS | Municipal Infrastructure Financing Company (Czech Republic) |
| NPL | Non-performing loan |
| O&M | Operations and maintenance |
| ODA | Official development assistance |
| PPP | Public-private partnership |
| QNIF | Quang Nam Development and Investment Fund |
| SBV | State Bank of Vietnam |
| SEDP | Socio-economic Development Plan |
| SOCB | State-owned commercial bank |
| SOE | State-owned enterprise |
| TNUDF | Tamil Nadu Urban Development Fund (India) |
| UN | United Nations |
| USD | United States dollar |
| VAMC | Vietnam Asset Management Company |
| VAT | Value-added tax |
| VDB | Vietnam Development Bank |
| VDR | Vietnam Development Report |
| VND | Vietnamese dong |

# Executive Summary

## Overview

**This report has the objective of informing the Government of Vietnam (GOV) on how the financing framework for municipal infrastructure in Vietnam can be strengthened.** It is based on an assessment of the constraints and opportunities that sub-national governments face in accessing financing for infrastructure development. It also draws upon lessons and good practices from international experience in this area, considering their relevance for Vietnam. A set of recommendations and implementable actions is provided, recognizing the broader context of ongoing reforms that are needed in Vietnam on institutions, incentives and the availability of information.

**Vietnam has experienced profound changes that have transformed the country in the last two decades.** The country's transition to a market economy has been accompanied by economic growth that averaged 7.3 percent between 1990 and 2010, through which per capita income almost quintupled. Vietnam's transformation is also marked by a shift in the locus of change to its cities, transitioning to a phase of rapid urbanization that offers unique opportunities for the country's development. Vietnam has also pursued a path of fiscal decentralization. Greater autonomy for sub-national governments has given them significant decision-making powers on public finances and infrastructure development. The challenges facing Vietnam's decentralized system include growing disparities across provinces, variability in administrative capacity at the local level, insufficient accountability, and fragmented and inefficient investment.

**A fundamental challenge for Vietnam is to improve the affordability and efficiency of infrastructure investment. The fragmentation of public infrastructure investment results in duplication and waste, and is a major underlying cause of investment inefficiency**. The financing needed to meet Vietnam's future infrastructure needs has reached an unaffordable level, because of the emphasis on raising the absolute level of investment, rather than paying attention to the efficiency of investment. Within Vietnam's highly decentralized administrative structure, individual provinces select and undertake their own infrastructure projects, and compete with one another. At the same time, there is a significant lack of predictability in the availability of funds available for investment from year to year. These result in allocative inefficiency in the selection of projects and areas for investment. Investment decisions are driven mainly by administrative considerations and the desire to develop revenue-generating projects, with only weak links to strategic national priorities and market-based mechanisms for the allocation of scarce resources. Yet, this challenge also represents an opportunity for Vietnam, in that a significant part of the investment needs can likely be met by more efficient use of available resources.

# Municipal Infrastructure Financing in Vietnam Today

**Bond issuance has been the most prominent form of debt financing at the sub-national level, even though the State Budget Law does not specify it as the only way to obtain financing.** The bond market in Vietnam is largely underdeveloped, with government bonds dominating the market. So far, the only sub-national governments that have accessed financing in the capital markets through bond issues are Hanoi, Ho Chi Minh City (HCMC), Da Nang, and Dong Nai Province. Of these, HCMC was the first to issue bonds, and the only one to have done so more than once: it successfully completed its bond issuance plan totaling VND 10,000 billion during the period 2003-2007.

**In the commercial banking sector, lending to sub-national governments has been very limited.** Banks are reluctant to finance local governments, and view lending for infrastructure as too risky. Past policies of 'directed lending' for infrastructure and other sectors have meant that banks conducted little or no technical and risk assessments, with few incentives to develop the capacity to evaluate and monitor projects according to commercial principles. The repayment capacity of projects and borrowers was rarely considered, because of the assumption of implicit guarantees by the local or central government. Loans were rarely secured with proper collateral, and those loans that did have collateral were in effect equivalent to project financing without recourse to the government sponsor.

**Local Development Investment Funds (LDIFs) have expanded considerably in Vietnam over the past decade, mobilizing significant amounts of capital for infrastructure investment**. LDIFs are special finance institutions created at the provincial level to mobilize capital and invest in municipal infrastructure. Following the successful experience with the Ho Chi Minh City Investment Fund for Urban Development (HIFU), at least 28 other provincial governments have established LDIFs. In 2011, the total charter capital of LDIFs in Vietnam was estimated to be approximately USD 450 million. The top seven LDIFs are investing approximately USD 100 million per year, accounting for an investment increase of 118 percent for these funds over the 2002 level.

**Several factors, related to financing and risk management, discourage private sector participation in infrastructure projects in Vietnam.** First, most projects require subsidies in order to be financially viable, but there is no clear and transparent system to determine the magnitude of the government's financial support. Second, most projects do not undergo sufficient preparation before they are put out to bid. Consequently, private sector bidders often lack important information on the risks associated with projects, and financial aspects such as tariff structures and government support, that would enable them to prepare detailed proposals. This in turn makes it difficult for the government to determine if a project offers better value as a public-private partnership (PPP), or as a project fully financed by the public sector. Third, most infrastructure projects with private sector involvement have been undertaken without competitive bidding, increasing the risk of poor outcomes and inefficiency.

**Current regulations allow the use of land for the creation of investment capital, in cash or in kind, for the construction of infrastructure. However, the use of 'land for infrastructure' faces limits: available land is finite, and there are many places where land values are not high enough.** Land can be used to finance infrastructure investments in two ways: the auction of land

use rights to generate cash for the direct funding of construction works, or the combined bidding of a construction project with associated land use rights as a way to create capital for the construction works ('land for infrastructure'). Land-based financing is in decline in larger cities due to the downturn in the real estate market, while in smaller cities, land values are not attractive to the private sector to begin with. Concerns have been raised in terms of the transparency of the land valuation process, as well as the degree to which local governments actually benefit from the increases in land value resulting from the improved infrastructure. Resettlement costs add considerably to the overall cost of mobilizing land resources.

**At the provincial level, significant disconnects exist between total planned investment needs in infrastructure, and the effective demand for such investment.** These disconnects arise due to two main reasons. First, weaknesses in Vietnam's decentralized structure and investment planning processes have resulted in systemic inefficiencies in infrastructure investment through fragmentation and unnecessary duplication. It is likely that for any given province, the efficient level of investment would be lower than what is currently stated in investment plans. Second, available funding is unpredictable and falls significantly short of the financing needs arising from current investment plans. This reflects both inefficiency in investment as well as the lack of coordination and linkages between line agencies in the planning process, which results in projections for investment that reflect the expectations of line agencies rather than the actual resources available.

**This report estimates the 'effective demand' for infrastructure investment – the lower level of actual investment that can be reasonably expected, given improvements in investment efficiency and existing constraints in available funding.** The effective demand for infrastructure investment in HCMC for the period 2011-2015 is estimated to be VND 314,981 billion, with a funding gap of 59 percent. The effective demand in Quang Nam, based on existing plans, is estimated to be VND 6,970 billion, with a funding gap of 34 percent. The effective demand in Quang Ninh is estimated to be VND 49,295 billion plus USD 842 million, with a funding gap of 88 percent for the VND portion – or VND 43,536 billion – and 100 percent for the USD portion.[1]

## The Way Forward

**The success of any initiative to improve the financing of municipal infrastructure in Vietnam hinges on advances in the broader landscape of policy reform as part of the country's long-term development. Meeting these challenges requires a comprehensive approach that addresses issues of governance, financing, and execution.** Any measures taken to address financing issues, including new financing instruments, would also depend on the effective implementation of complementary reforms in the areas of governance and execution. Examples of such reforms include: clarifying and strengthening property rights; creating impartial regulators for infrastructure sectors; improving regional coordination for infrastructure; and strengthening the public investment management cycle.

**Many of the constraints and weaknesses that Vietnam faces today can and should, in fact, be viewed as opportunities.** Existing inefficiencies in infrastructure investment

1 The current plans for municipal infrastructure investment in Quang Ninh consist of estimates of individual investment projects in terms of either VND or USD. In this report, the amounts in each currency have been retained, instead of applying an exchange rate to express the amounts in a single currency.

**represent an opportunity for efficiency gains – to do more with the same amount of resources.** This calls for stronger use of market-based mechanisms – not only would this increase efficiency, but would also attract greater investor interest and participation from the private sector. Operational efficiencies can also go a long way in improving service delivery and the financial condition of sub-national governments. If the private sector could be brought in to improve efficiencies in operations and service delivery, then the investment needs for additional infrastructure would likely be lower. Moreover, the current low levels of sub-national government debt also present a window of opportunity for Vietnam to put in place a robust and comprehensive system for sub-national public debt management – the importance of which is underscored by the Chinese experience where sub-national debt and contingent liabilities have become serious concerns.

**The sustainable financing of municipal infrastructure investment in Vietnam will require greater involvement of capital markets and the private sector, and cannot rely on State Budget resources and official development assistance (ODA) alone.** Budget resources, which for the most part are currently passed on as grants, will have to be used more strategically in the future, with an emphasis on greater efficiency of investment, and leveraging other sources of financing. Vietnam also needs to prepare for the transition to receiving less donor funding for municipal infrastructure. Although some resources may be available from equity markets, the bulk would likely be obtained from debt markets, through various types of bonds or loans. Vietnam's capital markets are relatively underdeveloped, and it will take a long time before the capital markets can play an important role in financing municipal infrastructure.

**This report provides several implementable recommendations for the further development of municipal infrastructure finance mechanisms in Vietnam.** The recommendations have been developed by the joint World Bank-MOF team through extensive consultations, and based on the in-depth assessment of specific provincial-level governments and their finances, as well as the review of relevant international experience. The team has highlighted key considerations for municipal finance mechanisms in the recommendations with regards to the policy framework, borrowing modalities, institutional arrangements for local governments and roadmap for implementation. These recommendations are cognizant of other ongoing programs supported by the Bank and other donors on PPP and fiscal decentralization, and are also very timely, given the ongoing government initiatives on land-based financing, infrastructure development, investment efficiency improvement, and the expected issuance of a revision to the State Budget Law in 2014. For example, the ongoing strengthening of LDIFs, which is supported by an ongoing World Bank financed project,[2] is consistent with and part of the detailed recommended mechanisms

**The specific recommendations for new instruments therefore comprise: (a) gradual development of a municipal development fund (MDF) that acts as a second-tier lender; and (b) strengthening the enabling environment for municipal bonds.** The recommendations for both of these options are fully customized to Vietnam's needs, and have been developed by taking Vietnam's specific circumstances into account. They also recognize that changes will take time to implement, and are therefore structured using a staged, step-wise approach. The first recommendation for development of an MDF has given consideration to the steps needed to establish and operationalize such a

2 Local Development Investment Funds Project (approved in 2009, project status: active)

fund, including the appropriate laws and regulations, funding sources, institutional arrangements, debt management and credit enhancement. The second recommendation for municipal bonds has considered enabling conditions for bond issuance such as regulatory amendments, simplified review and approval procedures, credit enhancement, and transparency and disclosure requirements.

**The MDF recommendation is based on the successful examples of *Financiera de Desarrollo Territorial* (FINDETER) in Colombia and Municipal Infrastructure Financing Company (MUFIS) in the Czech Republic**, where these MDFs act as second-tier lenders, encouraging first-tier lenders (commercial banks) to lend to sub-national governments on a market-driven basis. Implementation of the MDF model would take a gradual approach with short-, medium- and long-term actions, recognizing the wider context of transition in Vietnam. The MDF would start with a pilot second-tier lending facility managed by the MOF in the short-term, for the first two to four years. This pilot phase would provide the GOV with valuable experience and practical learning, leading up to the formal establishment of a full-fledged MDF subsequently. Relevant legislation and operational procedures would be developed, including the MDF's charter, funding process, criteria for eligible first-tier lenders and loans, and a clear recourse mechanism. Focused assistance to selected local governments will be required to identify and prepare bankable infrastructure projects, as well as gradually develop their investment planning and appraisal processes and debt management capacity.

**The MDF model is highly relevant for Vietnam, offering advantages in multiple areas. It addresses identified needs and gaps in financing municipal infrastructure, institutional development and strengthening at sub-national levels, and the broader agenda of policy reform and transition in Vietnam.** The primary direct benefit would be to develop and expand the market for commercial bank loans to sub-national governments, as a channel and key long-term instrument for financing investment in municipal infrastructure. In seeking these loans from commercial banks, sub-national governments will also improve their ability to plan and prepare infrastructure projects. They would have to demonstrate the bankability and financial viability of proposed projects, particularly in terms of expected direct and indirect revenues, cost recovery arrangements, operations and maintenance expenditures, and repayment capacity. Given that sub-national governments would also be responsible for debt repayments, the MDF model would help to improve debt management capability among sub-national governments, thus also helping the GOV to improve the management of contingent liabilities overall. As Vietnam moves towards having a banking sector where commercial banks operate competitively and make lending decisions based on commercial considerations, the MDF would foster the market-based operations of these banks, including their ability to analyze credit risks associated with lending to sub-national governments for infrastructure development. More broadly, the experience of MDF implementation would also offer useful experience for GOV in strengthening the legal and policy framework for the planning and management of public investment.

**A recourse mechanism would be a key feature of the MDF recommendation, but also beneficial to the inter-governmental fiscal transfer system and other financing instruments.** The basic concept of the recourse mechanism is for the loan from the first-tier lender (i.e., a commercial bank) to the sub-national government to be secured against legally mandated transfers from the central government and/or local government revenues in the case of net fiscal contributors. The recourse

mechanism would bring important credit enhancement for both first-tier lenders and the MDF. In particular, it would provide first-tier lenders with the necessary security that is currently absent in the market in Vietnam.

**The enabling environment for municipal bond issuance in Vietnam would be strengthened through improving the overall regulatory framework, and pilot credit ratings and financial management assessments for sub-national governments.** The national regulation on sub-national government bonds should be adjusted, in order to simplify the appraisal procedure, which currently requires the MOF's approval for a sub-national government's entire plan for capital mobilization. This would increase the autonomy and accountability of sub-national governments that will issue their own municipal bonds. Credit ratings and financial management assessments of selected sub-national governments undertaken by a ratings agency would later culminate in the pilot issuance of municipal bonds by these sub-national governments.

**In order to implement the recommendations above on the MDF and municipal bonds, several changes would be needed to specific laws and decrees.** For the piloting and subsequent full-scale establishment of the MDF, a new prime ministerial Decision and/or an amendment to Decree 11 would be needed. To enable the recourse mechanism, amendments would be needed in the State Budget Law, Decree 60, and Decree 79. To facilitate municipal bond issuance, a change in the Public Debt Management Law could made to remove the requirement of central approval, while also ensuring adequate guidance and regulations are put in place.

**Restructuring of the borrowing limits of sub-national governments should also be undertaken, to facilitate the operationalization of the MDF, and to facilitate municipal bond issuance.** The borrowing limits could be reviewed and redefined based on the repayment capacity of each sub-national government, according to indicators such as a debt service ratio. This would increase local governments' access to finance and enhance capacity for their debt management, as they would be incentivized by the increased funding opportunities. This would also be beneficial for the central government and commercial lenders, as the appraisal process would be simplified by applying the same set of indicators consistently to assess if a sub-national government is eligible for borrowing.

# 1

# The Municipal Infrastructure Context: Macro Considerations

## A. Objectives and Structure of This Report

**1. This report has the objective of informing the Government of Vietnam on how the financing framework for municipal infrastructure in Vietnam can be strengthened.** It is based on an assessment of the constraints and opportunities that sub-national governments face in accessing financing for infrastructure development. It also draws upon lessons and good practices from international experience in this area, considering their relevance for Vietnam. A set of recommendations and implementable actions is provided, recognizing the broader context of ongoing reforms that are needed in Vietnam on institutions, incentives and the availability of information.

**2. This report is structured into five main sections, supported by several appendices.** The first section examines the broader context of Vietnam within which municipal infrastructure operates, including the macro-level issues that have a significant influence. A comprehensive approach for infrastructure development, that guides the discussion in subsequent sections, is also presented. The second section analyzes the strengths and weaknesses of the existing framework for the financing of municipal infrastructure in Vietnam, reviewing aspects of governance – including institutions, laws and regulations – as well as specific financing instruments. A third section gives a review of actual practice and experience at the sub-national level, through case studies undertaken in Ho Chi Minh City, Quang Nam, and Quang Ninh. The fourth section then discusses the applicability and relevance of selected financing instruments, based on a global review of examples and experiences from other countries. The final section proposes a way forward for Vietnam, emphasizing that a sustainable and effective path not only involves specific financing instruments, but also requires meaningful reforms to the enabling environment for municipal infrastructure development. The appendices to this report offer detailed information from the component studies that were undertaken as part of this activity, the main findings of which are reflected in the various sections of this report.

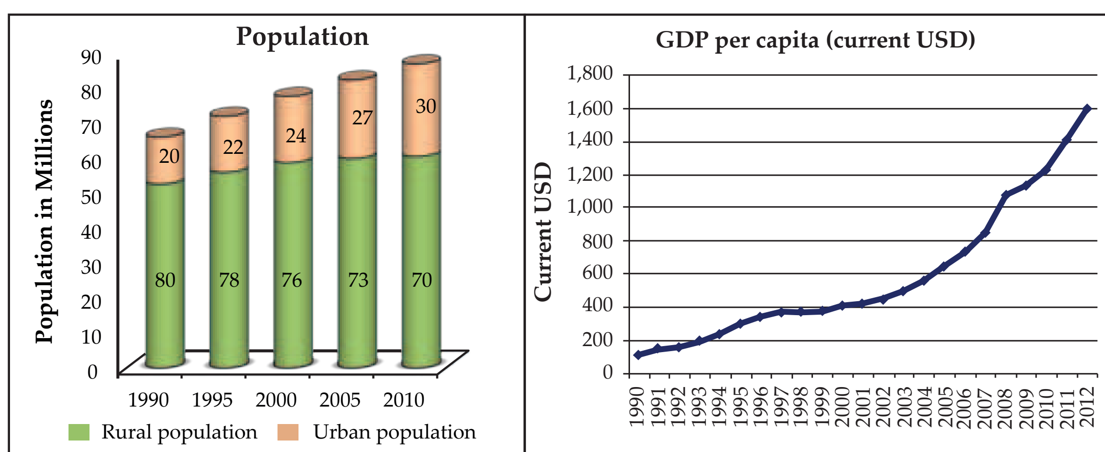
## B. Vietnam's Context – Transition and Transformation

**3. Vietnam has experienced profound changes that have transformed the country in the last two decades.** As recognized in the Vietnam Development Report (VDR) of 2012, the country's transition to a market economy has been accompanied by economic growth that averaged 7.3 percent between 1990 and 2010, through which per capita income almost quintupled. Industrial manufacturing has become increasing important as a share of both output and employment. Once one of the world's poorest countries, Vietnam is now a lower middle-income country with very high levels of access to primary education, healthcare and basic infrastructure services like paved roads and electricity (VDR 2012). The share of the population living below Vietnam's national poverty lines has declined dramatically, to less than 10 percent, and the country is likely to meet most of the Millennium Development Goals (MDGs).

**4. Vietnam's transformation is also marked by a shift in the locus of change to its cities, transitioning to a phase of rapid urbanization that offers unique opportunities for the country's development.** As noted by the French Development Agency (*Agence Française de Développement*, or AFD), cities are a "mainspring of change" in Vietnam today, influencing the organization of society and the economy since the 1990s (AFD 2010). The World Bank's Vietnam Urbanization Review described five shifts across Vietnam's entire urban system, in terms of administrative, physical, economic, demographic, and welfare changes. The Urbanization Review also noted strong

convergence in welfare across provinces, underpinned economically by strong growth in core cities and positive spillovers to the hinterlands (World Bank 2011). Population growth in the last decade has been fastest in the two largest cities, Hanoi and HCMC, and their surrounding areas. The country's urban population is now above 27 million – or more than 30 percent of the national population, and is projected to reach 35.5 million by 2020, and almost 44 million by 2030 when 43 percent of the total population is expected to be urban (UN 2012). This surge in the urban population, with rural folk arriving in search of opportunities, and the high rate of economic growth with rising incomes, have increased pressure on urban services and infrastructure. Figure 1 illustrates the growth in Vietnam's population and per capita income for the period 1990 to 2010.

**Figure 1. Since 1990, Vietnam has seen strong growth in GDP per capita and the share of population that is urban**

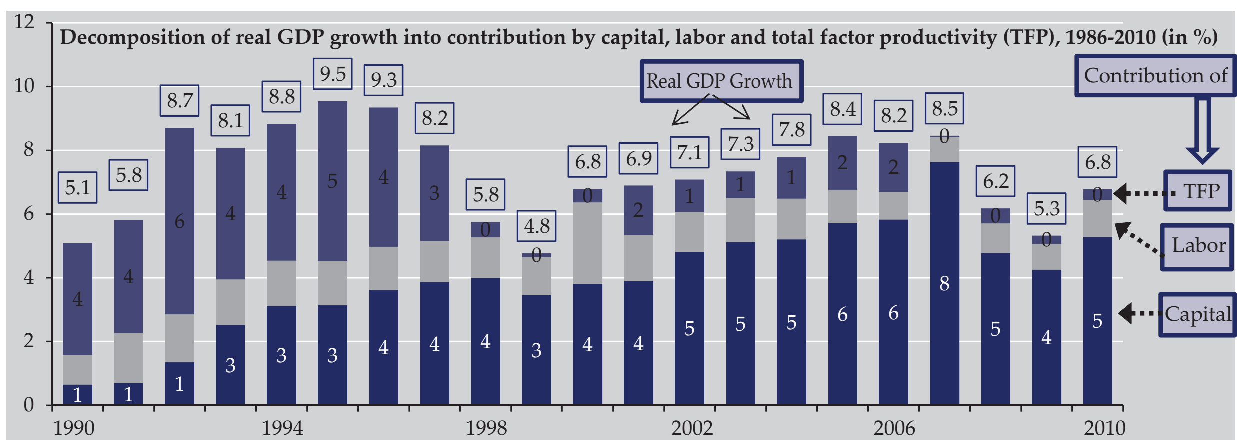



*Source:* World Development Indicators, World Bank 2013.

**5. Vietnam's continued transition towards becoming an industrialized, modern and market-based economy is still underway, with various challenges that need to be addressed.** Vietnam's Socio-Economic Development Strategy for 2011-2020 targets a per capita income level of USD 3,000 (in current dollars) by 2020, and identifies economic stabilization, infrastructure development, a skilled labor force, and market-based institutions, as priorities. VDR 2012 noted that Vietnam has experienced declining factor productivity in recent years, and that reliance on factor accumulation for rapid growth is unsustainable (see Figure 2). Accordingly, raising productivity in Vietnam is imperative, which will require restructuring state-owned enterprises (SOEs), improving the effectiveness of public investment, and reforming the financial sector (VDR 2012). Many of these challenges are not new, but have become more pressing over time: a report from 1999 on private participation in infrastructure in Vietnam highlighted weaknesses in the financial performance of SOEs and the limited role of the private sector in infrastructure. It showed how the private sector could help to bridge the investment funding gap, and increase the efficiency of infrastructure investment and operations (World Bank 1999). Yet, progress on SOE reforms remains limited today, and the successful restructuring of SOEs will require strong inter-agency coordination and improved transparency. Meanwhile, Vietnam's financial sector remains fragile, although the immediate risk of systemic crisis has receded and macroeconomic stability has been restored, in part through monetary tightening by the State Bank of Vietnam (SBV) and the establishment of the Vietnam Asset Management Company (VAMC) to help resolve non-performing loans (NPLs).

**6. Vietnam has also pursued a path of fiscal decentralization, with significant implications for the financing of municipal infrastructure.** The overarching objectives of decentralization were to promote equity across provinces, efficiency in service delivery, and enhanced transparency and accountability. Mandated in large part by the State Budget Law of 1996 and its revision in 2002, fiscal decentralization has affected the mobilization and allocation of resources across sectors and levels of government. Meanwhile, the challenges facing Vietnam's decentralized system include growing disparities across provinces, variability in administrative capacity at the local level, insufficient accountability, and fragmented and inefficient investment. Further revisions to the State Budget Law, as well as the Spatial Planning Law and the Public Investment Law, are currently under consideration. The findings of this report will thus also be linked to related World Bank work on fiscal decentralization that is part of the multi-year programmatic public finance review for Vietnam. Section II.A of this report discusses Vietnam's decentralized framework in greater detail.

**Figure 2. Recent growth in Vietnam has been based on factor accumulation and not productivity**




*Source*: CIEM (Central Institute of Economic Management) 2010 as cited in VDR 2012 (figures for 2009 and 2010 are World Bank estimates).

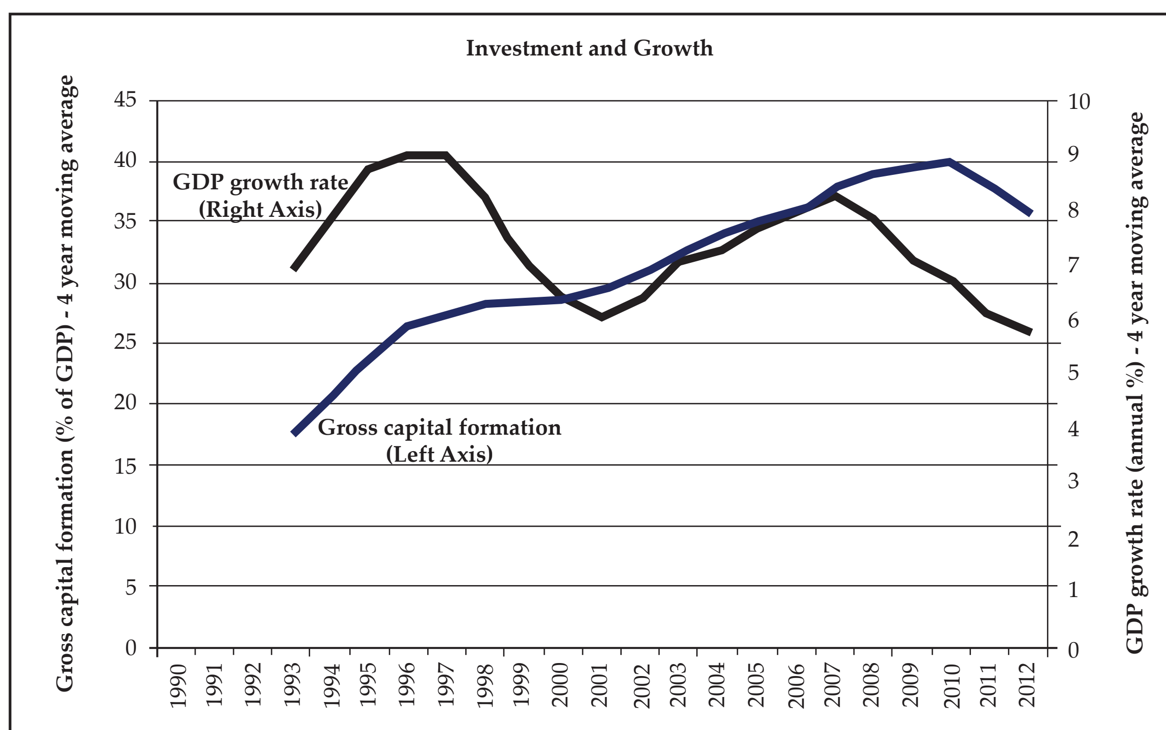
## C. Investment in Infrastructure – Inefficiency Concerns and the Issue of Fragmentation

**7. A fundamental challenge for Vietnam is to improve the affordability and efficiency of infrastructure investment, particularly public investment.** VDR 2012 showed how the financing needed to meet Vietnam's future infrastructure needs has reached an unaffordable level, because of the emphasis on raising the absolute level of investment, rather than paying attention to the efficiency of investment. Thanh and Dapice (2009) estimated an annual shortfall of USD 9 billion, given the infrastructure investment need of USD 25 billion annually (more than 20 percent of GDP), while then-available annual funding from the public and private sectors was less than USD 16 billion. Barely a decade earlier, the estimated annual gap was only USD 2.1 billion (World Bank 1999) – suggesting a clearly unsustainable trend in the more than ten-fold increase in the investment gap within one decade. The seriousness of the inefficiency in investment is shown in Figure 3: GDP growth decelerated between 2006 and 2010, even as the investment rate increased steadily during

that period. Given that public investment accounts for as much as 40 percent of all investment in Vietnam, the fact that growth has become less responsive to investment is a key concern (VDR 2012). This challenge also represents an opportunity for Vietnam, in that a significant part of the investment needs can likely be met by more efficient use of available resources.

**8. The fragmentation of public infrastructure investment results in duplication and waste, and is a major underlying cause of investment inefficiency.** Within Vietnam's highly decentralized administrative structure, the central government is responsible for national-level infrastructure projects (such as national highways), while local governments also have a large role in infrastructure development (see also Section II.A below on the enabling environment). The practical effect of these weaknesses at both central and local levels, however, has been allocative inefficiency in the selection of projects and areas for investment. Individual provinces select and undertake their own infrastructure projects, and compete with one another. Investment decisions are driven mainly by administrative considerations and the desire to develop projects that generate revenue, with only weak links to strategic national priorities and market-based mechanisms for the allocation of scarce resources. As pointed out by VDR 2012, across Vietnam there are nearly 260 industrial parks (IPs) under construction or already completed, 18 economic zones (EZs), 24 deep sea ports with more planned, and 20 operating airports with a few more in the pipeline; these numbers are disproportionately high in relation to the size of Vietnam's economy. Accordingly, the average IP occupancy rate is only 46 percent, many EZs have only slightly higher occupancy, and the utilization rate of Cai Mep-Thi Vai port is less than 30 percent, for example (VDR 2012).

**Figure 3. GDP growth decelerated from 2006, even as investment continued to rise (four-year moving averages)**



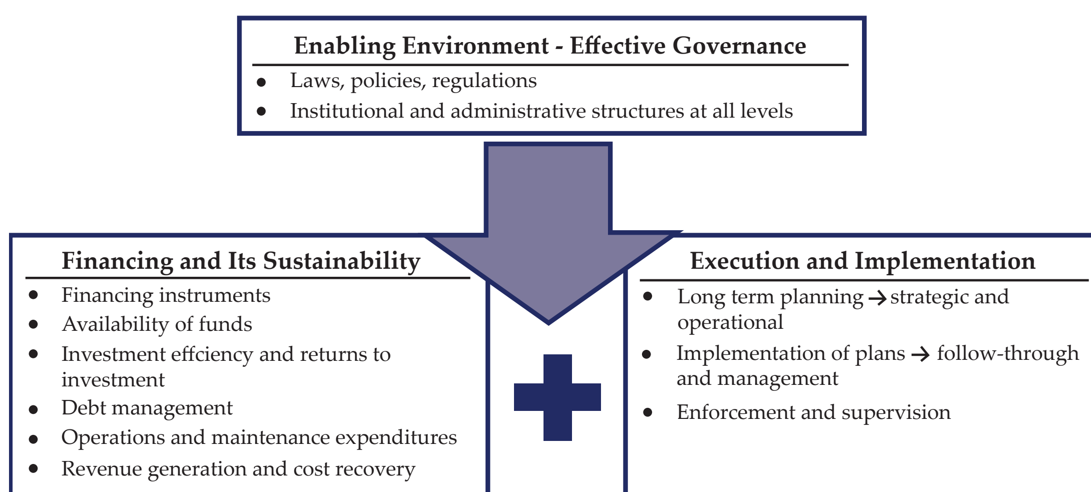

*Source:* World Development Indicators, World Bank as cited in VDR 2012.

## D. Comprehensive Approach – Governance, Financing, and Execution

**9. Meeting the challenges of municipal infrastructure in Vietnam requires a comprehensive approach that addresses issues of governance, financing, and execution.** Although this report focuses on financing issues, the success and sustainability of municipal infrastructure development in Vietnam also requires reforms in the areas of governance and execution. The discussion in the subsequent sections of this report is guided by this approach, which is illustrated in Figure 4. In line with this comprehensive approach, the work undertaken for this activity included top-down reviews of the national framework and international experience, and bottom-up case studies that provide the local perspective at the provincial level – details of which are available in the appendices to this report.

- Effective governance, in this context, refers to the framework of applicable laws, policies, and regulations in a wide range of areas that are of relevance to municipal infrastructure – including the roles and responsibilities of sub-national government, sub-national finances and borrowing, urban planning and land use, service delivery in various sectors, and private sector participation. Governance also includes institutional and administrative structures at national and sub-national levels, and their effective operation. Taken together, these constitute the enabling environment within which investments in infrastructure are made.
- Financing for infrastructure, to take a holistic approach, is not just about the quantity of funds available for investment. It also includes having appropriate financing instruments through which the needed funds can be raised, and considers overall financial sustainability in aspects such as operations and maintenance expenditures and efficiency, revenue generation and cost recovery, the management of debt and other liabilities, as well as the efficiency of, and returns to, investment.
- Execution that delivers sustained results refers to the ability first to plan strategically and operationally with a long-term view, and then to effectively implement planned activities and investments, with adequate follow-through and ongoing management. Implementation, in relation to governance and the enabling environment, is also linked to governmental and regulatory functions such as enforcement and supervision. Approaches strongly based on results can incentivize timely and efficient delivery.

**Figure 4. A comprehensive approach addresses governance, financing, and execution**



# 2

# The Existing Municipal Infrastructure Financing Framework

## A. The Evolving Enabling Environment

**10. Provinces (including provincial-level cities) are the most important level of sub-national government in Vietnam for most local infrastructure and services.** Vietnam has three distinct levels of sub-national government, each with certain autonomy in setting its own budget. The highest and most autonomous level of sub-national government consists of 57 provinces and five provincial-level cities (Can Tho, Da Nang, Ha Noi, Hai Phong, and HCMC). Cities and provinces are in turn divided into districts, precincts or towns (of which there are currently 690). These in turn are made up of wards, communes or villages (of which there are more than 10,000). The National Assembly approves an integrated State Budget every year, including revenue and expenditure aggregates, and intergovernmental fiscal transfers. At the sub-national levels, the provincial People's Councils (the legislative branch at these levels) review and approve budget proposals prepared by the respective provincial People's Committees (the executive branch) – including for the lower tiers of sub-national **government that fall under their jurisdiction.**

**11. In recent years, there has been a clear trend towards greater autonomy for sub-national governments, with the delegation of significant decision-making powers on public finances and infrastructure development.** As noted in AFD 2010, steps toward greater autonomy include Decree 12/2009 on public investment that subjects only the most important cases to central approval; Law 30/2009/QH12 on urban planning that gives greater latitude to local governments on zoning and building regulations; and various laws and decrees in 2007 on the water, waste and sanitation sectors. More broadly, the legal and regulatory foundations for municipal infrastructure finance in Vietnam are governed by multiple laws and decrees. These include*, inter alia*:

- The Law on State Budgets (2002) and the ensuing Decree 60/2003/ND-CP that details and guides its implementation (2003);
- The Law on Public Debt Management (2009);
- The Decree on the Issuance of Government Bonds, Government-guaranteed Bonds and Municipal Bonds (2011);
- The Law on Investment (2005);
- The Decree on Investments on the Basis of BOT, BTO and BT Contracts (2009); and
- The Public-Private Partnerships (PPP) Pilot Decision (2010).

**12. On the revenue side, the system of intergovernmental transfers and revenue sharing results in most provinces being net recipients of general government revenue.** The law assigns certain revenues to the local budgets, but the authority to set tax rates remains with the central government. Revenues available for local budgets include tax revenues that are fully assigned to provincial and city governments, tax revenues that provinces and cities have to share with the central government, other revenues assigned to local governments by the central government, and domestic borrowing. A growing share of government revenue is collected at the sub-national level, increasing from 30 percent in 2002 to 35 percent in 2012. Furthermore, the fiscal transfer system is pro-poor, with poorer provinces receiving higher per capita transfers – thus, only thirteen provinces are net revenue contributors, while 50 provinces are net recipients.

**13. On the expenditure side, provinces manage an increasing share of government expenditure, with broad definitions for capital investment and recurrent operating expenditures.** The

proportion of government expenditure executed at sub-national level has grown from 36 percent in 1996, to an estimated 45 percent in 2012. Provinces have the authority to assign expenditure responsibilities among district and commune governments, leading to differences in the way provinces manage expenditures. According to the law, capital expenditures include investments in the construction of socio-economic infrastructure projects and investments in State enterprises, economic organizations and financial institutions.

**14. The planning and implementation of municipal infrastructure investment reflect the overall trend towards greater local autonomy, but weaknesses in planning need to be addressed.** These weaknesses include the absence of a longer term budget/fiscal framework, poor coordination, and low levels of transparency. As mentioned in Section I.C above, one result of these weaknesses has been fragmentation and duplication of infrastructure investment. Formally, public investment projects must be based on the five-year Socio-economic Development Plan (SEDP), as well as on the relevant sectoral plan and master plan on land use. In practice, AFD 2010 observed that the SEDP is mainly an "exercise in style" where the most important thing is to formally comply with it. This is reinforced by the way in which provincial budgets are presented, where all investment expenditures are combined into a single category. This allows the provinces considerable flexibility on the details, while also being able to show achievement of the total volume of investments that had been agreed. To address this fragmentation and inefficiency, VDR 2012 proposed that the initial stages of the public investment management (PIM) cycle be strengthened, particularly strategic guidance and screening, project appraisal and review, and project selection and budgeting.

## B. Existing Financing Instruments: Effectiveness and Constraints

### i. Local government borrowing/debt

**15. In principle, the law indicates that local budgets should be balanced, but it also contemplates domestic borrowing (or "mobilization of capital") for investment in infrastructure projects.** According to the law, municipal debt can take the form of bonds, or loans from other lawful sources (including from the State Treasury). The conditions for domestic borrowing include meeting the criteria for project eligibility, approval by provincial-level People's Councils and by the MOF, and compliance with the borrowing limits established by the State Budget Law (30 percent of budgeted annual capital expenditure, or 100 percent in the case of Hanoi and HCMC). For the financing of revenue-generating projects, there are additional requirements, including the determination that the projects have the capacity to recover the capital invested, and explicit approval from the MOF. All projects to be financed by borrowing should be included in provincial-level budgets, and be part of the five-year plans of the provincial People's Councils. People's Committees prepare capital mobilization plans for the approval of the People's Councils; these plans must include the specific investment projects that will be funded with debt, the total investment capital to be mobilized, the form and cost of capital (interest rate) and projected sources of debt repayment.

**16. Decree 79/2010/ND-CP (Decree 79) defines various aspects of public debt management and establishes principles for the repayment of local governments' debts.** Aspects covered by this Decree include: debt management instruments; procedures for the borrowing, use and repayment of public debt; risk management and debt restructuring; accounting, statistical review and audit of debts; and public information on, and reporting of, public debts. This Decree includes a long-

term and medium-term framework for public debt management plans, and requires detailed annual plans for borrowing and debt repayment. Additionally, the Decree specifies benchmarks for the measurement and monitoring of public sector debt, as well as auditing and reporting mechanisms for all entities of the State. For on-budget loans, repayment must come from provincial-level budget funds. For loans used for programs and projects, revenues generated by these programs and projects are used to repay the loans first. When such revenues are insufficient for debt repayment, provincial-level budget funds must be allocated to repay the outstanding debts.

**17. Bond issuance has been the most prominent form of debt financing at the sub-national level, even though the State Budget Law does not specify it as the only way to obtain financing.** In early 2011, Decree 01/2011/ND-CP consolidated the regulations for the issuance of both domestic and international government bonds, and replaced the regulations contained in Decrees 141/2003/ND-CP and 53/2009/NC-CP. This Decree introduced more flexibility for the use of bonds, and links government bond issuance activity with public debt management goals. The Decree states that municipal bonds can be issued to fund investment in: (a) socio-economic development projects included in local budgets according to the State Budget Law, and under the investment portfolio defined in the five-year plan decided by the provincial People's Council; or (b) "local repayable projects" identified by the provincial People's Council. Municipal bonds are issued under bond issuance plans prepared by provincial People's Committees, accepted by provincial People's Councils, and approved by the MOF. Following the guidelines established in the State Budget Law, bond issuance plans must include the bond issuance objective, information on the projects to be funded, a repayment plan and the projected amount, maturity and interest rate on the bond. Municipal bonds are issued through tendering, underwriting or bond-issuing agents and must have maturities longer than one year. Municipal bonds need to be registered and deposited at the Securities Depository Center, and listed and traded on an exchange following the guidelines established by the MOF. Provincial People's Committees have responsibility for arranging for the payment of interest and principal on such bonds when due.

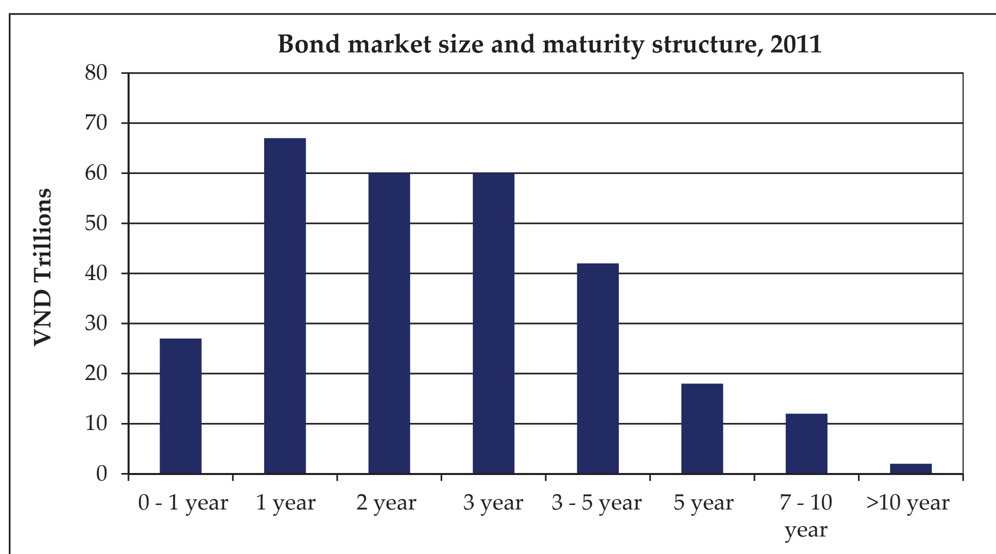
**18. The bond market in Vietnam is largely underdeveloped, with government bonds dominating the market.** The outstanding amount of government bonds stood at 18 percent of GDP in 2007, compared to 3 percent for publicly offered corporate bonds and 0.3 percent for municipal bonds. The principal purchasers of bonds have been state-owned commercial banks (SOCBs) and insurance companies. Both types of institutions are directed by the GOV to invest in bonds, in order to ensure full subscription of bond issue. At the same time, the demand for bonds is limited: there are few investors, especially institutional investors such as pension funds and mutual funds. Deficiencies in market infrastructure, including a lack of market makers for government bonds and of a credible credit rating system, as well as a fragmented and erratic payment and settlement system, are key weaknesses of the bond market. Figure 5 summarizes the size and maturity structure of the Vietnamese bond market in 2011.

**19. So far, the only sub-national governments that have accessed financing in the capital markets through bond issues are Hanoi, HCMC, Da Nang, and Dong Nai Province.** Of these, HCMC was the first to issue bonds, and the only one to have done so more than once: it successfully completed its bond issuance plan totaling VND 10,000 billion during the period 2003-2007 (VND 2,000 billion each year). As of the end of 2012, about VND 7,000 billion of HCMC's bonds were still outstanding. In the absence of a well-developed municipal bond market and limited demand from investors, as well as limited capacity at the provincial level and the lengthy central approval

process, all municipal bonds issued have had a maturity period of less than five years. The institutional and regulatory gaps that affect bond issuance are discussed further in Section II.C.

**20. In the commercial banking sector, lending to sub-national governments in Vietnam has been very limited.** Commercial banks are reluctant to finance local governments, and view lending for infrastructure as too risky, particularly in the absence of a clear recourse mechanism. Past policies of 'directed lending' for infrastructure and other sectors have meant that banks conducted little or no technical and risk assessments, with few incentives for banks to develop the technical capacity to evaluate and monitor projects according to commercial principles. The repayment capacity of projects and borrowers was rarely considered, because of the assumption of implicit guarantees by the local or central government. Loans were rarely secured with proper collateral, and those loans that did have collateral were in effect equivalent to project financing without recourse to the government sponsor. The result has been the accumulation of non-performing loans (NPLs), with loans often having to be restructured and extended. Lending by commercial banks is also constrained by the limited capital base of the banks, and maturity mismatches between short-term deposits and the long tenors needed for infrastructure loans.

**Figure 5. Short maturity periods of less than five years dominate the Vietnamese bond market**




*Source*: Ministry of Finance

**21. The Vietnam Development Bank (VDB) offers favorable terms for loans with longer tenors to sub-national governments, but such lending has also been limited and varies widely.** VDB, which is owned by the GOV, has only limited funds available at favorable terms, and it is often difficult to get access to such lending, which must be under a national target program approved by the GOV. Lending by VDB is also registered in the balance sheet of the central government, and is therefore less attractive for the government relative to lending by SOCBs. In the period 2005-2012, VDB provided a total of VND 3,362 billion to HCMC for financing municipal infrastructure projects, while the corresponding amount for Quang Nam was VND 68 billion and USD 3.8 million. Further details of VDB lending to the three case study provinces are discussed in Section III.D below.

### ii. Development Funds

**22. Local Development Investment Funds are special finance institutions created at the provincial level to mobilize capital and invest in municipal infrastructure.** LDIFs have the legal status of a sub-national state financial institution, and are expected to operate as commercial-oriented entities, raising medium and long-term capital from domestic and foreign sources, and investing in municipal infrastructure projects that will generate a sufficient financial return on investment. Following the creation of a pilot LDIF in HCMC – the Ho Chi Minh City Investment Fund for Urban Development, or HIFU – in 1997, the first law on LDIFs was promulgated in 2001, giving permission to all provincial governments to establish their own LDIFs. After multiple pilot projects, the precise definition of the operating mechanisms was defined in 2007 through Decree 138/2007/ND-CP on the Organization and Operation of LDIFs, which paved the way for the widespread implementation of the current version of LDIFs. LDIFs may mobilize up to six times their charter capital, from bond issues or from domestic and foreign (ODA) loans. In turn, LDIFs may invest in various ways, including issuing loans with maturities of up to 15 years, taking equity stakes in new companies, or entering into contracts with the private sector. Recently, GOV issued decree 37/2013/ND-CP in April 2013, which amends and supplements Decree 138. Significant improvements have been made through this latest decree on clarifying the sectors encouraged for investment, further delegating business decision-making to provincial People's Committees to attract more private sector investment for infrastructure, and providing for co-financing between LDIFs.

**23. The LDIF model has expanded considerably in Vietnam over the past decade, mobilizing significant amounts of capital for infrastructure investment.** Following the successful experience with HIFU, at least 28 other provincial governments have established LDIFs with the approval and support of the GOV. In 2004, the total charter capital of LDIFs in Vietnam was approximately USD 200 million; in 2011, it was estimated to be approximately USD 450 million. The average annual growth rate of operational capital among LDIFs between 2005 and 2011 was even stronger at 40 percent. The top seven LDIFs are investing approximately USD 100 million per year, accounting for an investment increase of 118 percent for these funds over the 2002 level. HIFU remains by far the most financially viable and operationally successful LDIF in Vietnam. It is recognized as a model LDIF in terms of internal policy and procedures, project appraisal, social and environmental safeguards and partnership with the private sector.

**24. The ongoing development of LDIF operations in Vietnam continues to be supported by the MOF and development partners.** The MOF has taken leadership over the coordination and supervision of LDIFs. A technical assistance program is underway to address key needs and allow the LDIFs to acquire the skills necessary for the implementation of Decree 138. At the same time, both AFD and the World Bank have been providing loans to LDIFs. The LDIFs that have qualified for such ODA funding have good financial positions, including very low non-performing loan ratios and acceptable profitability and balance sheet strength. The MOF carries out an annual qualification process to ensure the financial, operational and institutional soundness of LDIFs before they can receive ODA funding. Qualified LDIFs have a proven track record of building major infrastructure, which is currently operating adequately. They operate under a legally binding credit statute of the provincial government that mandates investment analysis to ensure cost recovery and provides guidelines for investment monitoring and workouts when necessary. These LDIFs also price their loans at market rates, and maintain annual audited financial statements based on accepted accounting standards.

### iii. Private sector participation and PPPs

**25. The legal and regulatory framework for private sector participation in infrastructure is given by the Decree regulating Concession Contracts (Decree 108/2009/ND-CP) and a Pilot Decision on Public-Private Partnerships (71/2010/QD-TTg).** Decree 108, also known as the Concession Framework, is a generic law, defining the sectors, conditions, procedures and incentives applicable to infrastructure projects developed under BOT (build-operate-transfer), BTO (build-transfer-operate) and BT (build-transfer) arrangements. The Concession Framework is applicable at the central and local level for the projects in the transportation, power, water and other infrastructure sectors. In April 2011, Decree 24/2011/ND-CP (Decree 24) modified some articles of Decree 108, and expanded the applicability of the Concession Framework to additional sectors: health, education and training, culture, sports, and facilities for state entities. To implement a BOT, BTO or BT project, the investor must establish a new project company following the procedures established in the Law on Enterprises and the Law on Investment. The authorized State body, the investor and the project enterprise sign a document permitting the project enterprise to assume and exercise the rights and obligations of the investor. In terms of project funding, Decree 108 establishes minimum equity ratios. For projects under VND 1.5 trillion, the equity of the project company must be equivalent to at least 15 percent of total investment capital; for projects over VND 1.5 trillion, the equity of the project company must be at least 15 percent for the first VND 1.5 trillion, and at least 10 percent for the portion of the investment above that threshold. The Decree also limits the contribution of public sector funds to 49 percent of total investment capital. However, public funding is not subject to this cap if it is used to support projects of high urgency through the construction of auxiliary works, land clearance or compensation for resettlement.

**26. The PPP Pilot Decision covers the provision of public infrastructure services through projects implemented jointly by the public and private sectors, with the overall goal of attracting private capital for investment in infrastructure development.** It covers the types of projects subject to the Concession Framework, as well as others such as build-own-operate (BOO) arrangements. It applies to the same infrastructure sectors as in the Concession Framework, and includes a specific reference to other sectors that were later included in Decree 24. Priority is given to large-scale projects required immediately for economic development; projects that allow for recovery of the capital invested through revenue from users; projects able to effectively use private sector capital, technologies and management competencies; as well as other criteria as may be defined by the Prime Minister. In terms of funding, the PPP Pilot Decision stipulates that the investor's equity capital must account for at least 30 percent of the private sector investment in the project. The investor can seek commercial loans and funding from other sources (without a government guarantee) to fund up to 70 percent of the private sector investment in the project. According to Circular 166, these funds must be mobilized in accordance with the project schedule and their disbursement must be certified to the Government. State participation in PPPs can take a variety of forms, including the provision of capital, investment incentives and other policies directed at enhancing the feasibility of the project. The total value of the State participation in a PPP cannot exceed 30 percent of the total project investment, unless otherwise authorized by the Prime Minister. The State contribution to the project cannot be considered as equity capital of the project company or generate the right to dividends.

**27. Several factors, mainly related to financing and risk management, discourage private sector participation in infrastructure projects in Vietnam.**

- First, most projects require subsidies in order to be financially viable, but there is no clear and transparent system to determine the magnitude of the government's financial support. Although the government offers support to BOT projects in a number of ways including through capital grants, land use rights and other forms of subsidies, these are not provided in a structured and transparent way.
- Second, most projects do not undergo sufficient preparation before they are put out to bid. Consequently, private sector bidders often lack important information on the risks associated with projects, and financial aspects such as tariff structures and government support, that would enable them to prepare detailed proposals. This in turn makes it difficult for the government to determine if a project offers better value as a PPP, or as a project fully financed by the public sector. At the same time, the government's infrastructure-related contingent liabilities, including those that arise from PPPs or other infrastructure ventures of SOEs, need to be managed better as part of a consolidated debt management system.
- Third, most infrastructure projects with private sector involvement have been undertaken without competitive bidding, increasing the risk of poor outcomes and inefficiency.
- Lastly, foreign investors face limitations on currency conversion, which compounds the currency risk arising from exchange rate movements.

### iv. Land for Infrastructure

**28. Current regulations allow the use of land for the creation of investment capital, in cash or in kind, for the construction of infrastructure.** Land can be used to finance infrastructure investments in two ways: the auction of land use rights to generate cash for the direct funding of construction works, or the combined bidding of a construction project with associated land use rights as a way to create capital for the construction works ('land for infrastructure'). Decree 181/2004/ND-CP of October 2004 establishes the general principles for these processes. Auctions of land use rights for cash consideration must clearly identify the land uses and the structure of the auction, as well as ensure proper separation between the auction of the rights and the bidding for the construction works. 'Land for infrastructure' schemes must also follow certain principles, including: (a) the point scales for assessing the construction works and the land use rights bids should be drawn up separately; (b) the provincial People's Committee must clearly identify the land use purposes and auction structure; and (c) the winning bidder must draw up a land use scheme to be considered and approved by the provincial People's Committee.

**29. More generally, the Land Law of November 2003 regulates the overarching legal framework for the administration and use of land in Vietnam, while Decree 181 regulates its implementation.** The law states that all land belongs to the people of Vietnam, with the State as the representative for the ownership of land. Leasing of land by the State means the grant of land use rights on the basis of a contract to an entity which has requirements for land use. Decree 181 provides guidance on various areas, including: land use planning, land assignment, land leasing, changes in land use purposes, land recovery, land requisition, registration of land use rights, land use rights in the real estate market, the rights and obligations of land users, land management, and settlement of land-related disputes and complaints. The Decree also defines the responsibilities of central and local

government agencies in regards to land management, and allocates ultimate decision-making to the central level. At the provincial level, responsibility for land management resides with the provincial Service of Natural Resources and Environment (the local land management agency). The district-level sections have responsibility for land management in their respective rural or urban districts, provincial capitals or towns. Decree 181 allows for the use of land for the execution of BT and BOT projects. For BT projects, the investors do not have to pay land use levies or land rents during the construction of works, and have to preserve the land areas assigned for the purposes intended under the project. Also, investors must comply with the transfer requirement established under the project and if they fail to do so, they must pay rent from the originally established date until the effective transfer of the land back to the government. For BOT projects, the State can either assign or lease the land to investors, who may benefit from exemption or reduction of land use levy or land rent.

**30. 'Land for infrastructure' is typically used as a financing mechanism in larger cities, where it can be the main source of funds for infrastructure investment, but its use raises several concerns.** The transfer of land use rights for real-estate development projects constitutes an important resource for the most dynamic provinces, with 'land for infrastructure' usually executed on a negotiated basis in the form of a BT contract. In HCMC in 2010, for example, land use levies generated VND 6.28 trillion for the provincial government – more than 17 percent of total revenue that year, although this represents a decline from the level in 2004 when land use levies were estimated to have accounted for 27 percent of total revenue. More broadly, there is no reliable information on how much Vietnam has actually mobilized through 'land for infrastructure'. Concerns have been raised in terms of the transparency of the land valuation process, as well as the degree to which local governments actually benefit from the increases in land value resulting from the improved infrastructure, especially if the land is valued according to the 'pre-development' market price. Neither the Land Law nor Decree 181 stipulate a particular process for land valuation under 'land for infrastructure' schemes. Resettlement costs are another concern, as these costs have to be assumed by the public sector, and add considerably to the overall cost of mobilizing land resources. A final concern lies in the quality of the infrastructure delivered by the private sector, especially for strategic projects that are large-scale, complex, and have significant investment requirements.

**31. The use of 'land for infrastructure' also faces limits: available land is finite, there are places where land values are not high enough, and private sector provision of infrastructure services is constrained.** It is widely expected that revenues from land use levies are in long-term decline, given that land is a finite resource which cities cannot keep selling indefinitely. As early as 2004, the Department of Finance of HCMC expected that would no longer be increases in revenue from land use levies after 2010 (UNDP 2005: 12). On the other hand, in the case of smaller cities, land values and land development are not very attractive to the private sector. Private sector investors often find it difficult to raise the large amount of financing for long term infrastructure in the local market, when the revenue from the sale of land provided under the BT contract has not been realized due to the absence of infrastructure needed to service the land in the first place. In addition, 'land for infrastructure' is not always an applicable instrument: the private sector is often reluctant, or not allowed, to provide public infrastructure and services being managed by public utilities, such as water or sanitation services. The institutional and regulatory gaps that affect 'land for infrastructure' are discussed further in Section II.C.

**32. Two examples of recent 'land for infrastructure' schemes consist of road construction and urban development projects that have been implemented using the BT scheme.** These projects were executed by POSCO and GS Consulting & Engineering Corporation (GSEC), respectively, both of South Korea. HCMC's Belt Road No. 1 project (10 kilometers) was led by GSEC, while POSCO led a road development project that connects Hanoi with the northern Hong River area. Under these projects, road construction is executed and funded by these companies that are granted the concession rights by the GOV, with the roads transferred to the government upon completion. The companies receive land development rights in return for bearing the cost of road construction, and construct residential properties and commercial buildings. The revenue realized from the sale of these properties is then used to recoup the cost of construction.

### v. Other financing instruments

**33. Sub-national governments may also obtain indirect international financing through the central government, which on-lends foreign funds (commercial, concessional or ODA) according to the guidelines established in the Decree 78/2010/ND-CP (Decree 78). The flow of ODA funds, however, is expected to slow as Vietnam becomes a solidly middle-income country.** Under this Decree, provinces have certain advantages relative to other sub-national borrowers – the central government's charge to cover operational expenses incurred in the management and recovery of on-lending does not apply to provincial governments. In order to benefit from on-lending, provinces must have socio-economic development projects that comply with established investment requirements, and a local budget with sufficient capacity to repay the debt. In turn, provincial-level People's Committees have the responsibility of making full and timely payment of debt obligations. The sources of debt repayment consist of the funds available under provincial-level budgets, and funds recovered under local investment projects that are capable of generating revenues. Prior to approving such on-lending, the MOF evaluates the provincial People's Committee's budget plan for the year in which the foreign loan agreement is signed, and the loan use and payment plan approved by the provincial-level People's Council. Provinces may borrow in either foreign or local currency, with differing interest rates depending on the nature of the original loan. For concessional and commercial loans, the on-lending interest rate is equal to the foreign lending interest rate. If the ODA on-lending is made in Vietnamese dong, then the on-lending interest rate includes an added exchange rate risk factor on top of the foreign currency lending interest rate.

**34. Many provinces and cities also finance and execute public infrastructure projects off-budget through public sector companies that manage and operate urban services**, including public lighting, road maintenance, street cleaning, waste management and sanitation. The provincial government appoints their senior managers, defines user fees, and subsidizes their operations if user fees are insufficient. Local public sector companies can receive loans from SOCBs and from the VDB. Some public sector companies operate in other areas of economic activity (in industry, commerce, and the financial sector) as a way to obtain additional resources to fund their 'core' activities that are not financially self-sustaining. The most advanced public sector companies are those located in the larger cities and some of these companies have even been partially privatized. According to AFD (2010), in 2009 HCMC had 381 public sector companies, operating in various sectors, including construction, transport and tourism. The same study mentions that an estimated 80 percent of the public investment of HCMC is made by these companies, while the remaining 20 percent is made directly by the provincial government.

## C. Key Institutional and Regulatory Gaps

**35. The current framework for municipal infrastructure investment lacks a proper mechanism for providing clear, transparent and efficient funding allocations.** Such a mechanism would need to link a coherent investment planning process at national and sub-national levels, to reduce unnecessary fragmentation and competition among provinces, with adequate and optimal allocations of funding from all available sources. Even when efficiently planned, many municipal infrastructure development projects are likely to need additional funding beyond what would be available through the conventional budgetary arrangements as currently stipulated in the State Budget Law. Thus, a transparent allocation framework can be developed to manage both State budget resources, which are increasingly transferred to the many provinces that are net recipients, as well as ODA resources, for municipal infrastructure. Directive 1792 of 2011 – on strengthening the management of investments funded by the State Budget and government bonds – is a step in the right direction, emphasizing the use of available capital for viable socio-economic infrastructure projects, and specifying the approach for allocating the proceeds of limited available bond capital for investment projects in an efficient manner.

**36. An adequate approach to managing sub-national debt arising from municipal infrastructure investment – including appropriate borrowing limits and an adequate recourse mechanism – is lacking.** Although the Public Debt Management Law allows the central government to lend to provincial governments, the Budget Law does not stipulate how lending and repayment are to be managed and integrated within the budget preparation and approval process. The existing formula for the borrowing limit for provinces does not reflect actual borrowing capacity, and fluctuates from year to year – this is because the limit for total outstanding debt for a province is set at 30 percent of the budgeted annual capital expenditure of that province (100 percent in the case of Hanoi and HCMC). Moreover, there is no clear legal framework for a recourse mechanism that would protect creditors in the case of a local government debt default, and which would be important for sub-national credit enhancement. According to the Public Debt Management Law, the only relevant clause on recourse is the Government Guarantee where the MOF is the Guarantee Provider to eligible entities and projects; the Law is silent on whether the sub-national governments can provide a guarantee, and this is interpreted as a formal prohibition of such guarantees.

**37. An enabling environment for the development of the municipal bond market does not yet exist.** In addition to the constraints already mention in Section II.B.i above, specific legal and regulatory changes would improve the environment for bonds. The State Budget Law allows provincial governments to issue municipal bonds, but the current appraisal procedure does not support increased and improved municipal bond issuance. This procedure requires the MOF's approval of a provincial government's entire plan for capital mobilization, which lengthens the overall bond issuance process. At the same time, this centralized approval for bond issuance does not enhance the autonomy, accountability and capacity of provincial governments in issuing their own bonds. The relatively small size and limited capacity of most provinces also suggests that allowing pooled financing – through joint bond issues by multiple provinces – would provide economies of scale in the face of high upfront fixed costs, and thus reduce the average cost of borrowing. As for transparency, the current municipal bond framework does not stipulate detailed requirements for information disclosure, nor does it encourage the use of ratings agencies – adequate information

disclosure that meets international standards would increase the transparency of bond issuance and comfort for investors.

**38. Existing arrangements for land-for-infrastructure need to be fine-tuned.** The land use planning process established in the Land Management Decree is very long, normally taking two years or longer to complete the necessary preparations and negotiations. In general, this Decree can generate certain constraints in the implementation of projects. First, the process is not standardized, creating concerns on transparency. Second, the price of land use rights is set before a project is developed, which does not allow local governments to capture the additional value created from development of the land. Third, there is no support mechanism to cover the high costs associated with the clearance of land for resettlement. A new decree to address these shortcomings is currently under preparation.

**39. Some of the market failures and regulatory shortfalls for the financing of municipal infrastructure reflect the absence of a specialized facility at the national level for credit enhancement, guarantee service, and funding of municipal infrastructure.** Such a specialized facility could help to address specific identified gaps, as well as be a demonstration of governmental commitment and policy effort on municipal infrastructure. Some or all of the functions that this facility could perform include:

- act as a municipal development fund investing in municipal infrastructure;
- raise long-term capital and provide long tenor loans to sub-national governments (potentially at a lower cost than what could be obtained through municipal bonds);
- co-finance municipal infrastructure projects that receive budget allocations to cover part of the investment, and provide oversight for the entire project, on behalf of the central government;
- provide guarantees for municipal infrastructure projects to financiers or private sector investors; and
- improve investment efficiency through the use of standardized investment appraisal processes.

# 3

# Municipal Infrastructure Financing at the Sub-national Level

## A. Overview

**40. This section is based on detailed case studies of HCMC, Quang Nam province, and Quang Ninh province, which represent different contexts/situations.** A bottom-up approach was utilized to evaluate the situation at the provincial level to identify constraints on the ground, and to assess local financing instruments that have proven to be successful or that can be improved. While HCMC is the main economic driver of the Southern Key Economic Zone, and Quang Ninh is a strongly growing province in the north, Quang Nam is still amongst the poorest provinces in Vietnam. Taken together, these three locations represent a cross-section of geographies and financial/fiscal positions. Table 1 summarizes some key economic and social features of the three locations, illustrating how they vary from across the three. For example, HCMC attracts vast sums of licensed foreign direct investment (FDI), relative to the other two provinces. At the same time, the licensed FDI is itself highly variable from year to year, as shown in Figure 6. A separate full report on the case studies for official use can be made available upon request.

**Table 1. HCMC, Quang Nam and Quang Ninh represent a cross-section of Vietnam's provinces**

| | Ho Chi Minh City | Quang Nam Province | Quang Ninh Province |
|---|---|---|---|
| Population in 2011 (millions) | 7.52 | 1.44 | 1.16 |
| Economic contribution (% of national GDP) | 20.2 | 0.4 | 2.2 |
| Income per capita (VND millions) | 68.2 | 8.4 | 47.0 |
| Licensed FDI in 2011 (USD millions) | 2,800 | 164.8 | 51.8 |
| Fiscal position within State Budget | Net contributor | Net recipient | Net contributor |

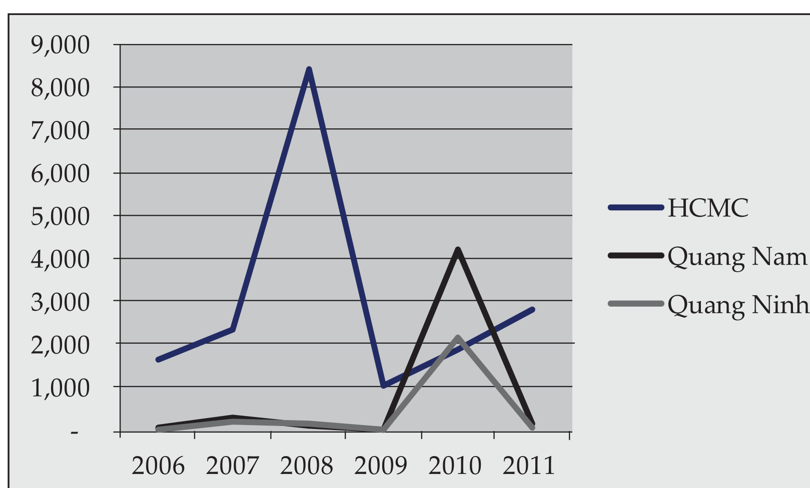
**41. Ho Chi Minh City, with a fast growing population of 7.52 million in 2011, and consistent and high economic growth over the last two decades, faces significant pressure for municipal infrastructure development** in sectors such as transport, water supply, drainage and wastewater treatment, solid waste disposal, housing, schools and health services. HCMC's actual population may be higher than suggested by the official statistics, with an estimated 2 million additional people in the city who are not registered with the local authorities. Drainage for both wastewater and storm water – and the threat of flooding – are serious issues, with more than half of the city's land lying just two meters above sea level.

**42. Quang Nam province has achieved some successes in economic development recently, but is still among the poorest provinces in Vietnam, accounting for just 0.4 percent of national GDP in 2011, and is a net recipient of fiscal transfers.** Located in the center of Vietnam with a total land area of 10,438 km$^2$ (of which 41 percent is forested) and a population of 1.44 million, Quang Nam is a coastal province and belongs to the Central Key Economic Zone. The terrain of the province consists of three ecological regions from west to east: the highland region, the midland region and the delta and coastal region. Quang Nam is located in the middle of the country's north-south traffic axis of for road, rail, sea and air traffic. In 1997, it separated from the former Quang

Nam-Da Nang province, and resumed its original name. The province now has 14 districts and two townships (Tam Ky and Hoi An). Key economic drivers include the Chu Lai Open Economic Zone, the Chu Lai Truong Hai Automobile Manufacturing Park, the North Chu Lai Industrial Park, the Dien Nam-Dien Ngoc Industrial Park, and the Vietnam Singapore Industrial Park.

**43. Quang Ninh province has registered strong economic growth in recent years – 12.1 percent in 2011, which was more than double the national growth rate that year – based on a diverse economic base.** Located along the northeastern coast of Vietnam, Quang Ninh is a mountainous and coastal province bordering China to the north, with a coastline of 250km and more than two thousand islands. The province is considered strategically important for both defense and economic development. Key economic drivers in Quang Ninh include the Van Don Economic Zone which aims to serve as an international trade hub and high-quality center for marine tourism and entertainment in the northern part of Vietnam (including Ha Long Bay, a World Heritage Site); and also the Mong Cai Border Zone. The province is rich in mineral resources, including coal, kaolin, clay, glass sand, and limestone. The coal reserve is about 3.6 billion tons, most of which is anthracite coal with high energy content. Coal mining is a backbone industry in the province, where mining generated 32 percent of provincial GDP in 2011 and is an important source of revenue.

**Figure 6. Licensed FDI has registered large inter-annual variations, in all three provinces**




## B. Effective Demand for Investment and Financing Gaps in the Existing Planning Context

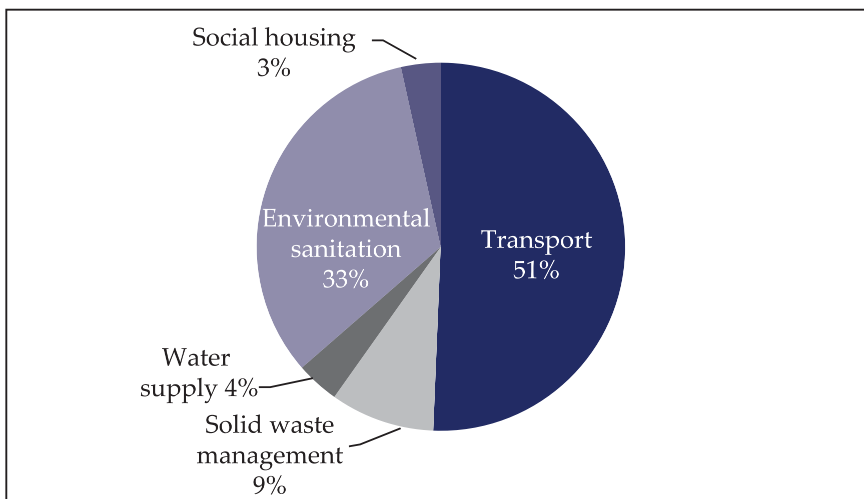
**44. At the provincial level, significant disconnects exist between total planned investment needs in infrastructure, and the effective demand for such investment.** These disconnects arise due to two main reasons. First, as already discussed in sections I and II above, weaknesses in Vietnam's decentralized structure and investment planning processes have resulted in systemic inefficiencies in infrastructure investment through fragmentation and unnecessary duplication. Therefore, it is likely that for any given province, the efficient level of investment would be lower than what is currently stated in investment plans. Second, available funding for investment falls significantly short of the financing needs arising from current investment plans. On the demand side, this reflects both

inefficiency in investment, as well as the lack of coordination and linkages between line agencies in the planning process, which results in projections for investment that reflect the unrealistic expectations of line agencies rather than the actual resources available. On the supply side, various constraints in the use of financing instruments are discussed in Section II above. Notably, from the provincial perspective, the availability of investment funding is highly variable from year to year, with a low level of predictability.

**45. For the reasons mentioned above, this report estimates the 'effective demand' for infrastructure investment in the three case study locations – the lower level of actual investment that can be reasonably expected, given improvements in investment efficiency and existing constraints in available funding.** Out of the total investment needs stated in existing infrastructure investment plans at the sub-national level, efficiency in investment would require each proposed investment to pass a value-for-money test, that also takes into account the financial capacity of the sub-national government and the financial viability of the project based on expected project revenues. For each case study, the estimates of effective demand were derived by the consultants based on available information and discussions with local officials and experts. For each infrastructure sector and financing source, an 'effective rate' of investment demand was estimated, based on the considerations mentioned above, in order to derive the amount of effective demand for financing relative to the full level of planned investment.

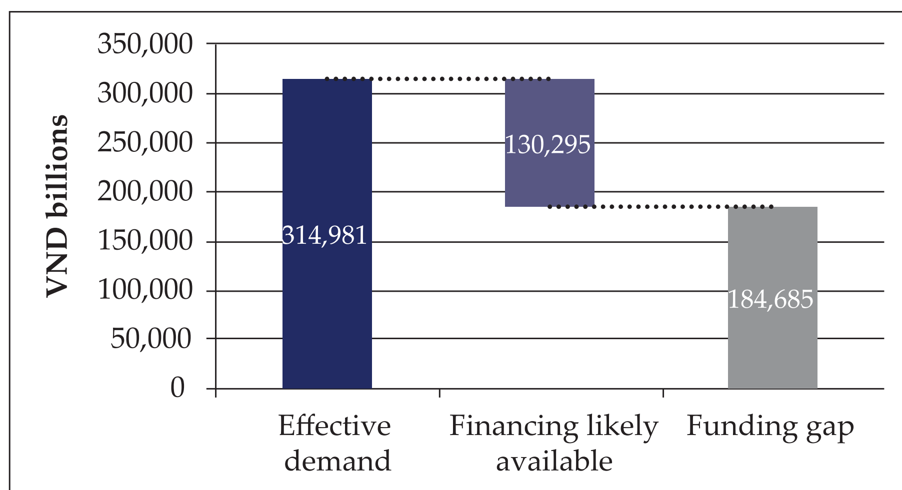
**46. The effective demand for infrastructure investment in HCMC for the period 2011-2015 is estimated to be VND 314,981 billion, with a funding gap of 59 percent, or VND 184,685 billion.** While the projected financing needs of all the key municipal infrastructure sectors for the period would reach VND 397,817 billion (not including an unknown amount for three solid waste projects), the effective financing demand is about 20 percent less. The funding that is likely to be available is limited to VND 130,295 billion, or 41 percent of effective demand. The transport sector and the environment sanitation sector account for more than 80 percent of total infrastructure investment needs for the period (see Figure 7). Accordingly, most of the capital shortfall is in the transport, environmental sanitation, and solid waste sectors. Table 2 summarizes the levels of current investment, effective financing demand, and financing gaps for various municipal infrastructure sectors in HCMC. Figure 8 illustrates the funding gap relative to effective demand and available financing. The HCMC government has been well aware of these funding gaps, and has proposed to raise funds from various financing sources, such as from the private sector through BT/BOT/PPP schemes, and the 'land for infrastructure' mechanism. However, a challenge for HCMC in pursuing these types of schemes is the need to have sufficient land – unencumbered and vacant (i.e., "clean" land) -- available, as well as having substantial funds available that may be needed to cover the costs of land clearance, compensation and resettlement.

**Figure 7. The transport and environment sanitation sectors account for more than 80 percent of HCMC's infrastructure investment needs for the period 2011-2015**




*Source:* Local Government Finance Assessment Report of Ho Chi Minh City, and estimates by the consultants, Vision Associates.

**Figure 8. HCMC faces a sizeable funding gap of 59 percent of effective demand**




*Source:* Local Government Finance Assessment Report of Ho Chi Minh City, and estimates by the consultants, Vision Associates.

**Table 2. Current level of investment, effective financing demand, available financing, and funding gaps of HCMC's municipal infrastructure sectors, 2011-2015**

(Units: VND billions, unless stated otherwise)

| Infrastructure Sector | Current Level of Investment[1] | Financing Needs | Effective Rate (%) | Effective Financing Demand | Financing Sources Likely Available | Funding Gaps |
|---|---|---|---|---|---|---|
| | A | B | C | D=BxC | E | F = D-E |
| **Transport financed by** | **16,870** | **201,479** | **84** | **170,054** | **46,983** | **123,071** |
| - Local budget | | 17,329 | 90 | 15,596 | 15,596 | - |
| - ODA | | 56,387 | 70 | 39,471 | 31,387 | 8,084 |
| - BT, BOT etc. | | 127,763 | 90 | 114,987 | to be identified | 114,987 |
| **Water supply** | **5,243** | **15,000** | **80** | **12,000** | **8,000** | **4,000** |
| **Environmental sanitation financed by** | | **130,978** | **72** | **94,481** | **70,328** | **24,153** |
| - State Budget and borrowings | | | | | | |
| + Wastewater drainage system | 335 | 9,523 | 90 | 8,571 | 8,571 | - |
| + Water collection and waste water treatment | | 52,717 | 90 | 47,445 | 47,445 | - |
| + Flood tide control | | 15,065 | 95 | 14,312 | 14,312 | - |
| - BT, BOT | | 53,673 | 45 | 24,153 | to be identified | 24,153 |
| **Solid waste management** | | **36,514** | **80** | **29,211** | **-** | **29,211** |
| **Social housing financed by** | 1,153 | **13,846** | **67** | **9,235** | **4,985** | **4,251** |
| - Local budget and socialization | | 5,538 | 90 | 4,985 | 4,985 | - |
| - ODA | | 6,369 | 50 | 3,185 | to be identified | 3,185 |
| - Central budget | | 1,938 | 55 | 1,066 | to be identified | 1,066 |
| **TOTAL** | **23,601** | **397,817** | | **314,981** | **130,295** | **184,685** |

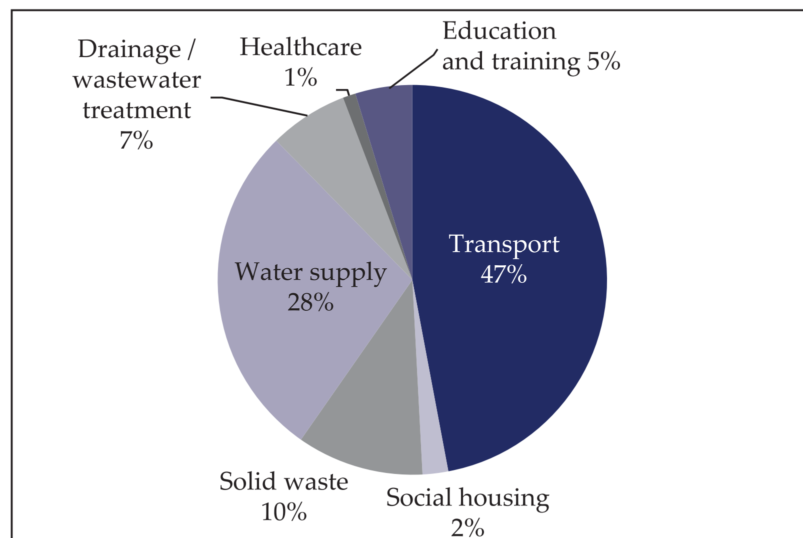
*Source:* Local Government Finance Assessment Report of Ho Chi Minh City, and estimates by the consultants, Vision Associates.

*Notes:* 1. Financed by State Budget over the period of 2010- 2012.
2. Not including three solid waste projects for which the level of investment is not yet known.

**47. The effective demand for infrastructure investment in Quang Nam, based on existing plans, is estimated to be VND 6,970 billion, with a funding gap of 34 percent, or VND 2,359 billion.** While the projected financing needs of all the key municipal infrastructure sectors for the period would reach VND 9,500 billion, the effective financing demand is about 25 percent less. The funding that is likely to be available is VND 4,610 billion, or 66 percent of effective demand. The transport and water supply sectors make up about three-quarters of total infrastructure investment needs for the period (see Figure 9). Although investment needs in transport seem to

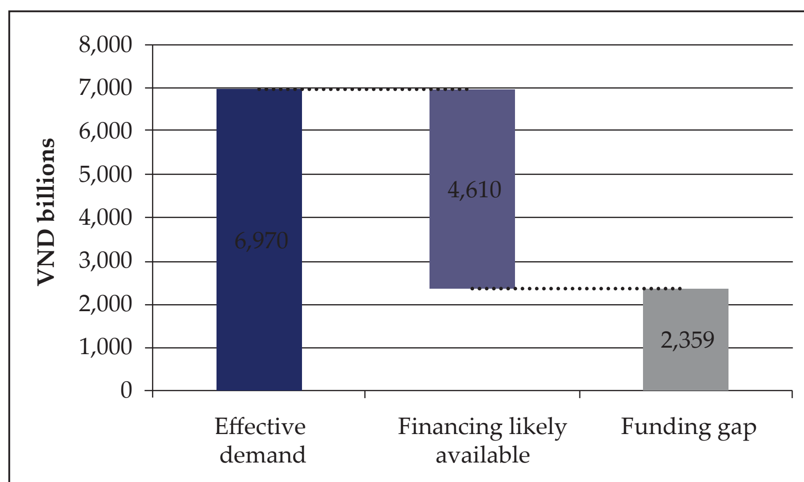
be adequately covered, those of water supply are not, which is where most of the funding gap lies. Table 3 summarizes the levels of current investment, effective financing demand, and financing gaps for various municipal infrastructure sectors in Quang Nam. Figure 10 illustrates the funding gap relative to effective demand and available financing. Because it is relatively poor, closing the funding gap in Quang Nam will be a challenge for the province. Unlike HCMC, Quang Nam has a low rate of urbanization, a less developed real estate market, and disadvantaged socio-economic conditions. Consequently, it is difficult to attract investors with sufficient technical and financial capacity, and thus 'land for infrastructure' or BOT/BT/PPP schemes would be relatively difficult to implement.

**Figure 9. The Transport and Water Supply Sectors Account for 75 Percent of Quang Nam's Planned Infrastructure Investment Needs**




*Source:* Local Government Finance Assessment Report of Quang Nam Province, and estimates by the consultants, Vision Associates.

**Figure 10. Quang Nam faces a funding gap of 34 percent of effective demand**




*Source:* Local Government Finance Assessment Report of Quang Nam Province, and estimates by the consultants, Vision Associates

**Table 3. Current level of investment, effective financing demand, available financing, and funding gaps of Quang Nam's municipal infrastructure sectors**

(Units: VND billions, unless stated otherwise)

| Infrastructure Sector (period) | Current Level of Investment<br>A | Financing Needs<br>B | Effective Rate (%)<br>C | Effective Financing Demand<br>D = BxC | Financing sources likely available<br>E | Funding Gaps<br>F = D-E |
|---|---|---|---|---|---|---|
| **Transport (2012-2015) financed by** | **3,274** | **4,469** | | **3,093** | **3,002** | **91** |
| - State Budget | | 4,288[1] | 70 | 3,002 | 3,002 | - |
| - BT | | 181 | 50 | 91 | - | 91 |
| **Water supply (2012-2020)** | **63** | **2,657** | **80** | **2,126** | **365 (local budget)** | **1,761** |
| **Drainage/wastewater treatment (2011-2015)** | **28** | **621** | **70** | **435** | **435 (ODA and local contributions)** | **-** |
| **Solid waste (2011-2015)** | | **1,001[2]** | **70** | **701** | **193 (local budget)** | **508** |
| **Health (2012-2015)** | **412** | **100** | **90** | **90** | **90 (State Budget, govt bonds)** | **-** |
| **Education and training (2012-2015)** | **657** | **450** | **90** | **405** | **405 (central budget, govt. bonds)** | **-** |
| **Social housing (2013-2015)** | **148** | **202** | **60** | **121** | **121 (borrowings, govt. bonds)** | **-** |
| **TOTAL** | **4,582** | **9,500** | | **6,970** | **4,610** | **2,359** |

*Source:* Local Government Finance Assessment Report of Quang Nam province, and estimates by the consultants, Vision Associates.

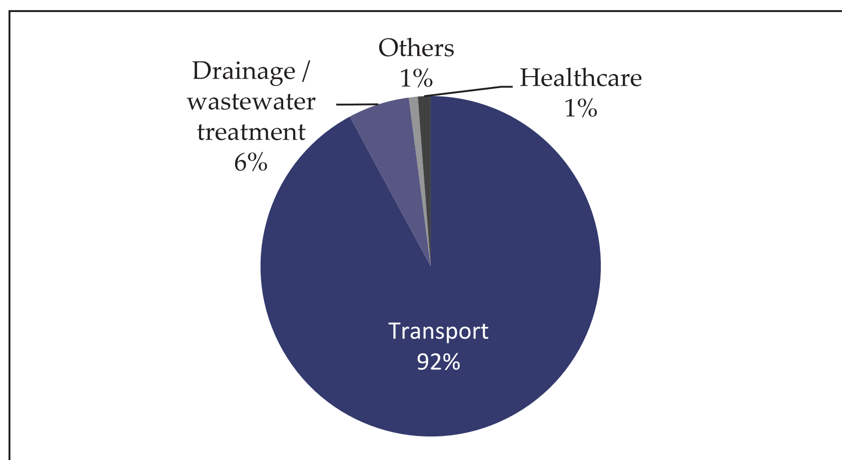
*Notes:* 1. By comparison, total spending by the State Budget in the transport sector for the period 2007-2011 was VND 3,274 billion, representing annual spending of VND655 billion.

2. By comparison, total spending in this sector for the period 2007-2010 was VND 110.5 billion, representing annual spending of VND27.6 billion.

**48. The effective demand for infrastructure investment in Quang Ninh, based on existing plans, is estimated to be VND 49,295 billion plus USD 842 million, with a funding gap of 88 percent for the VND portion – or VND 43,536 billion – and 100 percent for the USD portion.** While the projected financing needs of all the key municipal infrastructure sectors for the period would reach VND 78,538 billion plus USD 1,393 million, the effective financing demand is about 40 percent less. The funding that is likely to be available is VND 5,760 billion, which is a mere 12 percent of effective demand. The transport sector accounts for the lion's share of total infrastructure investment needs for the period, at 92 percent (see Figure 11). Table 4 summarizes the levels of current investment, effective financing demand, and financing gaps for various

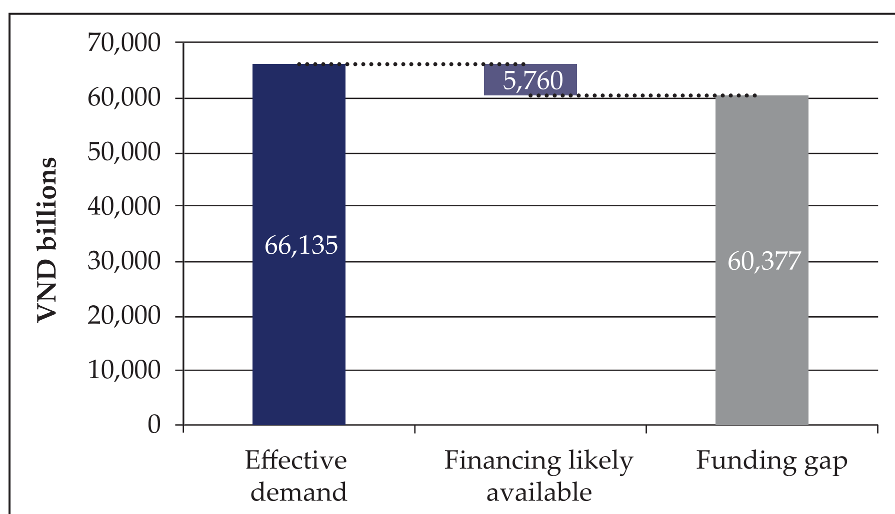
municipal infrastructure sectors in Quang Ninh. Figure 12 illustrates the funding gap relative to effective demand and available financing. Given the very large funding gap in the province, even after considering effective demand, it would be too ambitions for Quang Ninh to mobilize all the financing required to close this gap, especially in comparison to the current level of investment by the State Budget. The province expects to boost fund mobilization though BT/BTO/PPP, going forward, but similar to HCMC, the challenge in pursuing these types of schemes is the need to have sufficient 'clean' land available, as well as having substantial funds available for land clearance, compensation and resettlement costs. Moreover, real estate prices in Quang Ninh are far lower than in HCMC, thus limiting the opportunities for 'land for infrastructure' and BT/BTO schemes.

**Figure 11. The transport sector accounts for 92 percent of Quang Ninh's planned infrastructure investment needs**




*Source:* Local Government Finance Assessment Report of Quang Ninh Province, and estimates by the consultants, Vision Associates.

**Figure 12. Quang Ninh faces a vast funding gap of around 90 percent of effective demand**




*Source:* Local Government Finance Assessment Report of Quang Ninh Province, and estimates by the consultants, Vision Associates.

**Table 4. Current level of investment, effective financing demand, available financing, and funding gaps of Quang Ninh's municipal infrastructure sectors**

(Units: VND billions/USD millions, as indicated)

| Infrastructure Sector (period) | Current Level of Investment<br>A | Financing Needs<br>B | Effective Rate (%)<br>C | Effective Financing Demand<br>D = BxC | Financing sources likely available<br>E | Funding Gaps<br>F = D-E |
|---|---|---|---|---|---|---|
| **Transport financed by** | **VND 1,661** | **VND 71,430<br>USD 1,329** | **61<br>60** | **VND 43,873<br>USD 798** | **VND 3,045** | **VND 40,828<br>USD 798** |
| - State Budget (2012-2015) | | VND 3,383 | 90 | VND 3,045 | VND 3,045 (State Budget, govt. bonds) | - |
| - ODA (2012-2016) | | VND 8,604 | 60 | VND 5,162 | being mobilized | VND 5,162 |
| - BT, BOT, PPP | | VND 59,444<br>USD 1,329 | 60 | VND 35,666<br>USD 798 | to be identified | VND 35,666<br>USD 798 |
| **Water supply (to 2020)** | **VND 1,617** | **VND 606** | **85** | **VND 515** | **VND 515** | **-** |
| **Drainage/ wastewater treatment** | **VND 338** | **VND 6,202** | **75** | **VND 4,652** | **VND 1,945 (local budget)** | **VND 2,708** |
| **Health (2011-2015)** | **VND 946** | **USD 64** | **70** | **USD 45** | **to be identified** | **USD 45** |
| **Social housing (2013-2015)** | **-** | **VND 300** | **85** | **VND 255** | **VND 255 (local budget)** | **-** |
| **TOTAL** | **VND 4,563** | **VND 78,538<br>USD 1,393** | | **VND 49,295<br>USD 842** | **VND 5,760** | **VND 43,536<br>USD 842** |

Source: Local Government Finance Assessment Report of Quang Ninh province, and estimates by the consultants, Vision Associates.

**49. In the face of these very real funding gaps, sub-national governments in Vietnam have to make hard decisions on tradeoffs, when determining which infrastructure investments are to proceed.** Tradeoffs, in and of themselves, are characteristic of any environment that is resource constrained. However, it should be reiterated that in the context of municipal infrastructure investment in Vietnam, this problem is exacerbated by the weaknesses in the planning process. It would appear that most commonly in the planning process, the costing of infrastructure proposals is secondary, resulting in rough and unrealistic estimates of the total financing amounts required. In practical terms, one then has to work backwards to see what can be achieved from available funding sources. It then becomes a matter of tradeoffs between what can be started and what has to be deferred, and the delays are then passed on into the next planning period.

## C. Financing Operations and Maintenance: the Challenge of Cost Recovery

**50. In HCMC, cost recovery for operations and maintenance of water supply service is relatively high, but inadequate for wastewater and solid waste, where significant government subsidies are provided.** Water tariffs are regulated by the HCMC People's Committee, and adjusted every year. Current piped water tariffs[3] are: households: VND 5,300–VND 11,400/m$^3$; manufacturing: VND 9,600/m$^3$; government offices: VND 10,300/m$^3$; trading and services: VND 16,900/m$^3$ (all VAT exclusive). As a result of the increased water tariffs, some water companies in HCMC have recorded profits in recent years. However, these results may not fully reflect the actual financial situations of these companies, where the sector may be covering operations and maintenance (O&M) but not actually achieving full cost recovery that includes all capital costs. For wastewater treatment, HCMC charges 10 percent on the invoiced amount for tap water (VAT exclusive) based on Decision 88/2010/QD-UBND. In 2013, fees for industrial wastewater treatment were increased ten-fold with Decree No.25/2013/ND-CP. So far, the reported performance of wastewater fee collection in HCMC is poor, with achievement of 20-30 percent of annual targets[4]. In the solid waste sector, in 2012 HCMC spent VND 1,500 billion for solid waste collection and treatment, while fees collected amounted to only VND170 billion. The current average fee for solid waste per household in HCMC is VND20,000/month, which is much lower than the actual costs of providing the service. Thus, the state in effect subsidizes a large part of the full costs of providing these services. In the next five years, HCMC is expected to increase relevant service fees to ensure movement towards full cost recovery in this sector.[5]

**51. In Quang Ninh, cost recovery for municipal services is improving from a low base.** As reported by Quang Ninh Clean Water One Member Company Limited (QUAWACO),[6] the average water production cost of the company in 2012 was VND 7,265/m$^3$, while the average sale price was VND 6,110/m$^3$, meaning a loss of VND 1,155/m$^3$. As with other privinces in Vietnam, water tariffs in Quang Ninh are regulated by the People's Committee, and in 2012 were adjusted to:[7] households: VND 6,200–VND9,300/m$^3$; government ofices: VND7,800/m$^3$–VND 9,300/m$^3$; manufacturing: VND 10,100/m$^3$; trading and services sector: VND 14,000/m$^3$–VND19,000/m$^3$ (all VAT exclusive). This tariff structure is expected to increase the average water sale price to VND 7,800/m$^3$, which would be a level sufficient to cover O&M costs. Nevertheless, although water supply in Quang Ninh is no longer subsidized, full cost recovery is still an open question, since the assets of Quang Ninh water companies are likely undervalued, as is the case in HCMC. At the same time, the water loss rate of QUAWACO declined from 26.1 percent in 2010, to 24.2 percent in 2012, which is still high by international standards. QUAWACO plans to further decrease this rate to 22.5 percent by 2015. For wastewater treatment, Quang Ninh currently applies the

3 Based on Decision No.103/2009/QD-UBND dated 24/12/2009 by HCMC PC on water tariffs for the 2010-2013 period.

4 http://www.vcci.com.vn/phap-luat/20130512065142959/nghi-dinh-252013ndcp-go-vuong-ve-thu-phi-nuoc-thai.htm

5 Saigon Times Online (http://www.thesaigontimes.vn/Home/dothi/hatang/96101/)

6 http://www.baoquangninh.com.vn

7 Based on Decision No.1582/2012/QD-UBND dated 27/6/2012 by Quang Ninh PPC approving the water pricing plan and the water tariffs of Quang Ninh Clean Water One Member Company Limited, effective from 1/7/2012.

environment protection fees on municipal wastewater at 6 percent and 7 percent of water bill value, for households and other entities, respectively. This is based on Decision 3313/2010/QĐ-UBND. From 2013, environment protection fees for industrial wastewater treatment were raised ten-fold by Decree 25/2013/ND-CP.

**52. In Quang Nam, cost recovery has a long way to go, even as levels of existing service coverage are low. The situation can be expected to become more serious, as the quantity of infrastructure grows, and the required O&M expenditures increase commensurately.** Over 19 percent of the population of Quang Nam province received running water from centralized water supply sources as of the end of 2010, mainly in the districts of Tam Ky, Thang Binh, Dien Ban, Nui Thanh, and Hoi An. Fee collection faces considerable difficulties due to levels of public awareness of the need to pay fees for clean water supply. There is thus a shortage of funds for O&M each year, which leaves water production facilities in poor condition. Furthermore, these water supply systems use purification with sand, gravel and grit to meet low standards of hygienic water, but not the standards of TCVN:02/2009/BYT. Water tariffs, based on Decision 12/2012/QD-UBND in Quang Nam are currently: households: VND 4,700–VND 5,500/$m^3$; government offices: VND 8,000/$m^3$; manufacturing: VND 7,500–VND8,500/$m^3$; trading and services: VND 8,500–VND 9,500/$m^3$ (all VAT, environmental protection fees inclusive). This tariff structure is much lower than that of HCMC and Quang Ninh province.

## D. Utilization of Existing Financing Instruments: a Story of Variability

**53. Among the three sub-national governments of HCMC, Quang Nam province, and Quang Ninh province, there has been practically no borrowing from commercial banks.** The reasons for this have been discussed in Section II.B above, with constraints on the demand side related to how, and how much, sub-national governments may borrow, as well as on supply side with commercial banks being reluctant to lend. It should be noted that these statements apply to the provincial governments themselves. In HCMC, for example, HIFU/HFIC – the local development investment fund – has taken some *ad hoc* commercial loans from foreign banks such as Crédit Agricole and Société Générale, for financing municipal infrastructure in the city. These loans have been backed by government guarantees, but their small number and volume do not constitute an active commercial loan market to sub-national governments. Furthermore, SOE borrowing for municipal infrastructure is substantial – the World Bank has estimated that of the VND 55,559 billion of infrastructure financing from SOCBs in 2007, more than half of these loans were made to SOEs, and more than one-quarter was for municipal infrastructure (World Bank 2008: 22-23).

**54. The three sub-national governments have a track record of borrowing from VDB for municipal infrastructure investment, but the scale of financing varies by orders of magnitude.** According to VDB, in the period 2005-2012, 18 credit facilities totaling VND 3,362 billion were provided to HCMC for financing municipal infrastructure projects, and the outstanding loan balance is now VND 1,336 billion. In Quang Ninh, VDB granted credit facilities totaling VND 620.4 billion to five municipal infrastructure projects, between 1999 and 2012. As for Quang Nam, credit facilities of VND 68 billion and USD 3.8 million were provided for three municipal infrastructure projects, in the period 1998-2010.

**55. Municipal bonds, another form of borrowing, have only been issued by HCMC so far, and not by Quang Ninh or Quang Nam.** As mentioned in Section II.B above, HCMC was the first sub-national government in Vietnam to issue bonds. Between 2003 and 2007, HCMC successfully completed its municipal bond issuance plan, raising a total of VND 10,000 billion, or VND 2,000 each year. As an arms-length body of HCMC, HIFU was an authorized entity that issued these bonds on behalf of HCMC. In addition, Quang Ninh is now reported to be in the process of preparing its first bond issue.

**56. The local development investment fund as a financing instrument has been most successful in HCMC, with a solid track record, while Quang Nam's LDIF has followed more recently.** HCMC was the first sub-national government in Vietnam to set up an LDIF, with the experience of HIFU since 1996 widely recognized as a success story (see also Section II above). HIFU is regarded as a model LDIF in terms of internal policy and procedures, project appraisal, social and environmental safeguards and partnership with the private sector. With a strategic focus on municipal infrastructure finance and aiming to be a more effective financing vehicle, HIFU has been recently restructured into HFIC. In Quang Nam, the Quang Nam Development and Investment Fund (QNIF) was established in 2009. With charter capital of VND 128 billion, QNIF has invested in 24 projects in various sectors such as transport, water supply, drainage, healthcare, education, infrastructure of residential and urban areas, and industrial parks, with a total investment outlay of over VND 383.5 billion. There is no LDIF in Quang Ninh.

**57. The involvement of the private sector in financing infrastructure investment has been variable across the three locations, with HCMC being the most advanced.** HCMC has experience with developing and implementing BOT/BT schemes, with more than 60 projects already implemented or in pipeline. Most of these projects are in the transport sector. Such schemes are considered effective for raising money for financing local municipal infrastructure projects when budget sources are limited. There is also one pilot PPP project in the transport sector in the HCMC area, the Dau Giay–Phan Thiet Expressway. For management and implementation of this pilot PPP project, the Prime Minister has issued a specific mechanism in favor of this project where some incentives (such as the costs for ground clearance, resettlement, removal of utility facilities, and bomb /land mine disarming) are funded by the State Budget. Quang Ninh province has not been involved in any BTO/BT project so far, but nine projects using land resources ('land for infrastructure') with a total investment value of VND 656.2 billion were approved during the period of 1998–2002. Eight of these projects were in Ha Long City, and one in Van Don district. Quang Nam has implemented only one BT project so far, in which the local government pays the investor in cash. Quang Nam province has also attempted to implement projects under the 'land for infrastructure' mechanism since 2011, but most of the projects failed to meet the implementation schedule, and some even had to return the allocated land (for example, the Cua Dai bridge). Reasons include high cost overruns for land compensation and clearance, while property prices did not increase as expected. Box 1 describes another example of an unsuccessful 'land for infrastructure' project in Hanoi.

**Box 1. The Nam Cuong group returned an infrastructure project**

Building a north-south arterial road in former Ha Tay province, now merged with Hanoi, was one of the projects to be undertaken by Nam Cuong Group as an infrastructure developer. Nam Cuong stepped into the project in 2007 when the property market was vibrant. The project involved building a 63.3 km long, 42-meter-wide road at an estimated cost of VND 7,694 billion. In exchange, Nam Cuong was given 10,000 hectares along the road by the former Ha Tay provincial People's Committee, to develop four urban areas.

Nam Cuong reportedly pumped over VND 1 trillion into site clearance, compensation and building an overpass crossing Thang Long Avenue. The project then incurred delays as it had to wait for results from authorities' reviewing planned construction projects in the Hanoi area, and for the approval of Hanoi's expanded master planning. In mid-2012, Nam Cuong returned the project to the Hanoi authorities. How construction of the road is to continue to completion remains unclear. Other developers believe that one of the key reasons causing the return of project by Nam Cuong is the recent downturn in real estate market.

*Source:* www.vietnamnet.vn

## E. Execution at the Local Level: the Need for Strengthened Capacity

**58. Sub-national governments in Vietnam have limited resources and capacity to deliver on their municipal infrastructure needs. To enable adequate execution at the local level, strengthened capacity is needed at every stage of the investment cycle: planning, project management, and financing.** The weaknesses in planning processes have already been mentioned earlier in this report. In brief, the process of socio-economic development planning is complicated and overlapping, involving multiple steps and levels. Plans are driven more by expectations than by actual resource availability. Systematic improvements to planning processes would have a significant positive impact on local governments. Capacity at the local level is also needed for the various stages of the project life cycle: project identification, preparation, screening, selection and appraisal. This is especially important for projects that involve the private sector. As for capacity related to financing, this entails the strengthening of broad areas of municipal finance, such as skills and knowledge of public debt management at the local level, and the creation of debt management functions/units within the sub-national government apparatus. Know-how related to specific financing instruments is also needed – examples would include: municipal bond issuance planning and implementation, and the designs and management of contracts for private sector participation (e.g., PPPs).

# 4

# The Applicability of International Experience

## A. Overview

**59. This section analyzes the experiences and lessons learned from selected financing instruments for municipal infrastructure around the world, and discusses their applicability and relevance to the Vietnamese context.** Specific attention is paid to the enabling environments and best practices that made these instruments successful in their respective contexts. Successful models include municipal development funds: public funding intermediaries in Tunisia and market-oriented financial intermediaries in Colombia, Czech Republic and South Africa; credit enhancement entities in the Philippines and Indonesia; land-based infrastructure financing schemes in China, Brazil and Colombia; and PPPs in Brazil. (Full details of these models are given in Appendix II of this report.) In meeting the needs of Vietnam, there is consensus that an effective framework for financing municipal infrastructure should:

- provide access to predictable, long-term funding sources for infrastructure, and at the same time put in a place a clear accountability system for local governments;
- integrate well with intergovernmental fiscal arrangements, as budgetary sources and discipline play a key role; and
- improve the investment planning and appraisal capacity of local governments, as well as their capabilities for risk management, project implementation, operations and maintenance, and asset management.

## B. Debt financing/Borrowing

### i. Sub-national debt management

**60. Sub-national debt management has been commonly implemented in many countries, in order to effectively manage and promote sub-national borrowing.** Approaches for sub-national debt management, especially on the amount of debt allowed, vary across countries. While some countries allow sub-national governments to have unlimited borrowing authority under relevant laws, others adopt rule-based controls of sub-national borrowing by applying indicators for debt limits, such as the debt service ratio and the borrowing-to revenue ratio. The limit on sub-national borrowing is often set based on the repayment capacity of each municipality, rather than on the ratio of local government borrowing to its capital investments which is the case in Vietnam currently.

**61. China has experienced significant challenges with managing the debt of its sub-national governments, from which useful lessons can be drawn for Vietnam.** As described by the IMF, there is considerable local government-related activity in China that is off-budget quasi-fiscal in nature (IMF 2013). Local governments in China faced a general prohibition on borrowing, and thus have resorted to off-budget activity, including land sales, to help finance investment in infrastructure (see also Section IV.C on land-based financing in China, below). The IMF notes that local government-related entities have significantly increased borrowing since 2009, and has calculated that the level of "augmented" government debt – including the debt of local government-related entities and off-budget funds -- in China in 2012 was 45 percent of GDP (IMF 2013). A key challenge for China is thus to mitigate risk in local government finances, for which the IMF has recommended: (a) establishing and enforcing an institutional framework that limits government

debt, contingent liabilities, and off-budget borrowing (such as a fiscal responsibility law); (b) integrating government and government-related entities' investment spending into an overall public investment strategy; and (c) improving data and transparency on off-budget fiscal operations, fiscal risks, and contingent liabilities. Not only is the situation in Vietnam rather similar, with the vast activities and borrowings of local public sector companies (see Section II.B.v), but it is also striking that many of the recommendations being made for China in this area seem quite applicable to Vietnam today.

### ii. Municipal Bonds

**62. The first municipal bond issuance without a state guarantee in India was that of the Ahmedabad Municipal Corporation (AMC) in 1998. A few key lessons can be derived from AMC's experience, all of which can be emulated by Vietnamese provinces seeking to issue bonds.** AMC, an urban local body, issued INR 1,000 million (USD 25 million) of municipal bonds to partly finance a water supply and sewerage project. The first lesson relates to the fiscal and management reforms for bond issuance. Since 1994, AMC had instituted significant reforms, including improved tax collection, computerizing its accounting system, and strengthening AMC's workforce and financial management. AMC launched a major effort to improve collections of octroi tax, a tax on various goods brought into town. The second lesson is on obtaining an improved credit rating. In 1996, AMC received an initial credit rating of "A+" for its bond issuance by CRISIL, an independent rating agency. Following this rating, AMC revised the financial structure of the bond offering and added several credit enhancement features by setting up an escrow account of octroi taxes collected at ten collection centers, and a sinking fund for principal repayment. AMC also pledged all octroi taxes and other income to bondholders in the event that revenues from the ten collection centers were insufficient to make debt service repayments. Thus, the bond issuance was in effect a general obligation bond. With these additional efforts, AMC received an improved rating of "AA". The third lesson is on improving transaction documents. In municipal bond transactions, the disclosure (prospectus) document and trustee indenture are the important financial documents. In addition to a general overview of the economic, environmental and fiscal condition of the AMC, the prospectus provided sufficient details of internal and external risks for investors, in accordance with international norms.

## C. Land-based Financing

**63. Three models of land-based financing were examined in the International Experience Review: (a) land leasing in China; (b) sales of land development rights in Brazil; and (c) betterment levies in Colombia.** In China, all land is owned by the municipal government. The purchaser of a land lease acquires land rights for a period of 40 to 70 years. Many cities have financed half or more of their very high urban infrastructure investment levels directly from land leasing. According to the Chinese laws, from 2002, all land leasing must be conducted through bidding at auction. An illustration of this model is the construction of the outer ring road encircling the region around Changsha, the capital of Hunan province in central China. To finance this project, the municipality transferred to a public-private agency – the Ring-Road Investment Corporation – the leasing rights for strips of land 200-meters wide on the both sides of the highway that was to be built.

**64. The model of land-based financing, similar to that used in China, has already been used in Vietnam.** During the period 1999-2004, prior to the effectiveness of the Land Law of 2003, land-based financing in the form of the 'land for infrastructure' mechanism was allowed but subject to the approval of the Prime Minister for each project. Since the date of effectiveness of the Land Law of 2003 (i.e., 1st July 2004), the land-based financing in the form of a BT project is also allowed, where the use of land for creation of investment capital for construction of infrastructure could be implemented in either of the two following forms: (a) auction of land use rights to raise funds for direct investment in infrastructure construction; and (b) bidding of construction of works and auction of land use rights for construction of such works in the same bidding package. The current draft of the amended Land Law,[8] dated 28/01/2013, which was published to get the comments from Vietnamese people, contains a provision (in Article 60.3) allowing the withdrawal of land parcels in the areas surrounding the infrastructure works[9] to be built.

**65. In Brazil, the sale of land development rights is an alternative to the sale of land to capture the incremental land value generated by public infrastructure projects**. In this model, public authorities sell land development rights, which can be either (a) the right to convert rural land to urban use; or (b) the right to build at greater densities than would normally be allowed by existing zoning rules or height restrictions. This model has not yet been applied by any province in Vietnam. Although it does not seem to be contrary to the prevailing laws of Vietnam, to make it workable, explicit mention of this possibility could be made in the revision to the Land Law, with detailed guidance in the sub-laws to enable smooth application.

**66. In Colombia, betterment levies are charged directly on the increments in land values created by public works**. Such levies could be imposed on a one-time and upfront basis. In this Colombian model, a land parcel within a special planning district for conversion into urban use that is authorized by the municipal government could be subject to a betterment levy of between 30 and 50 percent, at the municipality's discretion. Payment of the betterment levy is due on the realization of the gain in land value at the time of sale or development. Betterment levies are not yet applicable under the prevailing laws of Vietnam, and would thus be difficult to apply unless the necessary legal and regulatory changes are made.

## D. Specialized Instruments/Entities to Respond to Specific Needs

### i. Municipal Development Funds

**67. Municipal development funds (MDFs) are identified in the International Experience Review as either public funding intermediaries, as in Tunisia, or market-oriented financial intermediaries, as in Colombia and the Czech Republic.** The Tunisian MDF – *Caisse de Prêts et de Soutien des Collectivités Locales* (CPSCL) – is a wholly public institution that provides financing only

8 The current draft of the amended land law seemed to be made in line with Resolution No.19/NQ-TW of the Sixth Conference of the Central Committee of the Communist Party of 11th Session on renovation of land policy.

9 According to this draft, infrastructure works include transportation, power, irrigation, water supply, drainage, waste collection and treatment, communications, oil & gas pipelines and storage, and other works in accordance with the laws on investment and construction.

to local authorities as part of the Tunisian state's five-year development plan. It provides financing at below-market rates, often combining subsidized loans with grants. CPSCL is not a bank, and is thus not subject to Tunisian banking regulations. It has been considering changing its status to that of a wholly state-owned, limited liability company in order to have greater autonomy in its daily operations and develop a broader client base.

**68. The Colombian MDF, FINDETER (*Financiera de Desarrollo Territorial*), acts as a second-tier lender, encouraging first-tier lenders (commercial banks) to lend directly to local governments and to corporatized entities under the control of a local government.** FINDETER is a local government development finance company that is 90 percent owned by the Republic of Colombia, with the balance of ownership held by Colombia's local governments. It gets funding from the national government and donors (e.g., loans). FINDETER lends at a discounted rate to a commercial bank, to cover all or part of a loan first provided by the bank to sub-national entities. The commercial bank conducts loan appraisal based on FINDETER's credit evaluation guidelines, and fully absorbs the credit risks. The loans made to local governments are mostly secured by constitutionally mandated transfers from the central government.

**Box 2. Possible options for a CPSCL-type national-level MDF in Vietnam**

Two alternatives exist for Vietnam to pursue the CPSCL-type model of a national-level MDF that provides subsidized loans to local authorities. The first alternative involves VDB, which does already provide development investment credits (i.e., soft loans) to provincial People's Committees, pursuant to a decision of the Prime Minister. For instance, VDB provides development investment credits to the local authorities for the implementation of the irrigation system reinforcement programs in the period 2009-2015 pursuant to Decision No.13/2009/QD-TTg dated 21 January 2009. However, according to Decree 75/2011/ND-CP (Decree 75), VDB's borrowers are investors in investment projects belonging to the list of eligible projects promulgated in attachment to Decree 75, and investors are defined in Article 1.2 as enterprises or state entities having income/revenue. Thus, under this alternative, an amendment could be made to Decree 75, defining sub-national governments as eligible investors. However, there would still be a key difference with CPSCL, as VDB is not an entity dedicated solely to financing local authorities. The other alternative for Vietnam would be to create new legislation – this could be in the form of a decree or decision of the Prime Minister – for the establishment of a municipal development fund at the national level, which has the function to provide loans/credits to local authorities.

**69. FINDETER has succeeded in establishing itself as a viable financial institution in Colombia, and has had a significant positive development impact for that country.** Although FINDETER relied on international financial institutions for its funding in the beginning, most of its activities are now funded out of income from its existing loans. In 2010, FINDETER had total disbursements of USD 1 billion, total revenue of USD 181 million, total capital market issuance of USD 1.1 billion, and net income of USD 15 million. Between 1990 and 2003, FINDETER financed about USD 2 billion in loans to more than 700 municipalities while maintaining low levels of bad debt (under 2 percent in 2003). FINDETER has encouraged commercial banks to operate in the local debt market and to offer local government borrowers long-term loans at attractive rates. FINDETER-funded loans can offer maturities of 8 to 15 years, whereas loans to municipalities without FINDETER

support would usually not exceed five years. Where appropriate, there can be a capital grace period of up to three years and an interest grace period of up to one year. FINDETER has achieved a AAA local credit rating (from Duff & Phelps), which has helped it in accessing less expensive financing.

**70. In the Czech Republic, the Municipal Infrastructure Financing Company (MUFIS) provided commercial banks with long-term funding at market rates for on-lending to local governments.** MUFIS' ownership structure comprised 49 percent by the Czech MOF, 49 percent by the Czech and Moravian Guarantee and Development Bank, and the remaining 2 percent by the Union of towns and cities. As the Czech municipal credit market matured, commercial banks began lending from their own resources rather than accessing the credit line at MUFIS. Thus, MUFIS stopped making new loans to commercial banks in 2003, 10 years after its creation. MUFIS' mode of operation is quite similar to that of FINDETER, but a major difference lies in the interest rates charged, with FINDETER providing commercial banks with discounted loans, while MUFIS provided loans at market rates. This model is therefore less applicable to Vietnam, providing second-tier loans at market rates would not address the existing constraints in commercial bank lending to sub-national governments in Vietnam.

**Box 3. Adapting the FINDETER model to Vietnam's circumstances**

The relevance and usefulness of the FINDETER model to Vietnam should not be underestimated. FINDETER began operating in 1989, when Colombia had an income level (as measured by GNI in purchasing power parity terms, in current international dollars) of USD 3,860 per capita, similar to Vietnam's level of USD 3,440 in 2012. Moreover, Colombia's decentralized fiscal system is not vastly different from Vietnam's. However, applying this model to Vietnam would require the appropriate legal and regulatory framework for its operation, in particular for an adequate recourse mechanism.

In terms of the changes that would be needed in Vietnam: first, a by-law (e.g., in the form a decree or decision of the Prime Minister) can either regulate or create a legal basis for the establishment and operation of a municipal development fund at the national level in a model similar to FINDETER. Second, a clear recourse mechanism is needed, so that commercial banks would view lending to sub-national governments for infrastructure investment as less risky. The necessary legal basis for this recourse mechanism would enable commercial banks to secure their loans to sub-national governments. Such a mechanism could be of the form where the sub-national government has to set up a special account opened at the commercial bank for receiving its budget revenue (e.g. budget transfers from the central government), and the lending commercial bank has a senior right to intercept this revenue if the sub-national government defaults on loan repayments (see also Section V). Sub-national governments in Vietnam would welcome this type of MDF, as it provides an additional channel for financing infrastructure.

### ii. Pooled Financing

**71. Pooled financing can be an effective financing instrument for small municipalities with lower debt requirements and lower creditworthiness. The Tamil Nadu Urban Development**

**Fund (TNUDF) in India mobilizes private capital by facilitating innovative financing schemes, including through credit pooling.** TNUDF is a public-private partnership providing long-term finance for infrastructure on a non-guarantee model. The fund provides loans for revenue generating projects such as toll roads and a mix of loan and grants for basic environment infrastructure. Eligible borrowers are urban local authorities, public undertakings and private investors. TNUDF has received support from various donors, including: World Bank, the Japan International Cooperation Agency (JICA), United States Agency for International Development (USAID) and Kreditanstalt fuer Wiederaufbau (KfW). Under pooled financing, the cost of funds is lowered because the risk of default is spread across all borrowers in the pool – the larger and more diverse the pool, the lower the risk. Through the pool, each borrower can thus access capital at a much lower interest rate than it would otherwise get if it borrowed on its own. With bond pooling, a local specialized financing institution aggregates the borrowing needs of multiple local authorities and issues one large bond. The bond proceeds are then on-lent to those local authorities in the pool. The resulting economies of scale also contribute to reducing the average cost of borrowing (Vision Associates 2007).

**Box 4. What would be needed to enable pooled financing in Vietnam?**

Many of Vietnam's provinces have little prospect of issuing bonds on their own in the medium to long-term, as they have relatively small borrowing needs, limited financial and institutional capacity, and are insufficiently creditworthy. On the other hand, bond issuance entails high upfront fixed costs, and is thus usually not cost-effective unless the size of the issue is sufficiently large to make the upfront cost a small share of the total.

For pooled financing to be workable in Vietnam, legal changes would be needed, in addition to sustained efforts at the provincial level. The Law on Public Debt Management and the relevant legal documents have no particular provisions for such pooling (i.e., joint bond issuance by sub-national governments), so it would be necessary to review and amend such legal documents to allow sub-national governments to cooperate in capital mobilization through the issuance of joint bonds for the purpose of investment in municipal infrastructure, in accordance with the socio-economic development plans of the respective localities. Cooperation among small provinces has not yet been tested in Vietnam, with substantial variability in capacities across provinces. Thus, even with the necessary legal and regulatory changes, pooled financing in small provinces (e.g., Quang Nam) would require substantial efforts on the part of the provincial governments and their supporters.

### iii. Credit Enhancement Entities

**72. The Local Government Unit Guarantee Corporation (LGUGC) in the Philippines is a private financial service corporation, with the objective to develop the municipal bond market in that country.** LGUGC guarantees the indebtedness of local government units and others, with the guarantee being straight insurance of the periodic debt service payment. All LGUGC guarantee policies involve the assignment of the project revenue, project assets and internal revenue allotments. There is a recourse mechanism for the debt service of a bond issued by a local government, through the government financial institution bond trustee which has a right to intercept local government revenues and pay the LGUGC if the local government fails to pay its debt service.

**73. The Indonesia Infrastructure Guarantee Fund (IIGF) is the Indonesian government's single window for the appraisal and processing/structuring of risk guarantees for PPP projects**. IIGF was established by the Indonesian Government with support from the World Bank. IIGF enters into: (a) guarantee agreements with PPP investor(s); and (b) recourse agreements with contracting agencies, which are the government's representative or partner in the PPP (e.g., a government ministry or local government). To make this IIGF model workable in Vietnam, it is necessary to have a complete PPP framework as well as a clear recourse mechanism as already mentioned noted above.

**Box 5. Adapting the Philippine model of a guarantee corporation to Vietnam**

A guarantee corporation along the lines of LGUGC of the Philippines does not yet exist in Vietnam, but would be permissible under existing Vietnamese law. However, it would need regulatory changes to enable the recourse mechanism. For instance, according to the Law on Credit Institutions of 2010, credit institutions (including banks and financial companies ) are allowed to provide guarantees to bond issuers, which include local government units (e.g., provincial governments and LDIFs) and state-owned or private enterprises. As already noted in the case of the FINDETER model, changes to the legal and regulatory framework in Vietnam would be needed to enable a clear recourse mechanism.

## E. Sub-national PPPs

**74. In 2004, the Brazilian Government adopted a PPP law that applies to all levels of government. The law includes a safeguard for public finances**, limiting total public finance commitments to PPP projects to a maximum of one percent of the local government's net revenue. If a local government exceeds this limit, the Federal Government is authorized to withhold fiscal transfers. The law also provides for the creation of a guarantee fund to which public assets are contributed to backstop government obligations under PPPs. The sub-national PPP model in Brazil could be a good reference when drafting a PPP Law in Vietnam. Under the Vietnam's prevailing legal framework, there is Decision 71/2010/QD-TTg[10] of the Prime Minister, promulgating the regulation on pilot investment in through PPPs (Decision 71). As this decision has not guaranteed a complete legal framework for the implementation of a PPP model, a specific law on PPP would provide the full legal foundation for the private sector to engage in infrastructure development in the form of PPPs in Vietnam.

10 The MPI is now in charge of drafting a new Decree combining Decision 71 with Decree 108 (governing BOT, BTO and BT contracts), which will likely be issued in year 2015.

# 5

# The Way Forward

## A. Revisiting a Comprehensive Approach to Municipal Infrastructure Finance

**75. The success of any initiative to improve the financing of municipal infrastructure in Vietnam hinges on advances in the broader landscape of policy reform as part of the country's long-term development. Any measures taken to address financing issues, including new financing instruments, would crucially depend on the effective implementation of complementary reforms in the areas of governance and execution.** As the framework laid out in Section I illustrated, meeting these challenges requires a comprehensive approach that addresses issues of governance, financing, and execution, to ensure that the right enabling environment is in place for effective and efficient investment. Examples of specific reforms include those recommended in VDR 2012, such as: clarifying and strengthening property rights; creating impartial regulators for infrastructure sectors; improving regional coordination for infrastructure; and strengthening the public investment management cycle. Substantial capacity in many areas within sub-national governments also needs to be built, to ensure that execution also takes place effectively at the local level, with a strong focus on delivering results.

**76. Many of the constraints and weaknesses that Vietnam faces today can and should, in fact, be viewed as opportunities. Existing inefficiencies in infrastructure investment represent an opportunity for efficiency gains – to do more with the same amount of resources.** In other words, Vietnam can potentially obtain more infrastructure without increasing the current level of available funding, if investment efficiencies could be identified and realized. This calls for stronger use of market-based mechanisms – not only would this increase efficiency, but would also attract greater investor interest and participation from the private sector. Operational efficiencies can also go a long way in improving service delivery and the financial condition of sub-national governments. It has long been noted that Vietnam should not look to the private sector only as a means of filling financing gaps, but rather also seek the broader operational efficiency benefits that come with private ownership and management. If the private sector could be brought in to improve efficiencies in operations and service delivery, then the investment needs for additional infrastructure would likely be lower (World Bank 1999). Moreover, the current low levels of sub-national government debt reflect the constraints in financing municipal infrastructure, but the situation also presents a window of opportunity now for Vietnam to put in place a robust and comprehensive system for sub-national public debt management – the importance of which is underscored by the Chinese experience where sub-national debt and contingent liabilities have become serious concerns (see Section IV.B.i).

**77. The sustainable financing of municipal infrastructure investment in Vietnam will require greater involvement of capital markets and the private sector, and cannot rely on State Budget resources and ODA alone.** Budget resources, which for the most part are currently passed on as grants, will have to be used more strategically in the future, with an emphasis on greater efficiency of investment, and leveraging other sources of financing. Vietnam also needs to prepare for the transition to receiving less donor funding for municipal infrastructure. Although some resources may be available from equity markets, the bulk would likely be obtained from debt markets, through various types of bonds or loans. At the same time, it must be recognized that Vietnam's capital markets are relatively underdeveloped, and it will take a long time before the capital markets can play an important role in financing municipal infrastructure.

**78. In the context of the broader policy reforms that would be needed for the enabling environment, this report provides specific implementable recommendations for the further development of municipal infrastructure finance mechanisms in Vietnam.** The recommendations have been developed by the World Bank and MOF teams through extensive consultations, and based on the in-depth assessment of specific provincial-level governments and their finances, as well as the review of relevant international experience. The identification of specific recommendations was based on the examination of the full range of possible options, including the pros and cons of each option (see Table 5 below). The teams have also highlighted key considerations for municipal finance mechanisms in the recommendations with regards to the policy framework, borrowing modalities, institutional arrangements for local governments and roadmap for implementation. These recommendations are cognizant of other ongoing programs supported by the Bank and other donors on PPP and fiscal decentralization, and are also very timely, given the ongoing government initiatives on land-based financing, infrastructure development, investment efficiency improvement, and the expected issuance of a revision to the State Budget Law in 2014. For example, the ongoing strengthening of Local Development Investment Funds (LDIFs), which is supported by an existing World Bank project, is consistent with and part of the detailed recommended mechanisms (please refer to the synthesis report in Appendix I and the existing World Bank project for additional details on LDIFs).

## B. New Financing Instruments for Municipal Infrastructure

**79. New financing mechanisms for municipal infrastructure are needed.** Both the MOF and local governments' access to the opportunity for land-based financing is limited, given the government's ongoing program on road concessions and utilization of upfront, undeveloped land sales for infrastructure development, as well as related transparency concerns and the broad property market slow-down. The MOF has also indicated that bonds are not likely to be an important source of financing in the initial stage of reform, as their use has been very limited so far, even among large sub-national governments. Due emphasis was also given, in the process of formulating recommendations, to different mechanisms that take account of the level of development of the sub-national governments. Clearly, regardless of whether there is a centralized budget system (as it is now) or a more decentralized scheme (under consideration but unlikely to be approved), new sub-national financing instruments will be required. In this regard, the MOF has focused on a municipal development fund and credit enhancement mechanisms as interventions that could be developed in the short to medium term.

**80. In the absence of a well-developed municipal bond market, financial intermediaries often play important roles, in order to mobilize resources for municipal infrastructure financing and to fill regulatory and capacity gaps.** As shown in the review of successful international experience (see Section IV above, and also Appendix II), such financial intermediaries have typically been set up as national or state-owned non-banking financial institutions to channel funds to multiple municipalities for infrastructure investment, in the form of grants or loans, or both. FINDETER in Colombia and MUFIS in the Czech Republic, as second-tier financial institutions, expanded loans from commercial banks to municipalities by providing matching loans to the commercial banks. Both institutions are legally autonomous and managed by professional management, excluding political intervention. They provide market-based loans based on technical and financial criteria, following their appraisal procedures. By creating a credible track record of municipal debts, these financial intermediaries also induced commercial banks to start lending to municipalities.

**Table 5. The pros and cons of options for financing municipal infrastructure**

| Option | Pros | Cons |
|---|---|---|
| 1. Increasing allocations from the State Budget for investment | • Sub-national governments would not need to raise debt or look to other financing channels.<br>• Potential for better coordination of investment, if investment planning process is improved. | • Not a sustainable option in the long-term, given widely recognized limits in State Budget resources.<br>• Does not support broader policy reform agenda of decentralization and greater private sector participation. |
| 2. Greater private sector participation, including PPPs, land-based financing, etc. | • Increases access to private sector financing.<br>• Supports broader policy reform agenda in the context of market-driven economy.<br>• Leverages private sector expertise and innovation to increase operational efficiency and cost effectiveness. | • Not a significant option in the short to medium term, given the identified needs to increase the attractiveness of the investment environment for investors, which will take time.<br>• Limited experience and capacity with PPPs to-date at the central level, with almost no experience and capacity at the local level.<br>• Current PPP policy framework is not comprehensive and lacks guiding procedures (the World Bank is supporting the first pilot PPP transaction)<br>• Lack of bankable projects at both central and local levels<br>• Land-based financing is constrained by land availability and low property values, with concerns on transparency and governance.<br>• Land-based financing can work only in a few big cities, and not in smaller cities due low land values and underdeveloped land markets. |
| 3. Expanding LDIFs | • A proven financing channel that has been replicated in many provinces across Vietnam.<br>• Significant donor support for funding and operations of LDIFs through existing projects. | • Limited scope for further expansion: this option is already being pursued, and thus its potential is close to being fully realized.<br>• Less than half of the provinces are able to set up LDIFs due to their limited resources for the first paid-in capital.<br>• LDIFs are constrained by limited capital (mainly using paid-in capital from local budgets and retained earnings), being unable to mobilize capital from the domestic market, and so are able to invest in small-scale, local infrastructure only. |

| Option | Pros | Cons |
|---|---|---|
| 4. Piloting and then establishing a full Municipal Development Fund | • Catalyzes improvements in sub-national investment planning.<br>• Strengthens project preparation and appraisal, with emphasis on financial viability and cost recovery.<br>• Directly promotes long-term loans by commercial banks to sub-national governments.<br>• Builds debt management capacity among sub-national governments.<br>• The recourse mechanism would offer lenders the necessary security.<br>• Fosters market-based lending by commercial banks. | • The broader set of complementary policy reforms – on governance, execution and the enabling environment – is necessary for success.<br>• Significant time and effort would be needed to develop the full legal and regulatory framework, including the recourse mechanism. Therefore, a phased approach is recommended. |
| 1. Strengthening the environment for municipal bonds | • Promotes long-term debt as a source of infrastructure financing for sub-national governments.<br>• Builds debt management capacity among sub-national governments.<br>• Supports the development of the long-term debt market in Vietnam. | • Few examples of municipal bond issues to-date.<br>• Not an option for many small local governments with limited capacity, because of the high transaction costs of small issuances and insignificant investment/need of small projects at the local level<br>• Does not offer improvements in investment efficiency. |

**81. The specific implementable recommendations for new instruments therefore consist of: (a) gradual development of a municipal development fund that acts as a second-tier lender; and (b) strengthening the enabling environment for municipal bonds.** The recommendations for both of these options are fully customized to Vietnam's needs, and have been developed by taking Vietnam's specific circumstances into account, including timeliness with respect to ongoing initiatives such as the revision of the State Budget Law expected in 2014. They also recognize that changes will take time to implement, and are therefore structured using a staged, step-wise approach. The first recommendation for development of an MDF has given consideration to the steps needed to establish and operationalize such a fund, including the appropriate laws and regulations, funding sources, institutional arrangements, debt management and credit enhancement. The second recommendation for municipal bonds has considered enabling conditions for bond issuance such as regulatory amendments, simplified review and approval procedures, credit enhancement, and transparency and disclosure requirements. Table 6 summarizes the steps under these recommendations, over the short, medium and long-term.

**Table 6. Options for an MDF and to strengthen municipal bonds, taking a step-wise approach**

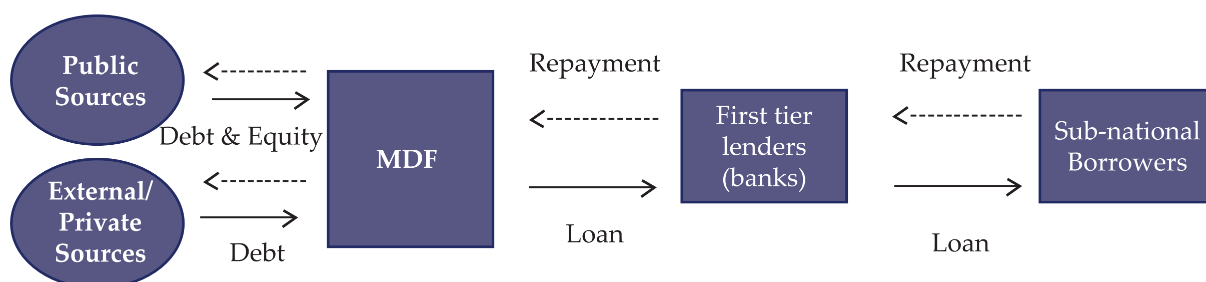
| | Short-term (2-4 years) | Medium-term (4-6 years) | Long-term (more than 6 years) |
|---|---|---|---|
| 1. Municipal development fund (MDF) | Encourage pilot credit a second-tier lending facility (like FINDETER in Colombia and MUFIS in the Czech Republic), managed by MOF. | Full-scale, independent MDF in operation. | The MDF mobilizes resources from the market by issuing its own bonds. |
| 2. Municipal bonds | Improve regulations for municipal bonds.<br>Pilot credit rating exercise and financial management assessments for selected local governments. | Pilot municipal bonds issuance by a selected local government.<br>Establish a credit enhancement mechanism. | Municipal bonds issuance by local governments under the new regulations. |

## i. Municipal Development Fund

**82. The MDF recommendation is based on the successful examples of FINDETER in Colombia and MUFIS in the Czech Republic**, where these MDFs act as second-tier lenders, encouraging first-tier lenders (commercial banks) to lend to sub-national governments on a market-driven basis. In this model, a sub-national government applies for a loan from a commercial bank, which conducts loan appraisal based on the MDF's guidelines and banking sector standards. If the appraisal is successful, the MDF authorizes the commercial bank to lend to the sub-national government for the infrastructure investment (in certain cases, this loan could be complemented by grant funding from the central government). The MDF then gives a loan of that same amount to the commercial bank, at a discounted rate and of medium to long tenor. The commercial bank is responsible for servicing its discounted loan from the MDF, regardless of its own repayment experience with the sub-national government borrower, and thus absorbs the full credit risk. The MDF's own credit risk is based on the credit risk of the commercial bank. This basic model is summarized in Figure 13 below.

**83. Implementation of the MDF model would take a gradual approach with short-, medium- and long-term actions, recognizing the wider context of transition in Vietnam.** The MDF would start with a pilot second-tier lending facility managed by the MOF in the short-term, for the first two to four years. Market tests with the banking sector will be done, once the recommendation is officially supported by the Government. Similarly, focused assistance to selected local governments will be required to identify and prepare bankable infrastructure projects, as well as gradually develop their investment planning and appraisal processes and debt management capacity. This pilot phase would provide the GOV with valuable experience and practical learning, leading up to the formal establishment of a full-fledged MDF subsequently. In the meantime, preparation for the full-scale MDF operation would get underway. Relevant legislation and operational procedures such as the MDF's charter, funding process, criteria for eligible first-tier lenders and loans, and a clear recourse mechanism, would need to be developed (see below for more details on the recourse mechanism). This staged approach would help to address identified shortfalls in the current financing framework in the short-term, while also providing GOV with hands-on experience from the pilot before the formal establishment of the full-scale MDF. In the medium-term, the full-scale MDF would be established as an independent second-tier lending institution, within six years. Thereafter, in the longer-term (beyond six years), the MDF would aim to mobilize resources from the capital market by issuing its own bonds, and potentially also assume a broader guarantee function for sub-national borrowing .

**Figure 13. The MDF model**




**84. The proposed recourse mechanism would be a key feature of the MDF recommendation, but also beneficial to the inter-governmental fiscal transfer system and other financing instruments. The design and details of this mechanism will need to be customized for Vietnam's circumstances.** The basic concept of the recourse mechanism is for the loan from the first-tier lender (i.e. a commercial bank) to the sub-national government to be secured against legally mandated transfers from the central government and/or local government revenues in the case of net fiscal contributors. The sub-national government establishes a special (escrow) account into which the transfers from central government are paid or local government revenues can be drawn. The first-tier lender has a senior right to intercept these transfers/revenues, should the sub-national government borrower default on its loan repayments. The first-tier lender in turn endorses its liens over to the MDF, such that the MDF is also able to recover its funds should the first-tier lender become insolvent. The result would be to provide the necessary security for lenders, which is currently lacking in the debt market. It is expected that the recourse mechanism would work effectively under the unitary budget system in Vietnam where the central government controls all sources of budget revenues, even at the local level. The proposed regulatory changes could take the form of revisions in relevant regulations, or a Decision of the Prime Minister comprising all the proposed changes.

Detailed procedures for the recourse mechanism would be developed by MOF in close consultation with sub-national governments and participating commercial banks. Figure 14 below illustrates the concept of the recourse mechanism. Table 7 summarizes the benefits and risks of the recourse mechanism for commercial banks, sub-national governments and the national government, as well as relevant risk mitigation measures.

**Figure 14. Recourse mechanism for the MDF option**

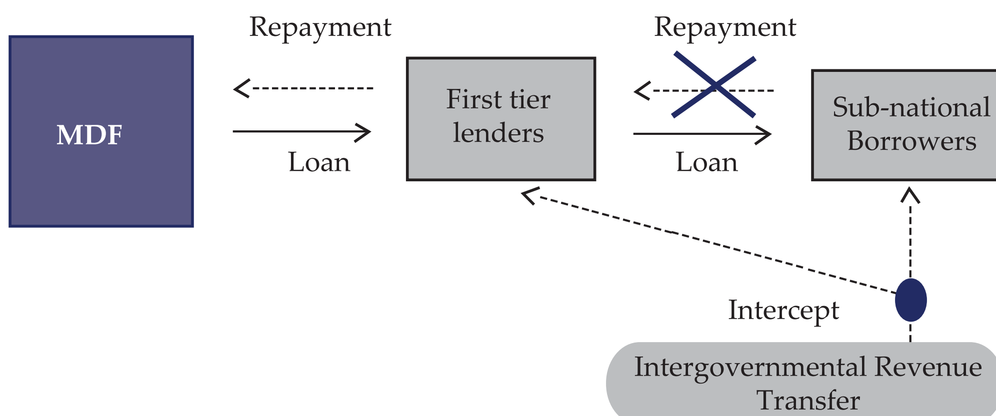



**Table 7. Benefits and risks of the recourse mechanism, and risk mitigation measures**

| | Benefits | Risks | Risk Mitigation Measures |
|---|---|---|---|
| For the national government | • Helps the GOV to better monitor and regulate the contingent liabilities of sub-national governments. | • Loan default by a sub-national government would result in intercept of central government transfers by the creditor. | • The recourse mechanism will be set up under the appropriate regulatory framework, which will enable strong and transparent management of the contingent liabilities of all levels of government. |
| For sub-national governments | • Incentivizes sub-national governments to perform proper debt management functions, integrated with the regular budget process<br>• Encourages sub-national governments to fully consider the financial viability of investment projects, in order to ensure loan repayments. | • Poor overall financial management within a sub-national government, or external shocks that severely impact its financial position, may result in inadequate capacity to repay loans and the subsequent intercept of central government transfers through the recourse mechanism. | • The MDF's guidelines and standards in the loan appraisal process would hep to ensure that projects are bankable and viable.<br>• Related reforms would strengthen the capacity of sub-national governments to improve investment efficiency, operational efficiency and cost minimization, and maximizing direct and indirect revenues.<br>• Debt management functions within a sub-national government would reduce the risk of default. |

| | Benefits | Risks | Risk Mitigation Measures |
|---|---|---|---|
| For commercial banks | • Offers participating banks the necessary security for lending to sub-national governments<br>• Provides incentives for banks to expand their lending to sub-national governments | • If banks over-rely on the security provided by the recourse mechanism, they may not exercise full due diligence in properly assessing the credit risk of sub-national government borrowers. | • Banks would be required to use the MDF's procedures for assessing the credit risk of sub-national borrowers, when originating such loans<br>• In the case of a sub-national government' loan default, banks' obligations to make repayments of the second tier loans to the MDF remains. Even if they have intercept of revenue transfer, they have to take the credit risks of sub-national borrowers. This would incentivize banks to exercise credit assessment properly. |

**85. The MDF model is highly relevant for Vietnam, offering advantages in multiple areas. It addresses identified needs and gaps in financing municipal infrastructure, and supports institutional development and strengthening at sub-national levels, particularly for investment planning and execution.** In light of the basic constraints to obtaining financing, the primary direct benefit would be to develop and expand the market for commercial bank loans to sub-national governments, as a channel and key long-term instrument for financing investment in municipal infrastructure. Not only would this offer flexibility in meeting the investment needs of all sub-national governments, but for poorer provinces this would be a key opportunity, given their dependence on the State Budget and ODA, and their inability to issue bonds or use land-based financing. In seeking MDF-backed loans from commercial banks, sub-national governments will also improve their ability to plan and prepare infrastructure projects. They would have to demonstrate the bankability and financial viability of proposed projects, particularly in terms of expected direct and indirect revenues, cost recovery arrangements, operations and maintenance expenditures, and repayment capacity. Given that sub-national governments would also be responsible for debt repayments, the MDF model would help to improve debt management capability among sub-national governments, thus also helping the GOV to improve the management of contingent liabilities overall. The MDF's guidelines and standards for project preparation and appraisal would also help to catalyze these improvements since they would become standard requirements that sub-national governments would have to fulfill. Consultations with the three provincial-level governments where the case studies were undertaken (see Section III) indicate that they see the MDF model as creating more opportunities for greater access to funding, while the requirements of the recourse mechanism would be acceptable and not burdensome.

**86. The MDF model also offers additional benefits, as it would support the broader agenda of policy reform and transition in Vietnam.** As Vietnam moves towards having a banking sector where commercial banks operate competitively and make lending decisions based on commercial considerations, the MDF would foster the market-based operations of these banks, including their ability to analyze credit risks associated with lending to sub-national governments for infrastructure

development. In so doing, it would help to make the banking sector more robust, and boost the attractiveness of the investment environment. The MDF would also help to address one of the key gaps in the enabling environment for borrowing by sub-national governments in Vietnam, which is the absence of a recourse mechanism. The recourse mechanism would bring important credit enhancement for both first-tier lenders and the MDF. In particular, it would provide first-tier lenders with the necessary security that is currently absent in the market in Vietnam. The recourse mechanism would therefore encourage more investors to expand into the underdeveloped debt market, and facilitate the market's growth. This is particularly important given the need for sub-national governments to reduce their investment dependence on the State Budget and ODA resources, and move toward loans on less concessional terms as well as fully market-based. More broadly, the experience of MDF implementation would also offer useful experience for GOV in strengthening the legal and policy framework for the planning and management of public investment. Table 8 summarizes the various the issues and needs that have been identified across various areas, and describes how the MDF model addresses these.

**Table 8. The MDF model addresses multiple issues in municipal infrastructure finance in Vietnam**

| Area | Issues and Needs | What the MDF Offers |
|---|---|---|
| Investment planning | • Limited planning capacity.<br>• Little attention to actual availability of resources and value-for-money.<br>• Resultant fragmentation, duplication, and investment inefficiency. | • Helps to catalyze improvements in sub-national level investment planning and capacity.<br>• Sub-national governments are required, guided and incentivized to pay more attention to financial viability. |
| Project preparation and appraisal | • Weak project preparation quality and transparency. | • To obtain commercial loans, projects would need to demonstrate bankability and financial viability, thus improving the quality of sub-national governments' project preparation, and mitigating the impact of administrative decisions.<br>• MDF's guidelines and standards for project preparation and appraisal help develop the capacity of participating sub-national governments and commercial banks. |
| Funding for municipal infrastructure | • Limited funds available from State Budget.<br>• ODA funding expected to decrease.<br>• Underdeveloped debt and capital markets, especially at sub-national level. | • Directly promotes and supports the financing channel of long-term loans by commercial banks to sub-national governments.<br>• For poorer provinces that are unable to issue bonds or use land-based financing: likely to be the only funding source apart from the State Budget and ODA.<br>• Offers flexibility in responding to different priorities of various sub-national governments. |

| Area | Issues and Needs | What the MDF Offers |
|---|---|---|
| Sub-national debt management | • Limited capacity for debt management among sub-national governments.<br>• Full extent of government's contingent liabilities is unclear. | • Sub-national governments responsible for debt repayments.<br>• Associated policy reforms and capacity building will build capacity for sub-national debt management at both local and central levels. |
| Recourse mechanism | • No recourse mechanism available<br>• Lenders reluctant to lend due to perceived high risk. | • Requires and catalyzes the development of a full-fledged recourse mechanism, with appropriate legal and regulatory framework.<br>• Provides the necessary security for lenders, which is effectively missing in the debt market currently.<br>• Helps GOV to formally monitor and regulate the contingent liabilities of sub-national governments.<br>• Requires and incentivizes sub-national governments to perform debt management functions, integrated with the regular budget process. |
| Banking sector development | • Banking sector not fully market-driven<br>• Domination of SOCBs and legacy of 'directed lending'. | • Fosters market-based lending by commercial banks.<br>• Banks improve their capacity to assess and take on credit risk of lending to sub-national governments, through the use of the MDF's capital and investment appraisal procedures. |
| Operations and maintenance / cost recovery | • Low tariffs set by sub-national governments – weak finances of public utilities that are unable to access capital markets.<br>• Sub-national governments lack incentives to increase tariffs and achieve full cost recovery. | • By assuming responsibility for debt repayments, sub-national governments are incentivized to ensure financial sustainability, including through sustainable increases in tariffs and improved cost recovery. |

**87. The MDF model would benefit from appropriate support from donor agencies for institutional setup, program inception and operation.** Donor support would be drawn upon to tap the extensive experience in applying the MDF model in similar past operations that have proven successful, such as FINDETER in Colombia, the Tamil Nadu Urban Development Fund (TNUDF) in India, and the Indonesia Infrastructure Guarantee Fund (IIGF). Donors such as the World Bank, the Asian Development Bank, the Inter-American Development Bank, and other bilateral agencies provided technical assistance in setting up those financial intermediaries and credit enhancement schemes, as well as financial support for the initial start-up period until the institutions became self-financing.

### ii. Municipal Bonds

**88. An initial step in developing the market for municipal bonds in Vietnam involves improving the overall regulatory framework.** The national regulation on sub-national government bonds should be adjusted, in order to simplify the appraisal procedure, which currently requires the MOF's approval for a sub-national government's entire plan for capital mobilization. This would increase the autonomy and accountability of sub-national governments that will issue their own municipal bonds, and if designed properly, would not compromise central government supervision of this aspect of sub-national government finances.

**89. Pilot credit ratings and financial management assessments of selected sub-national governments would increase their readiness to issue their own bonds.** This exercise would work initially with a few selected larger sub-national governments that are interested in issuing municipal bonds, and that have some minimum existing financial capacity to do so, and at agreement with MOF. An international or domestic ratings agency would perform the analysis and review necessary to give the sub-national government a credit rating. Linked to this, a detailed financial management assessment of the sub-national government would be undertaken by the ratings agency, revealing areas of weakness in financial management, thus enabling the identification and prioritization of actions to address these weaknesses. This would later culminate in the pilot issuance of municipal bonds by these sub-national governments. These exercises with the rating agency would also bring greater transparency with respect to financial management of the sub-national government, which also improves information disclosure and enhances comfort for investors of municipal bonds.

**90. In the longer term, the enabling environment for municipal bond issuance in Vietnam would be strengthened by the establishment of a credit enhancement mechanism, supported by the proposed recourse mechanism.** The credit enhancement mechanism/entity would provide guarantees to investors/bondholders, with the guarantee being straight insurance of the periodic debt service payment of the bond. The recourse mechanism for municipal bonds is analogous to the recourse mechanism for the MDF, in that it guarantees repayment in case the borrower defaults. The debt service of bonds issued by the sub-national government would be implemented through the bond trustee, who has a right to intercept sub-national government revenues/transfers from the central government and pay the credit enhancement entity, if the sub-national government defaults on the debt service.

## C. Specific Institutional and Policy Changes Needed

**91. In order to implement the recommendations above on the MDF and municipal bonds, several changes would be needed to specific laws and decrees.** For the piloting and subsequent full-scale establishment of the MDF, a new prime ministerial Decision and/or an amendment to Decree 11 would be needed. To enable the recourse mechanism, amendments would be needed in the State Budget Law, Decree 60, and Decree 79. To facilitate municipal bond issuance, a change in the Public Debt Management Law could made to remove the requirement of central approval, while also ensuring adequate guidance and regulations are put in place. Consistency with other relevant laws – such as the Public Investment Law which is also in the process of being revised – would be important. A summary of the proposed changes by instrument, and including indicative timeframes, is provided in Table 9 below.

**92. Restructuring of the borrowing limits of sub-national governments should also be undertaken, to facilitate the operationalization of the MDF, and to facilitate municipal bond issuance.** The borrowing limits could be reviewed, and redefined based on the repayment capacity of each sub-national government, according to indicators such as a debt service ratio. This would increase local governments' access to finance and enhance capacity for their debt management, as they would be incentivized by the increased funding opportunities. This would also be beneficial for the central government and commercial lenders, as the appraisal process would be simplified by applying the same set of indicators consistently to assess if a sub-national government is eligible for borrowing.

**Table 9. Summary of legal and regulatory changes needed**

| Legal Documents | Proposed Changes/Content | Time Period | Notes |
|---|---|---|---|
| State Budget Law of 2002 | • Review borrowing limits for sub-national governments.<br>• Establish a recourse mechanism which will facilitate the local governments to better mobilize capital. | 2013-2014 | The amended Law is expected to be issued in 2014.[1] |
| Public Debt Management Law of 2009 | Remove the requirement that local bond issuance plans need central government approval. | 2015-2016[2] | At the request of provincial governments. |
| A new Decision of the Prime Minister | For the pilot establishment and operation of the MDF. | 2014 | Actual changes to be discussed further. |
| Decree No.11/2011/ND-CP on the management of urban development | For the establishment of the full-scale MDF. | 2016-2017 | |
| Decree No.123/ND-CP and Decree No.124/ND-CP of 2004, on the special financial and budgetary regime for Hanoi and HCMC, respectively | Review borrowing limits for Hanoi and HCMC. | | Subject to the amendment of the State Budget Law as proposed above. |
| Decree No.60/2003/ND-CP guiding the Law on State Budget | For the recourse mechanism, where sub-national government debt repayments would be secured through a special escrow account opened at a bank. | 2016-2017 | Subject to the amendment of the State Budget Law as proposed above. |
| Decree No.79/2010/ND-CP on public debt management | | | |

*Notes*:

1. The proposed changes in the State Budget Law could be made in the period 2013-2014 as it is part of the "Preparation Program" as provided in Resolution No.20/2011/QH13, adopting the list of laws/ordinances to be promulgated and prepared during Session XIII of the National Assembly (2011-2016), and as adjusted in Resolution No.23/2012/QH13.

2. As the amendment of this law is not in the Program for drafting the of laws/ordinances during Session XIII of the National Assembly of XIII Session as provided in Resolution No.20, the proposed change could not be adopted in period 2011-2016 unless there is an additional adjustment to Resolution No.20.

## D. Implementation Roadmap

**93. This section describes the implementation roadmaps and timeframes for the recommendations of the MDF and municipal bonds.** The establishment and operationalization of the MDF requires several key steps, such as preparation of the pilot MDF facility and regulatory changes. Table 10 below shows the key items required to promote the MDF and the specific activities related to each.

**Table 10. Items needed to implement the MDF recommendation**

| | Items | Specific Activities |
|---|---|---|
| 1 | Prepare pilot MDF framework | • Develop a work plan and secure resources<br>• Develop pilot operational procedures<br>• Select pilot banks and local governments |
| 2 | Prepare regulations and operational procedures of MDF | • Issue a decision of the Prime Minister, or a revision to Decree No.11/2011/ND-CP, on organization and operation of MDF<br>• Prepare charter and operational procedures of MDF |
| 3 | Prepare eligibility criteria for first tier lenders | • List commercial banks based on the financial conditions and ability to assess credit risks<br>• Prepare monitoring procedures for first tier lenders |
| 4 | Facilitate the recourse mechanism | • Revise the Law on State Budget and the Law on Public Debt Management, and/or<br>• Decree No.60 and/or Decree No.79 should be amended accordingly, or a prime ministerial Decision allowing a recourse mechanism be piloted under the proposed MDF mechanism<br>• Prepare recourse arrangement procedures between the relevant stakeholders |
| 5 | Review sub-national governments' borrowing limits | • Revise Law on State Budget and Law on Public Debt Management, or a prime ministerial decision allowing revised limits to be implemented on a pilot basis |
| 6 | Improve sub-national governments' capability for municipal bond issuance | • Provide capacity building on debt management based on the results of credit rating and financial management assessment |

**94. Table 11 below shows the roadmap and timeframe for implementing the MDF recommendation.** The first two years would be a project preparation period, through which a pilot MDF would be established first. After four years of pilot MDF operation, the full-scale MDF would be established in year six.

### Table 11. Roadmap for the MDF recommendation

| Year | Tasks |
|---|---|
| Years 1 and 2 | • Assign a working team inside the MOF (Month 1)<br>• Develop and approve a work plan and budget (Month 3)<br>• Develop and approve operational procedures (Month 9)<br>• Select qualified commercial banks as first-tier lenders and interested local governments as borrowers (Month 12)<br>• Invite qualified commercial banks and local governments to consultation process(es) (Month 14)<br>• Approve first pilot transactions (Month 20-24) |
| Year 3 | • First year mid-term monitoring and evaluation of the pilot operations (Month 24 onward)<br>• Start preparation of the legislation to establish and operationalize a full-scale MDF (Month 32 onward)<br>• Appraise and approve second batch of transactions |
| Years 4 and 5 | • Finalize and approve the legislations to establish and operationalize the full-scale MDF<br>• Develop and approve the operational procedure for the full-scale MDF<br>• Monitoring and evaluation of the pilot operations |
| Year 6 | • Establish the full-scale MDF |

**95. Strengthening the enabling environment for municipal bonds also requires several key steps such as the preparation of a municipal bond framework and regulatory changes.** Table 12 below shows the key items required for promoting the municipal bonds and the specific activities related to each. Table 13 below gives a roadmap and timeframe for implementing the municipal bonds recommendation. Years 1 and 2 would focus on preparation activities such as pilot credit rating and regulatory changes. Municipal bond issuance would then take place in year 3.

### Table 12. Items needed to implement the municipal bond recommendation

| | Items | Specific Activities |
|---|---|---|
| 1 | Prepare pilot municipal bond issuance framework | • Develop a work plan and secure resources<br>• Select pilot local governments for credit rating and FMA<br>• Conduct pilot credit rating and FMA of selected local governments |
| 2 | Revise appraisal procedure on municipal bond issuance | • Revise Decree on issuance of municipal bonds (Decree No.01) |
| 3 | Prepare establishment of a credit enhancement entity | • Develop a work plan for the establishment of a credit enhancement entity |

| | Items | Specific Activities |
|---|---|---|
| 4 | Facilitate recourse mechanism | • Revise the Law on State Budget and the Law on Public Debt Management, and/or<br>• Decree No.60 and/or Decree No.79 should be amended accordingly, or a PM Decision allowing a recourse mechanism be piloted under the proposed MDF mechanism<br>• Prepare recourse arrangement procedure between the relevant stakeholders |
| 5 | Review local governments' borrowing limits | • Revise Law on State Budget and Law on Public Debt Management, or PM decision allowing revised limits be implemented on a pilot basis |
| 6 | Improve local governments' capability for municipal bond issuance | • Provide capacity building on debt management based on the result of credit rating and FMA |

**Table 13. Roadmap for the municipal bond recommendation**

| Year | Tasks |
|---|---|
| Year 1 | • Assign a working team inside the MOF (Month 1)<br>• Develop and approve a work plan (Month 3)<br>• Undertake detailed review of existing legal and regulatory framework for municipal bonds (Months 4-6)<br>• Develop first draft of revised regulation for municipal bonds (Months 7-9)<br>• Undertake consultations on first draft with all relevant entities (Months 8-9)<br>• Develop second draft (Months 10-11)<br>• Identify and select local governments for pilot credit rating and FMA (Months 11-12)<br>• Undertake consultations on second draft (Months 12-13) |
| Year 2 | • Identify and select ratings agency (e.g., Standard & Poor's) to perform credit rating and FMAs (Months 13-16)<br>• Develop third draft, and submit for formal government approval (Months 16-18)<br>• Ratings agency undertakes credit rating and FMA assessments for selected local governments (Months 18-24)<br>• Review and finalize credit rating and FMA reports (Months 24-25)<br>• Formal government approval and effectiveness of new legal and regulatory framework for municipal bonds |
| Year 3 | • Workshop to present results of credit rating and FMAs<br>• Local governments take next steps toward actual bond issuance |

# Appendix I – Synthesis Review

## I. Overview of Municipal Infrastructure

### A. There has been great demand in Vietnam for infrastructure at the local level, both revenue-generating and non-revenue-generating

Vietnam is in the midst of rapid urbanization; in the last decade, the country's urban population increased from 18.1 to 25.4 million, and is projected to reach 45 million in 2025. Cities, especially major ones, have attracted large shares of the expanding population seeking employment opportunities absent in rural areas. Subsequently, the surge in the urban population and the high rate of economic growth have increased pressure on services; rising urban population density and associated issues have had an impact on local infrastructure across sectors. For example, a recent estimate showed a 20 percent annual increase in the use of public transportation in Ho Chi Minh City in recent years. Accordingly, the demand for investment in infrastructure among local authorities is large and rapidly growing.

The issue of urban transport presents a major political and economic challenge for Vietnam, as the rapid urban population growth and expansion of the middle class continues to fuel the rapid proliferation of the motorized urban dweller. Given the current unmet demands, the policy approach has been to develop mass transport networks in the metropolises (aggressive objectives of 35 to 40 percent of motorized transport by 2025) and to extend bus services to 63 provincial capitals (from the baseline of 49). Two-wheeled motor vehicles are currently the predominant means of urban transport, but there is a rapid increase in car purchases, although the total figure remains relatively low. Toward the end of the last decade, Vietnam counted approximately 1 million cars and 20 million motorcycles, compared with 450,000 and 6 million, respectively, at the end of the prior decade. For the time being, the transport system exists in a negative environment—congestion and pollution—particularly in the two main metropolises of Hanoi and HCMC. Issues related to urban transport are now beginning to come to the fore in a few other cities, especially Haiphong and Danang.

While Vietnam has made remarkable gains in increasing access to water in urban areas in the last decade, access is still not universal, and the country exhibits an uneven social landscape in terms of access to water. A survey of 65 utility companies revealed that while only 12 percent of households in the areas serviced by the companies had access to the water network in 2002, by the end of the decade, the figure had increase six-fold. Coverage has improved with urbanization, but much remains to be done in extending access to water more evenly.

Access to sanitation is quite low and also shows an uneven distribution across the country. Furthermore, the situation is uneven when considering the various measures of access to sanitation. In both urban and rural areas, wastewater collection and treatment, as well as sanitation infrastructure systems, are deficient. Despite a rapid increase in the percentage of households with access to a toilet, urban-rural gaps are still considerably large. In the last decade, the rate of urban households with toilet

access rose from 17 to more than 67 percent. In comparison, among rural households, the rate rose from 13 to only 48 percent.

In terms of wastewater treatment, operations are at very low levels across Vietnam, even in urban areas. In the middle of the last decade, none of the cities collected or treated municipal wastewater. Five years later, only six cities had built wastewater treatment plants. In total this represented a treatment capacity of less than 380,000 cubic meters per day, out of the 4.3 million cubic meters produced per day—a treatment rate of 8 percent.

At the end of the last decade, Vietnam's housing stock stood at 1,058 million square meters, including 320 million in urban areas, representing an average of 12.2 square meters per inhabitant. Despite the ongoing rise in the stock, the GOV's target of 18 square meters per inhabitant by 2020 would require adding an additional 50 million square meters each year. In addition, the average figures conceal wide disparities. Entire sections of the population, lower-middle classes, and particularly the poor and recent migrants, continue to lack access to decent housing.

In city centers, land pressure resulting from economic activity has prompted actions to rehabilitate precarious housing in city centers, sometimes financed by ODA. This has generally resulted in eviction and/or resettlement of poor populations that do not have the means to stay put. At the same time, housing problems reach beyond the poorest households. Most housing programs are unattainable to the lower categories of income levels, and current housing construction remains inaccessible to 80 to 90 percent of urban Vietnamese, despite a growing middle class.

Vietnamese cities have largely attempted to provide a pluralistic supply of housing to meet demands from various population segments. Especially among low-income groups, much of the demand has been targeted through three main channels: (a) small contractors' construction of traditional townhouses on available land within the city or immediate periphery; (b) government action to extend road networks to integrate villages with cities; and (c) incremental upgrading and maintenance of existing housing stock by individuals, and the upgrading of infrastructure and services by the government.

In the power sector, Vietnam has achieved high electricity access. Access to electricity in Vietnam has increased dramatically in recent years, from around 14 percent of households in 1993 to above 96 percent by the end of the last decade. This figure is considerably higher than the regional average of 91 percent. Access to electricity has extended broadly across the country, with urban-rural discrepancies closing, but some regional disparities remain. In particular, the Northwestern region has access levels of just above 80 percent.

While infrastructure demand and investment in the traditional sectors are at the core of local infrastructure development in Vietnam, there is also significant—and unfulfilled—demand in the social sectors, particularly in the areas of education and healthcare. The lack in quality and supply of adequate, publicly funded, social-sector infrastructure continues to be a reality in Vietnam. Investment in infrastructure in the social sector, particularly in education and health care, has traditionally been dominated by the public sector. In a resource-constrained environment, this has largely resulted in underinvestment in the social sector, low-quality service levels, and inadequate capacity of service providers. In recent years, this has sparked an interest in attracting private sector involvement in the provision of social services. Indeed, the GOV views private sector participation in

investing in social-sector infrastructure as a strategic development goal (for example, the government aims to have the private sector provide 20 percent of hospital beds by 2020). More ambitiously, the government's Higher Education Reform Agenda (HERA) sets the target of having 40 percent of higher education enrollment provided by private universities and colleges by 2020.

## B. Demands for investments in infrastructure development

In general, there has been massive shortage of fundings for infrastructure development in Vietnam. Traditional financing sources such as State buget, ODA, government bonds, etc. typically satisfy only about 50-60 percent of financing needs in the period of 2005-2010. By sector, the fund actually mobilised for the transport sector could meet around VND 20,000 biliion per year, about 50 percent of the total demand. For energy sector, the fund actually mobilised could meet around VND 12 trillion per year, about 70 percent of the total demand. For Information and Communication Technology (ICT) sector, the capital needed was about VND 14 trillion and the implemented capital accounted for about 80 percent, equivalent to VND 11.2 trillion. For commercial and social housing and social infrastructure sector, the capital needed was about VND 45 trillion per year on average and the implemented capital was VND 176 trillion, equal to 65 percent of the total.

In order to implement the socio-economic development strategy in the period 2011-2020 successfully, Vietnam needs to maintain the average GDP growth rate of 8 percent per year with the target GDP of around USD 300 billion by 2020, the fund for infrastructure development should account around 10-11 percent of GDP or 25-30 percent of total social investments. Accordingly, about USD 30 billion would be needed to invest in socio- economic infrastructures each year.

During the period of 2011-2015, the total capital of about VND 2,200-2,300 trillion (or USD 110-115 billion) would be needed, of which VND 1,100-1,150 trillion would be needed for transport infrastructure development (VND 500 trillion for roads, VND 300 trillion for railways (excluding express railways), VND 100 trillion for aviation, and VND 250 trillion for sea ports); VND 427 trillion for electricity (VND 300 trillion for power generation and VND 127 trillion for power grid); VND 80 trillion for irrigation; VND 64 trillion for water supply and VND 85 trillion for drainage; VND 60 trillion for education and training infrastructure, VND 60 trillion for health care infrastructure; about VND 220 trillion for urban, big city and rural infrastructure; VND 100 trillion for the information, communication and technology (ICT) sector.

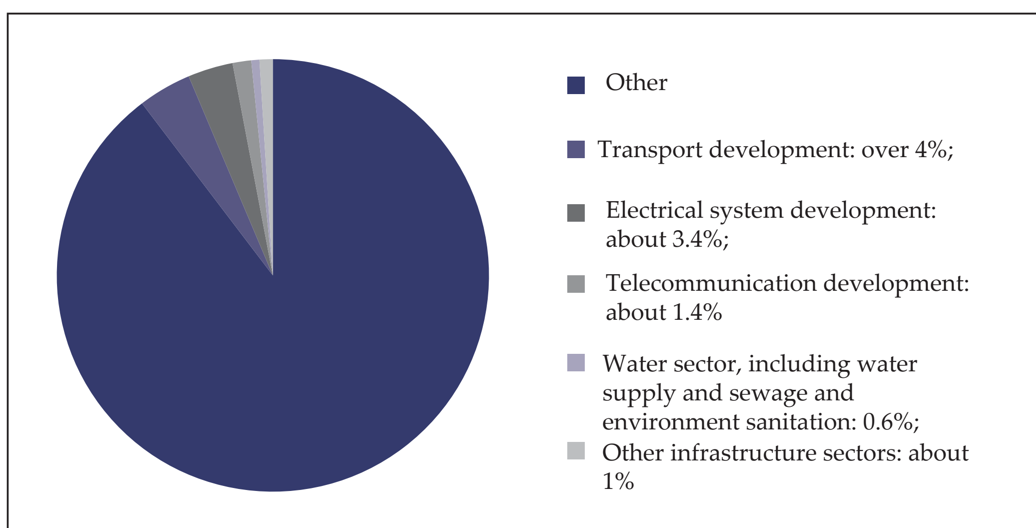
During the period of 2016-2020, the total capital of about VND 3,700-3,800 trillion (or USD 185-190 billion) would be needed, of which VND 2,100 trillion would be needed for transport infrastructure development (VND 1,100 trillion for roads, VND 650 trillion for railways (excluding express railways), VND 100 trillion for aviation, and VND 250 trillion for sea ports); VND 503 trillion for electricity (VND 319 trillion for power generation and VND 184 trillion for power grid; VND 150 trillion for irrigation; VND 75 trillion for water supply and VND 110 trillion for drainage; VND 110 trillion for education and training infrastructure, VND 110 trillion for health care infrastructure; about VND 350 trillion for urban, big city and rural infrastructure; and VND 200 trillion for ICT sector.

In order to ensure the average annual GDP growth rate of 8 percent by 2020, the experiences showed that the fund from different sources such as the State budget, State Owned Enterprises, ODA and government bonds is unlikely to increase in the next 10 years and could meet only 50 percent of the

above demands due to the restrictions by the ceiling level of budget deficit and the limits of national credits such as ODA, government bonds and Government guaranteed bonds, etc. For satisfying 50 percent of such demand, Vietnam is implementing appropriate solutions to attract capital from the private sector and the market, including about VND 700 trillion from infrastructure users (transport charges and water charges, etc.), about VND 1,700 trillion from domestic and foreign private partners of the State, and about VND 40 - 60 trillion from other sources through market channels.

As can be seen in Figure A1.1, it is estimated that total investment in infrastructure in 2007-2011 period was about 10 percent of GDP, of which Transport 4 percent; Electrical 3.4 percent; Telecommunication 1.4 percent; Water sector 0.6 percent; and Other sector 1 percent.

**Figure A1.1. Investment in infrastructure as percentage of GDP**




*Source*: Consultant estimate

## C. While there is currently no accurate estimate on total investment demand for municipal infrastructure, the needs can be further assessed at the local level

For urban infrastructure, the annual financing requirements for water supply, wastewater collection and treatment and low-income housing are estimated to be USD 380 million, USD 280, and USD 835, respectively. Municipal financing sources for infrastructure mainly come from land and lottery. It is estimated that in 2006-2010 period, expenditure from these two sources for infrastructure was about 2.7 percent of GDP. The provinces have earmarked US$ 1.8 to 2.7 billion for investment, but the need for additional financing remains considerable. In HCMC, a recent master plan for transportation estimated that the city needs USD 18 to 26 billion to address traffic issues until the end of the decade.

The demand for investment in infrastructure among local authorities is large and rapidly growing. The GOV has been attempting to tackle this growing demand, with mixed or limited results thus far. A key issue is the need to improve the operational capacity of local governments. At the same time, Vietnam's debt markets are underdeveloped and the sources of financing for infrastructure by local authorities are quite limited. Over the long term, sustainable financing would have to rely in

large part on domestic capital markets. While some resources may be available from equity markets, the bulk would depend on debt markets, through various types of bonds as well as commercial banks. Significant reforms would be needed for these resources to be adequately tapped.

Therefore, a policy area of central importance is the challenge of local government financing for the needed infrastructure services. Legislative changes in 2002 shifted powers and responsibilities to the provinces and special cities. Subsequently, the share of expenditures allocated to the sub-national level has dramatically increased. However, most local government revenues come in the form of intergovernmental transfers from the central government. Local governments have limited options to raise their own revenues and increasingly rely on the sale of land for investments. Provinces are allowed to borrow up to 30 percent of the value of capital investments annually (the exceptions are Hanoi and HCMC, which can finance 100 percent). There is, however, a lack of long-term debt financing. User fees for most important urban sectors neither cover operating costs nor generate revenues sufficient for investment. Many operations rely more on non-core functions (e.g., subsidiaries that engage in businesses such as real estate and construction) for revenue than they do on service fees. Sustaining strong investment for local infrastructure will depend on more sustainable sources of financing.

### D. Water supply is most advanced among the sectors, but cost recovery remains an issue, especially in smaller cities

Water supply is the urban service that has seen the most rapid development in Vietnam, and has closely tracked the country's urban growth. From 1997 to 2009 the market for urban water supply quadrupled, and investment in the sector has increased alongside urbanization. The sector's strong development is substantially driven by the fact that water supply directly and visibly affects urban populations—unlike sanitation, for example—and thus presents a more direct political interest. In addition, the water supply service draws a major part of revenues from users, but its development continues to be limited by a number of constraints.

Overall, despite sizeable investments, the needs remain large; the coverage rate is rising, but still insufficient. The coverage rate for urban households rose from 35 to 75 percent between 1997 and 2009. Households connected to the network have average access of 90 to 100 liters per day per person, against a national target of 120 to 150. At the same time, considerable differences exist in the coverage rates among cities. For example, the coverage in 2009 in the urban districts of HCMC and Haiphong ranged from 82 to 100 percent, while those in certain Class 4 cities were less than 20 percent. These small cities with much lower coverage levels are the urban areas that will be experiencing highest rates of population growth during the next round of urbanization.

For an urban population of 30 million people, in order to achieve a 90 to 95 percent coverage rate, production capacity of 8 to 9 million cubic meters per day would be required. This would entail increasing production by 4 million cubic meters per day, representing investments of approximately USD 3.7 billion. Subsequently, there are significant needs for extending coverage and improving the efficiency and quality of water production and distribution, including construction of new production units, improvement of quality of networks, water quality control.

Much investment at the sub-national level has been—and is currently still—supported by ODA and future investment will continue to be dependent on such support. Even though the financing

from ODA has been significant, it is unsustainable in the long run. The continued growth of the Vietnamese economy will result in a decrease in the amount of ODA funds available to the country in the upcoming years. In addition, the support would become less concessional and the cost of ODA funding would rise to be closer to commercial terms.

Currently, the financial standing of cities' water companies spans a wide range. This high degree of heterogeneity is due to the fact that tariffs are set by political authorities, the varying quality of management and the size of investments financed with debt. Examples include:

- Danang: The water company spends almost as much on operating costs as on loan repayments, and breaks even only via a subsidy.
- Binh Duong-Thu Dau Mot: Income prior to a 2009 tariff increase barely covered operating costs, but now finances part of the investments.
- Can-Tho: Turnover hardly covers operating costs (roughly 7 percent surplus in recent years), but none of the investment or associated expenditures.
- HCMC: The system was in deficit towards the end of the previous decade. The financial standing of the system is heavily dependent on the tariff at which water is purchased from BOOs and BOTs, and secondarily on the bulk sale price to its partially subsidized subsidiaries. The company recently requested a 30 percent tariff increase, which would allow it to cover expenditures, including investment costs.
- Haiphong: It is estimated that tariffs cover all operating costs; in a new sector supplied, where there is a surcharge on tariffs, the costs of installing the new network in 2005 are also covered.

Overall, with only a few exceptions, operators' investment capacities are low in the current context of tariffs charged, and in all cases, generally well below the objectives announced in terms of coverage and production.

As noted, in general, prices for basic services in Vietnam are low and in many cases do not cover operational, capital, and debt-service costs. While for special cities and Class 2 cities tariffs appear to barely cover operating and debt services costs, in Class 3 and 4 cities, these costs are on average higher than tariffs. Class 1 cities have generally managed to set tariffs at levels that cover those costs.

Water supply tariffs are generally "subsidized" on average (up to about 40 percent), sufficient only to finance operations and sometimes maintenance. Indeed, tariffs in Vietnam are low compared with international benchmarks, including East Asia and Pacific (EAP) averages. Further, for all city classes, the average water tariff represents only 3 to 4 percent of GNI per capita, suggesting that there is room for increasing tariffs to cover both operational costs and support investments, while still maintaining affordability for the urban poor. Ensuring cost recovery through increased household tariffs is important, as it opens possibilities for financing that would not otherwise be possible, and would help make investments in the sector viable. Industrial clients already represent a sub-segment where sale prices are more compatible with economic equilibrium.

## E. The sanitation sector continues to struggle to recover operating costs—not to mention investment- from user charges

Vietnam's wastewater collection systems are underdeveloped and exist mainly in major cities. Until recently, urban sanitation was more of a private good, with households installing septic tanks or

latrines. In theory, residential and commercial constructions must have septic tanks, but in reality, such systems are not built or maintained adequately, and effluents generally end up polluting soil and waterways. Existing collection systems are generally combined sewerage systems (rain and wastewater), except for in a few recently developed areas. Construction of sanitation infrastructure has lagged, compared with the excreta and flood management services needs of growing urban areas. Until recently, onsite sanitation, mainly via septic tanks, was considered sufficient to hand excreta in most cities. However, as population density and access to piped water has increased, wastewater discharge into combined sewerage/drainage networks has increased beyond capacity.

In 2004, none of Vietnam's cities were treating wastewater. Since then, several treatment plants have been built, but the percent of wastewater treated is in the single digits. Inadequate sanitation in Vietnam has caused large financial and economic losses. Financial losses, reflecting expenditure or income losses related to poor sanitation, amount to roughly 0.5 percent of GDP, while overall population welfare losses are about 1.3 percent of GDP. In addition, there are great inefficiencies in the financing of sanitation in Vietnam—in most cities wastewater fees cover only about 10 percent of operating and maintenance costs. The remainder is financed through transfers from the provincial/city governments. At the current and projected revenue bases, this arrangement is unsustainable.

At the same time, investment needs are estimated at USD 15 billion over the next decade, but there is no clear strategy for financing the sector. Furthermore, there is no clear plan to gradually increase coverage and treatment of wastewater in the country. Many cities are financing expensive, energy intensive treatment plants, but have no policy to connect households, most of which have private septic tanks, to the wastewater collection system. This has resulted in inefficient public spending.

At the moment, an Environmental Fee set by law at 10 percent of the related water tariff is levied to cover wastewater, environmental sanitation, and solid waste treatment. While the law allows for the collection of additional waste water fees to cover operating and maintenance costs plus movable assets, few provinces have applied this extra fee.

An added complication is that local governments have not distinguished between the environmental charge and the wastewater fee. They all have fixed a wastewater fee, collected by the water utility, representing a small portion of the water bill—as a convenient arrangement for fee collection. Sewerage operators have not been keen to collect the sanitation charges directly, due to the added cost required to create a parallel billing system to collect the charge from all customers. While the collection rate for water bills is high, at over 95 percent, the water tariff is quite low (approximately USD 0.25 per cubic meter), and thus the amount allocated toward sanitation is even lower.

The government has set aggressive targets for wastewater treatment at the secondary level—at least 40 percent by 2015, 60 percent by 2020, and 70 percent by 2025. For collection of sewage through sewerage systems, the GOV aims to achieve 70 percent by 2015, 80 percent by 2020, and complete coverage by 2025. These targets will require large amounts of investment, but since financing and other resources are limited, prioritization criteria and alternative options of finance need to be identified.

# II. Municipal Infrastructure Finance

## A. Institutional, Legal and Regulatory Framework

**Vietnam has three distinct levels of sub-national government, each with certain autonomy in setting its own budget.** The highest and most autonomous level of sub-national government consists of 57 provinces and five cities,[11] which have the same powers and responsibilities as provinces and independent jurisdictions. Cities and provinces are in turn divided into district-level governments (currently 690), which are further divided into communal government units (more than 10,000).[12]

**The legal and regulatory foundations for local infrastructure finance in Vietnam are given by multiple Laws and Decrees**. These include, *inter alia*: (a) the Law on State Budgets (2002) and the ensuing Decree detailing and guiding its implementation (2003); (b) the Law on Public Debt Management (2009); (c) the Decree on the issuance of Government Bonds, Government-guaranteed Bonds and Municipal Bonds (2011); (d) the Decree on Investments on the basis of BOT, BTO and BT Contracts (2009); and (e) the Public-Private Partnerships (PPP) Pilot Decision (2010). In terms of legal ranking, after the Constitution, the law has the highest validity then Government's resolutions or decrees, then Decisions or instructions of the Prime Minister, and then decisions, circulars or instructions of head of ministries or ministerial level agencies. [13]

### 1. Budget and Debt Management

#### *a. Budgeting*

**The Law on State Budgets (December 16, 2002) constitutes the overarching legal framework for the budgeting and financing of central and local government infrastructure.** Decree 60/2003/ND-CP (June 6, 2003) regulates the implementation of the Law on State Budgets. This Law is mainly concerned with the budget formulation process and the definition of revenues/expenditures, but it also sets the framework for the mobilization of third party capital by provinces and cities (domestic borrowing).Provinces and Cities (Provincial People's Committees and Councils) constitute the main level of sub-national government and have responsibility for defining the local budget: the estimated revenues and expenditures for the district and commune levels of Government that fall under their jurisdiction

**Even though the Law on state budgets provides local governments with certain budgetary autonomy, all of the budgets must be integrated into a single State Budget.** The budget process starts with the lowest level of sub-national government and progresses through the different administrative stages until it reaches the National Assembly for final approval. The People's Committee at the Commune level prepares a budget based on its own revenue estimates and taking into account the instructions received from the central government (through the respective Provinces and Districts) and submits it for approval to the Communal People's Council. A similar procedure is followed by the People's Committee and Council at the District level, which pass the approved budget on to the Province. At this level, all of the budgets of communes and districts under the responsibility of the Province are compiled into a single

11 Ho Chi Minh City, Da Nang, Ha Noi, Hai Phong and Can Tho

12 Nguyen-Hoang and Schroeder (2010)

13 Reviewing the Legal and Regulatory Framework on the Capital Market in Vietnam

budget, which once approved by the Provincial People's Council, is sent to the Central Government. The National Assembly approves the integrated State Budget and distributes the results to the sub-national governments and to treasury offices located around the country and responsible for recording the revenues and expenditures of the local governments under their jurisdiction.

**The Law assigns certain revenues to the local budgets but the authority to set tax rates remains with the central level of Government**. Revenues available for local budgets include tax revenues that are fully assigned to provincial and city governments, tax revenues that provinces and cities have to share with the central government, other revenues assigned to local governments by the central government, and domestic borrowing. The revenues that are fully available to local governments include proceeds from certain taxes (land and house, natural resource, license, land use right transfer, and agricultural land use), lotteries, non-refundable grants from international organizations, and other revenues. The provincial and city governments also get a fraction of the revenues from value added, corporate income, personal income, special consumption and petrol taxes. Finally, the local governments also benefit from central budget allocations.

**The Law also provides a list of "spending tasks" associated with local budgets with broad definitions for capital and operating expenditures.** According to the Law, capital expenditures (development investments) include investments in the construction of socio-economic infrastructure projects and investments in State enterprises, economic organizations and financial institutions. Regular expenditures include non-business activities, such as education and training, healthcare, culture, sports, arts, sciences and the environment; national defense and security; and support for the social and political organizations of the State. Provinces have the authority to assign expenditure responsibilities among district and commune governments, leading to differences in the way provinces manage expenditures.

**Under this Law, provinces and centrally-run cities with capital expenditures (development investments) under the scope of provincial-level budgets are allowed to mobilize domestic capital.** Although in principle, the Law indicates that local budgets should be balanced, it also contemplates domestic borrowing for investment in infrastructure projects that are included in provincial-level budgets and are part of the five-year plan of the provincial People's Councils. The amount of capital mobilized must not exceed 30 percent (with an exception of 100 percent for Hanoi and Ho Chi Minh Cities) of the local-level budget's capital spending (Article 8, Clause 3). People's Committees are required to prepare and submit capital mobilization plans for the approval of the People's Councils. These plans must include the specific investment projects that will be funded with debt (included in the approved five-year investment plan), the total investment capital to be mobilized, the form and cost of capital mobilization (interest rate) and the debt repayment capacity projected sources of repayment.

***b. Debt Management***

**The Public Debt Management Law of 2009 further defines the forms of municipal debt and introduces the possibility of indirect international financing through central government.** According to the Law, municipal debt can take the form of bonds, or loans from other lawful sources (including from the State Treasury). The Law, however, does not specify specific lawful sources of municipal debt. Also, the law contemplates municipal borrowing from only domestic and foreign sources for both non-revenue generating and direct/indirect revenue generating projects.

Provincial-level People's Committees have the responsibility of making full and timely payment of debt obligations. The sources of debt repayment consist of the funds available under provincial-level budgets and funds recovered under local investment projects capable of generating revenues. Domestic-borrowing conditions include meeting the criteria for project eligibility, approval by provincial-level People's Councils and by the Ministry of Finance and compliance with the borrowing limits established by the Law on State Budget. For the financing of revenue-generating projects, there are additional requirements, including the determination that the projects have the capacity to recover the capital invested and an explicit approval from the Ministry of Finance.

**Provincial-level People's Committees are not allowed to directly take international loans, but under certain conditions, may borrow funds from the Government's foreign loans for the financing of permitted investments.** In order for provinces and centrally-run cites to be eligible to benefit from central government on-lending, they must fulfill certain conditions: be authorized by the competent authority, have socio-economic development projects that comply with established investment requirements, and have a local budget with the sufficient capacity to repay the debt (Article 24, clause 3). For the Government loans lent to Provincial-level People's Committees, the Ministry of Finance evaluates the solvency of provincial-level budgets under the law on budget decentralization (Article 25, clause 5).

**The Public Debt Management Law defines municipal debt management procedures and defines the functions of the Provincial-level People's Committees and Councils with respect to the issuance of local administration debt.** Committees elaborate detailed annual borrowing and debt repayment plans, keep a record of eligible projects according to their source of financing, prepare debt issuance plans, execute debt issuances, allocate proceeds and monitor the use of funds. Councils have the responsibility for reviewing and approving the plans submitted by the Committees and supervising the borrowing, loan use and debt repayment tasks performed by the Committees.

**On July 14 2010, the Government issued Decree No. 79/2010/ND-CP (Decree 79) on public debt management operations.** This Decree builds upon the Public Debt Management Law and defines various aspects of public debt management, including: debt management instruments; procedures for the borrowing, use and repayment of public debt; risk management and debt restructuring; accounting, statistical review and audit of debts; and public information on and reporting and publicity of public debts. Decree 79 introduces long and medium term framework public debt management plans and annual detailed plans for borrowing and debt repayment. Additionally, the Decree establishes benchmarks for the measurement and monitoring of public sector debt and institutes auditing and reporting mechanisms for all of the entities in the State.

**In addition to governing the overall national framework for public sector debt management, Decree 79 establishes principles for the repayment of local governments' debts.** For on-budget loans, repayment must come from Provincial-level budget funds. For loans used for programs and projects, revenues generated by these programs and projects is used to repay loans first. When such revenues are insufficient for debt repayment, Provincial-level budget funds must be allocated to repay the outstanding debts. Provincial-level People's Committees must direct Provincial-level departments and functional sectors to closely monitor the use of proceeds from loans that fund programs and projects. Specifically, these units must prepare and furnish quarterly implementation and financial performance reports. According to this Decree, the on-lending to local administrations must comply with the law on on-lending of the Government's foreign loans (Decree 78 of 2010).Concurrent with

Decree 79, the Government also issued Decree No. 78/2010/ND-CP regulating the on-lending of Government's foreign loans. This Decree is analyzed in the next section on local government debt.

**2. Local government debt**

**Although the State Budget Law does not specify bond issuance as the only way to raise money, defining borrowing simply as "mobilization of capital", bond issuance has been the most prominent form of financing at the sub-national level.** The only three sub-national governments that have accessed substantial financing in the capital markets are Ho Chi Minh City, Hanoi and Dong Nai Province. Until 2011, when a new framework for the issuance of municipal bonds was established, the capital mobilizations had to be done through the issuance of investment bonds in accordance with Decree No. 141/2003/ND-CP. The present section describes the new framework for the issuance of municipal bonds.

**The Vietnamese government revamped and simplified the legal framework for the issuance of municipal bonds in early 2011.** Until February 2011, domestic bond issuance was regulated by Decree 141/2003/ND-CP (November 20, 2003) and international government bond issuance by Decree 53/2009/ND-CP (June 4, 2009). Decree 01/2011/ND-CP (January 5, 2011) consolidated the regulations for the issuance of both domestic and international government bonds and replaced the regulations contained in Decrees 141/2003/ND-CP and 53/2009/NC-CP. This Decree provides the new framework for the issuance of government bonds, government-guaranteed bonds and municipal bonds. This new Decree introduces important changes to the government funding framework, introducing more flexibility to the use of bonds and linking government bond issuance activity with public debt management goals.

**Under the current framework, provincial and city People's Committees are authorized to issue bonds to finance local investment projects that meet certain conditions.** Municipal bonds are defined as debt securities issued by the Peoples' Committees of provinces and cities under central authority (Provincial People's Committee) in order to raise funds for local investment works and projects. The Decree states that Municipal Bonds can be issued to fund investment in: (a) socio-economic development projects included in (under the spending task of) the local budgets, according to the Law on State Budget, and under the investment portfolio defined in the five-year plan decided by the Provincial's People's Council; or (b) "local repayable projects" identified by the Provincial People's Council. The provincial People's Committees have responsibility for arranging for the payment of interest and principal on the bonds when due. The Provincial People's Committees (PPCs) are required to ensure repayment of debt obligations come from the local budget and from local revenue-generating projects.

**Municipal bonds are issued under bond issuance plans prepared by provincial People's Committees, accepted by provincial People's Council and approved by the Ministry of Finance.** Following the guidelines established in the Law on State Budgets, bond issuance plans must include the bond issuance objective, information on the projects to be funded, a repayment plan and the projected amount, maturity and interest rate on the bond**.** Municipal bonds have to be registered and deposited at the Securities Depository Center and listed and traded on a stock exchange following the guidelines established by the Ministry of Finance. Municipal bonds are issued through tendering, underwriting or bond issuing agents and must be issued with maturities longer than one year.

**Decree 79 (analyzed under public debt management above) regulates the preparation of local governments' borrowing and debt repayment plans.** According to this Decree, the Provincial-level People's Committees set the borrowing limits for local budgets for reporting to Provincial-level People's Councils and submission to the PM for approval. A Provincial-level People's Committee that needs loans in excess of its borrowing limit has to elaborate a specific plan and submit it to the MOF for appraisal and reporting to the PM for final decision. Provincial-level People's Committees elaborate annual detailed plans on borrowing and debt payment and submit them to Provincial-level People's Councils for approval.

**These plans are based on the borrowing limits under the State Budget Law, the capacity to balance provincial-level budgets for debt payment, implementation schedule and funding needs of debt-financed projects**. The centralized approval and monitoring process ensures that the loans are only allocated for operations that provide a rapid return on investment and can generate cash flows sufficient to guarantee repayment. It also holds the province or centrally-run city responsible for the repayment of the debt.

**3. On-lending of foreign loans to sub-national governments**

**The Central Government also on-lends foreign loans (commercial, concessional or ODA) to local governments according to the guidelines established in the Decree 78/2010/ND-CP (Decree 78).** The Decree allows the Central Government, specifically through the MOF, to on-lend foreign loans to Provincial-level People's Committees. Prior to approving the loan, the MOF evaluates the Provincial-level People's Committee's local budget plan for the year in which the foreign loan agreement is signed and the loan use and payment plan approved by the Provincial-level People's Committee. The MOF has 30 days to issue a written notice on the evaluation results to the Provincial-level People's Committee.

**Under the Decree, Provincial governments have certain advantages relative to other sub-borrowers.** Although the Central Government charges an on-lending charge from sub-borrowers in order to cover operational expenses incurred in the management and recovery of the on-lent loan, this charge does not apply to on-lending to Provincial-level People's Committees. For provincial-level governments (including centrally run cities), the on-lending currency is the original currency in which the loan has been borrowed.

**Provincial Governments may borrow funds from international loans granted to the Central Government in both foreign and local currency with differing interest rates depending on the nature of the original loan.** For Concessional and commercial loans, the on-lending interest rate is equal to the foreign lending interest rate. The interest rate for the on-lending of ODA loans in foreign currency is equal to two thirds of the commercial reference rate or the commercial reference rate, whichever is lower. If the on-lending takes place in Vietnamese Dong, then the on-lending interest rate results from adding an exchange rate risk factor (calculated by the MOF for the ratio between Vietnamese Dong and US Dollars, Japanese Yen and Euros) to the foreign currency lending interest rate.

**4. Private sector participation in local infrastructure finance**

**The legal and regulatory framework for private sector participation in infrastructure is given by a Decree regulating Concession Contracts (Decree 108-2009-ND-CP) and a Pilot Decision**

**on Public-Private Partnerships (71/2010/QD-TTg).** Development Banks are supporting the Government on capacity building, preparation of first PPP transactions and further refinement of PPP regulation. Decision 71 does not provide detailed guidance on how a PPP project is prepared, processed and implemented. Types and level of government support, including a viability gap funding mechanism, are not well defined. Guidance for competitive selection of investors is currently not in place. It is the intention of the Government to refine and improve Decision 71, taking into account the experience of the first PPP pilot transactions, including the expressway PPPs being developed with the assistance of the World Bank.

***a. Concession Framework (BOT, BTO and BT Decree)***

**In November 2009, the Vietnamese Government issued Decree No. 108/2009/ND-CP for regulating investment on the basis of BOT (Build-Operate-Transfer) contracts, BTO (Build-Transfer-Operate) contracts and BT (Build-Transfer) contracts (Decree 108 or Concession Framework).** This Decree is a generic law, defining the sectors, conditions, procedures and incentives applicable to infrastructure development investment projects develop under the above mentioned contract types. This Decree replaced the previous framework for private participation projects based on Decree 78/2007/ND-CP.

**Decree 108 has been followed by Government circulars setting guidelines for its implementation.** In January 2011, the Ministry of Planning and Investment issued Circular No. 03/2011/TT-BKH (Circular 03) to provide guidelines on implementation of some articles of Decree 108. This circular clarified certain aspects regarding the implementation of the Concession Framework. On 17 November 2011, the Ministry of Finance issued Circular No. 166/2011/TT-BTC (Circular 166) to provide additional guidelines on the implementation of Decree 108.

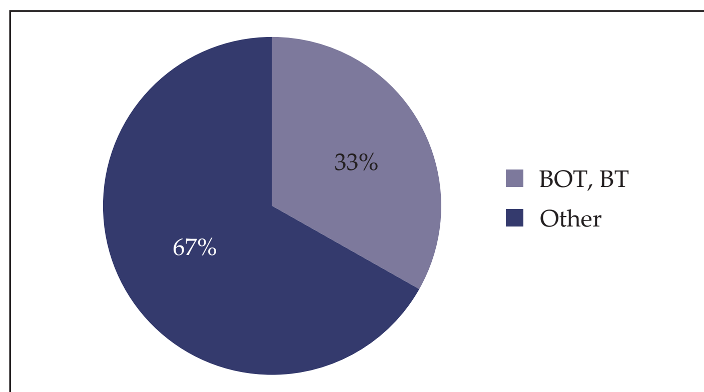
**The Concession Framework is applicable at the central and local level for the development of projects in the transportation, power, water and other infrastructure sectors**. The Decree contemplates the following sectors: (a) roads, bridges, tunnels and related utilities; (b) railways and tramways; (c) airport, seaports, river ports and ferry-landings; (d) water plants and power transmission; and (e) other infrastructure sectors as decided by the Prime Minister. In April 2011, the Vietnamese Government issued Decree 24/2011/ND-CP (Decree 24) modifying some articles of Decree 108. Decree 24 expands the applicability of the Concession Framework to the following additional sectors: medical health, education and training, occupational training, culture, sports and facilities for state entities.

**To implement a BOT, BTO or BT project, the investor must establish a new project company following the procedures established in the Law on Enterprises and the Law on Investment to establish companies in Vietnam.** The authorized State body, the investor and the project enterprise sign a document permitting the project enterprise to assume and exercise the rights and obligations of the investor pursuant to the provisions in the project contract. This document constitutes a fundamental part of the project contract. The Law defines the State body authorized to enter into and implement a project contract as any entity implementing the State's administrative function, and being a subsidiary unit of a ministry, branch or provincial People's Committee and delegated with such authority. Ministries, branches and provincial People's Committees are charged with formulating lists of BOT, BT and BTO projects in their respective sectors or jurisdictions

**Regarding project funding, Decree 108 establishes minimum equity ratios that are less restrictive than those contemplated under the Decree 78 and a maximum ratio for public funds contributions.** According to the Decree, for projects under VND 1.5 trillion, the equity of the project company must be equivalent to at least 15 percent of total investment capital. For projects over VND 1.5 trillion, the equity of the project company must be at least 15 percent of the total investment capital for the first VND 1.5 trillion and 10 percent for any portion of the investment above that threshold. The Decree also limits public sector funds contributions to 49 percent to total investment capital. Public funding is not subject to this cap if it is used to support projects of high urgency through the construction of auxiliary works, land clearance and resettlement compensation.

**According to the Concession Framework, investors must satisfy certain conditions in order to participate in the tendering process.** Circular 03 established a general process of open tendering or direct appointment to select an investor based on capability and experience and the best technical and financial proposals in accordance with criteria set out in the tender invitation documents or set of requirements. There is need for more detailed guidance on the selection process, the form of bidding documents and key covenants of concession contract, as well as for contract monitoring and asset handover. Until early 2012, no competitive selection of investor has been implemented.

**Figure A1.2. BOT and BT forms of investment in total investments for transport projects approved by Ministry of Transport, 2012-2013**

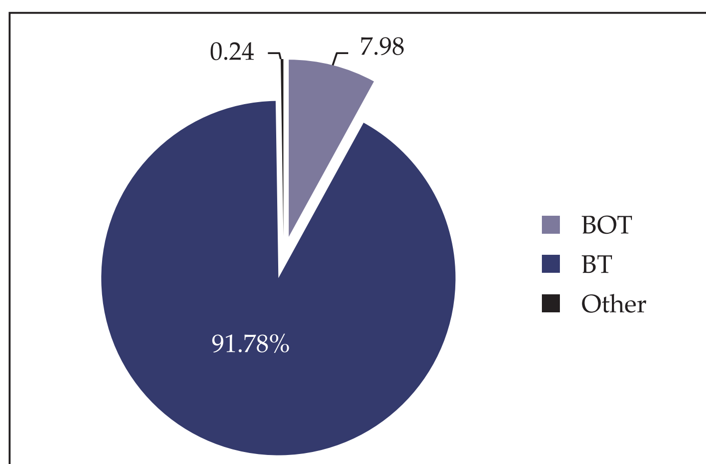



*Source*: Consultant estimate

As indicated in Figure A1.2 above, of the total of VND 164,221.30 billion needed for transport projects in the priority list of Ministry of Transport for 2012-2013 periods, investments in BOT and BT forms are VND 54,492.50 billion (or 33.2 percent). This indicates increasing role of BOT/BT forms of investment in this sector.

Another feature of BOT and BT investment forms is that most past investments have centered on the transport sector. For example, of five BOT/BT projects licensed by the Ministry of Planning and Investment (MPI) during the 2007-2011 period, more than 99 percent of capital went to this sector (see Figure A1.3).

**Figure A1.3. Capital investment in BOT and BT projects licensed in 2007-2011**




*Source*: Consultant estimate

***b. Public-Private Partnerships (PPP Pilot Decision)***

**The PPP Pilot Decision covers the provision of public infrastructure services through projects implemented jointly by the public and private sectors.** These joint projects are to be developed based on an agreement between the government and a private investor. Therefore, there is some degree of overlap with the Concession Framework Decree and ensuing Circular. The PPP Pilot Decision covers part of the project schemes subject to the Concession Framework Decree, as well as others, such as Build-Operate-Own (BOO) that were not contemplated in Decree 108.[14] The overall goal of the pilot is to attract private capital (local and foreign) for investment in infrastructure development.

**PPPs can be pursued in infrastructure sectors to support projects meeting specific criteria.** The PPP Pilot Decision contemplates the same infrastructure sectors as the Concession Framework and includes a specific reference to others not mentioned in Decree 108 (but later included in Decree 24), such as healthcare (hospitals) and environment (water disposal / processing). In terms of project eligibility, the Decision gives priority for PPP implementation to: large-scale projects required immediately for economic development; projects that allow for recovery of the capital invested through revenues obtained from users; projects able to effectively use private-sector capital, technologies and management competencies; and other criteria defined by the Prime Minister.

**The PPP Pilot Decision incorporates specific guidelines in terms of the capital investment required from the private sector partners and financiers.** In terms of funding, the PPP Pilot Decision stipulates that the investor's equity capital must account for at least 30 percent of the private sector investment in the project. The investor can seek commercial loans and funding from other sources (without a Government Guarantee) to fund up to 70 percent of the private sector investment in the project. According to Circular 166, these funds must be mobilized in accordance to the project schedule and their disbursement must be certified to the Government.

14 Study on PPP Infrastructure Projects in Vietnam, Draft Final Report, Japan Economic Research Institute, April 2011.

**State participation in PPPs can take a variety of forms including the provision of capital, investment incentives and other policies directed at enhancing the feasibility of the project.** The State contribution in the project cannot be considered as equity capital of the project company or generate the right to dividends. According to the Decision, the total value of the State participation in the PPP cannot exceed 30 percent of the total project investment unless authorized by the Prime Minister. There is still unclear understanding and guidance on how to estimate different types of state participation, including guarantees and incentives.

**5. Land for Infrastructure**

**Regarding the regulatory framework for land, the Land Law (November 26, 2003) regulates overarching legal framework for the administration and use of land.** The law states that land belongs to all of people in Vietnam, with the State as the representative of the ownership of land. Land lease by the State means the grant of land use rights by the State on the basis of a contract to an entity which has requirements for land use.

**Decree 181/2004/ND-CP181 of October, 2004 (Decree 181) regulates the implementation of the Land Law.** The Decree provides guidance in regards to various areas of the Land Law, including: land use planning, land assignment, land lease, land use purpose change, land recovery, land requisition, land use right registration, land use rights in real estate market, agricultural land use regime, non-agricultural land use regime, rights and obligations of land users, land management and user order and settlement of land-related disputes and complaints.

**The Decree sets the responsibilities of central and local government agencies in regards to land management and as is common in Vietnam, allocates ultimate decision-making to the central level.** According to the Decree, at the local level (provincial/municipal level), responsibility for land management resides with the Provincial / Municipal Services of Natural Resources and Environment (local land management agencies). The district-level sections of these services will have responsibility for land management in their respective rural or urban districts, provincial capitals or towns. However, a lot of the responsibility still resides in the central level. In coordination with the Ministry of Home Affairs, the Ministry of Natural Resources and Environment has the responsibility for detailing the organizational apparatuses and administrative procedures of the local land management agencies. The People's Committees of provinces and centrally –run cities and the People's Committees of urban and rural districts have to build and implement the organizational apparatus of the local land management agencies according to the guidance provided by the central level.

**Provincial/ municipal People's Committees are in charge of the elaboration of general land use plans.** The provincial / municipal People's Committees send their plans to the Ministry of Natural Resources and Environment for approval and incorporation into a nation-wide land use plan. According to the Decree, the dossiers presented by local governments to the central government must include a general report explaining the use of the land and a map showing the current use of the land. However, the Decree does not specifically mention land-based financing of infrastructure as one of the aspects to be taken into account when elaborating these plans.

**Land used for infrastructure would fall under the definition of "non-agricultural land", and specifically, in the "special-use land" category.** In the Decree, the category of "Non-agricultural Land" includes special-use land such as business land and land use for public purposes under the

realm of provincial/municipal People's Committees. This is land that can be used for public purposes, including transportation, water and sanitation, power and social infrastructure. This type of land is eligible for participation in the real estate market and can be assigned by the State in exchange for land use levies or rent**.** The Decree's provisions for land use rights in real estate markets and the non-agricultural land use regime can be applied to domestic or foreign private investors.

**Current regulations allow the use of land for the creation of investment capital, in cash or in kind, for the construction of infrastructure.** Funding derived from land can be used to finance infrastructure capital investments in two ways: i) through an auction of the land use rights to generate cash proceeds for direct funding of construction works (auction of land use rights for cash consideration); or ii) through the combined bidding of a construction project plus the associated land use rights as a way to create capital for the development of the works ("land for infrastructure").

**Decree 181 establishes general principles on which the above-mentioned processes have to be carried out.** Land right use auctions for cash consideration must ensure independence between the auction for the land use rights and the budding for the construction of works and clear identification of the land use purposes and of the structure of the auction. Also, the "land for infrastructure" scheme must also follow certain principles including: (a) the point scale for marking the bids for construction of works and the point scale for marking the land use right auction shall be drawn up separately; (b) the provincial/municipal People's Committees must clearly identify the land use purposes and structure for land put to auction; (c) when using the bid-winning land, the bid winners must draw up land use schemes to be considered and approved by Provincial/municipal People's Committees; and (d) the procedures for the auction of the land use rights and biddings for works involving land use must comply with the regulations issued by the Prime Minister. It is not clear to what regulations this last principle refers to.

**The Decree allows for the use of land for the execution of Build-Transfer (BT) and Build-Operate and Transfer (BOT) projects (Article 87).** The regulations for the use of land for the development of these types of projects falls under the Non-agricultural land use regime (Chapter VII). According to the regulations, the State can assign land to investors for the execution of projects under these modalities. For BT Projects, the investors do not have to pay land use levies or land rents during the construction of the works under the approved projects and have to preserve the land areas assigned for the purposes intended under the project. Also, investors must comply with the transfer requirement established in the project and if they fail to do so, they must pay rent from the originally established date until the effective transfer of the land back to the government. For BOT projects the State can either assign or lease the land to investors, who may benefit from land use levy or land rent exemption or reduction.

### 6. Local Development Investment Funds (LDIFs)

**LDIFs are governed by Decree 138 on the Organization and Operation of the LDIFs, issued in 2007.** Following the creation of a "pilot" LDIF in Ho Chi Minh City (HIFU) in 1997, the first law on LDIFs was promulgated in December 2001. After multiple pilot projects, the precise definition of the operating mechanisms was defined in Decree 138 of August 2007 on the organization and management of LDIFs, which paved the way for the widespread implementation of the current version of LDIFs.

**This Decree, along with accompanying MOF guidelines, identifies the legal status, objectives and scope of activities for LDIFs.** The activities include: mobilizing mid to long-term financing from institutions and individuals both in Vietnam and internationally; investing in social and economic infrastructure projects; and managing investments and liabilities and issuing local municipal bonds under the approval of local governments. LDIFs are not subject to the new Law on Credit Institutions, which entered into force in 2011. The MOF has taken leadership over the coordination and supervision of LDIFs.

**The MOF has established a Project Management Office (PMO) to support the LDIFs implement these policies and has set qualifying criteria for LDIFs to receive technical assistance and capital funding.** The MOF is in charge of developing an institutional/capacity training program to help them achieve qualification. A technical assistance program to address the key needs and allow the LDIFs access skills necessary for implementation in terms of Decree 138.

**7. Government Guarantees**

**Government guarantees are contemplated in the Law on Public Debt Management of 2009.** According to the Law, the Ministry of Finance (MOF) is the entity in charge of providing and managing government guarantees for loans or for the issuance of international and domestic bonds. These guarantees are available for enterprises implementing projects and programs directed by the National Assembly or the PM; programs or projects applying high technologies, in the energy and extractive industries sectors or export-oriented in accordance with the national development plans; projects and programs in areas eligible for state investment incentives; and programs and projects funded with commercial loans associated with ODA funds in the form of syndicated credits. In order to make use of government guarantees, projects and programs must have followed the investment procedures established in the investment law and have a financing scheme approved by the MOF. Local governments are currently not allowed to receive Government guarantees.

**Decision No. 44/2011/QD-TTgof August 2011 (Decision 44) sets out a more specific list of prioritized programs and projects for Government guarantee consideration and expands eligibility to infrastructure projects.**[15] The prioritized programs include: investment programs and key projects in all sectors for which the National Assembly (NA) or the PM has approved the investment decision as requiring urgent commencement; credit programs implemented by State policy banks in sectors for which the PM has approved; programs and projects funded by Official Development Aid (ODA); programs and projects in the sectors of energy and mining (power sector development, petroleum refinery plants and natural gas, alumina and aluminum mining for which the National Assembly has approved the investment policy); programs and projects for manufacturing important mechanical engineering products for substitution of imported goods; programs and projects in construction and infrastructure development, comprising: transportation projects, procurement of locomotives in projects for investment in the national railway system for which the National Assembly has approved the investment policy; and investment projects for construction of educational, training and vocational establishments with the capacity to recover their invested capital.

15 On 18 August 2011, the Prime Minister (PM) issued Decision No. 44/2011/QD-TTg (Decision 44) promulgating the list of prioritized programs and projects for considering issuance of Government guarantees. This list was formulated to implement Article 6.2 of Decree 15/2011/ND-CP (Decree 15) dated 16 February 2011 on provision and management of Government guarantees.

**Decree No. 15/2011/ND-CP of February 2011 (Decree 15) regulates the provision and management of Government guarantees for foreign and domestic loans.** The Decree gives the MOF the power to provide Government guarantees in accordance with a decision of the PM for each guaranteed tranche of debt (loans or bonds) as long as the guarantees meet certain conditions (detailed below). The written undertaking to provide a Government guarantee is made in the form of a letter of guarantee, a contract of guarantee or a decision on guarantee (collectively referred to "letter of guarantee").

**The MOF is the Government entity in charge of implementing Decree 15 in coordination with other Government entities**. The MOF provides Government guarantees in accordance with a decision of the PM on each loan or bond issue tranche; appraises the financial plan and the application file for the guarantee; and approves assignment or transfer of a Government guaranteed loan or bond issue. According to the Decree, the Ministry of Justice (MoJ) is responsible for negotiating the legal agreements and providing a legal opinion for issues involving foreign loans. The Ministry of Foreign Affairs (MoFA) coordinates with MOF the appointment of the appropriate Vietnamese representative offices abroad to receive legal files regarding Government guarantees in cases where the legal proceedings procedures stipulated in the foreign loan agreement and letter of guarantee require such office in the foreign country to receive the legal file. *Nonetheless, the framework still lacks detailed guidance on how to prepare and appraise a guarantee, as well as an effective institutional setup, including a specialized unit mandated with providing guarantees and managing the associated risks.*

**Decree 15 establishes certain conditions regarding the amount and nature of Government Guarantees.** According to this Decree, the level of a guarantee must not exceed 80 percent of the total investment of the program/project including all relevant loan fees. For an enterprise with a foreign ownership share, the guarantee is only provided for the part of the loan in proportion to the liability of the Vietnamese party in the enterprise. The enterprise (guaranteed borrower) may only transfer the Vietnamese parties' shares or contributed capital (in whole or in part) to foreign investors only after it has fulfilled or debt payment obligations with respect to the guaranteed loans in proportion to the ratio of shares to be transferred and after giving notification to the MOF. Owners of shares or contributed capital of 5 percent or more of the total contributed charter capital shall jointly make a written commitment to hold at least 65 percent of their capital while the guarantee is in force.

**The beneficiary of the guarantee has the responsibility of discharging the guarantee obligations, paying guarantee fees and securing repayment to MOF in the event of a call on the guarantee.** The maximum guarantee fee must not exceed 1.5 percent per year of the guaranteed debt balance. In the case of late payment of guarantee fee, the enterprise will pay interest on the late amount. Upon repayment, if the enterprise fails to pay or fails to make full payment, the guarantor will pay as committed in the letter of guarantee. The guaranteed enterprise will be responsible to return to the guarantor all such payments made plus all costs incurred as a result of such payment on its behalf. The assets created from government-guaranteed loans may be mortgaged to secure the fulfillment of the borrower's obligations vis-à-vis the MOF in proportion to the loans' share of the funding. Assets formed from government-guaranteed loans may not be used to secure the fulfillment of other civil obligations.

**Some aspects of the current framework need to be further analyzed when considering the provision of Multilateral Guarantees with a counter-guarantee from the Government.** First,

according to Decree 15, the Government only provides guarantees and does not provide backstop existing guarantees ("re-guarantees"). It is unclear if this would impede the Government from providing an indemnity to a multilateral providing a guarantee on its behalf. Also, in the case of a foreign-invested enterprise eligible for a Government guarantee, only the portion of the loan capital of the Vietnamese party in the enterprise will be guaranteed. This would pose a restriction to the structure of the guarantee and preclude foreign investors from benefiting from it.

## B. Main institutional and Regulatory Gaps

### 1. Lack of a mechanism for providing clear and transparent fiscal allocations for municipal infrastructure development

- Municipal infrastructure development often needs additional fiscal allocations, other than the traditional budgetary arrangements currently stipulated in the Budget Law.
- A transparent fiscal allocation framework can be developed to manage both central government budget resources and ODA resources for development of urban services.

### 2. Lack of a comprehensive sub-national debt management mechanism, including local government borrowing limit, fiscal risk management and recourse arrangement between national and provincial budget

- The Public Debt Management Law allows the central government to lend to provincial governments. However the Budget Law does not stipulate how lending and repayment are managed and integrated with in the budget preparation, approval and implementation process.
- Sub-national debt management on borrowing limit does not reflect the repayment capacity of each local government. Local governments are currently allowed to borrow, however the borrowing limit is set based on the ratio of local government borrowing to its annual capital investments: up to 30 percent for all provinces except for Hanoi and HCMC, which can borrow up to 100 percent. This borrowing limit mechanism also complicates the central government's structured monitoring of the local government borrowing capacity as the borrowing limit is changed every year due to the fluctuation of annual provincial capital budgets.
- There is no clear legal framework to have a recourse mechanism, including its detailed procedures. The recourse mechanisms ensure that, in the case of local government default, the central budget can fulfill its obligations with financiers and recover the funds from the provincial budget. The recourse mechanism would play an important role in credit enhancement for local governments by providing financers the necessary security that is currently absent in the market in Viet Nam.
- According to the Law on Public Debts Management, the only relevant clause on recourse is the Government Guarantee (Chapter VI- Managing the Government Guarantees), where the MOF is the Guarantee Provider to the eligible entities and projects. The Law is silent on whether the Local Government (Provincial People Committee- PPC) can provide a guarantee. This is interpreted as formal prohibition for the PPC to provide guarantees.
- Alternatively, the PPC may opt to take the local government loans by taking the loans from MOF, issuing bonds or borrowing from other sources as provided in the Chapter V- Managing Debts of the Local Governments of the Law on Public Debts Management. If the PPCs see the need to provide guarantee to any Entities and legally, it cannot be done, then it can be technically done by PPCs taking the loans and providing on-lending to the Entities.

- Decree 78/2010/ND-CP (Decree 78) provides guidance on on-lending of the Government loans, where the Government loans can be on-lent to: (a) the Intermediate Financial Institutions (IFIs); (b) the Entities (Business Enterprises); and (c) the PPCs. The recourse is allowed if the borrowers are (a) the IFIs; or (b) the PPCs. An exception is allowed for enterprises if approved by the Prime Minister. Thus, technically, the loans on-lent to entities from MOF are all non-recourse (collateral-backed loans).
- The only other exception allowed for the Entities which could be interpreted as recourse is the case when the Entity applying for the loan has just been newly established (less than three years since the establishment). In this case, a written guarantee from the holding company or the representative from the owner/ shareholder must be prepared and furnished to MOF.
- In conclusion, the current Law on Public Debt Management and the relevant Decrees do not provide appropriate legal context for recourse to happen. The Guarantee by PPC, under the current law is not a possible option. The other means/ techniques of recourse may be allowed by a Decree/ Decision from the Prime Minister.

**3. Absence of a specialized facility at the national level for credit enhancement, guarantee service, and funding of municipal infrastructure**

Such a specialized facility can provide some or all of the following services, *inter alia*:

- act as a municipal development fund investing in municipal infrastructure;
- lend long term capital to provincial governments (when allowable in the Budget Law) and to public utilities;
- co-finance municipal infrastructure projects that receive budget allocations to cover part of the investment, and provide oversight for the entire project, on behalf of the central government;
- provide guarantees for municipal infrastructure projects, to either financiers or private sector investors;
- raise long term capital and provide long tenor loans (potentially at a lower cost than what could be achieved with municipal bonds) to local governments; and
- improve investment efficiency through the use of standardized investment appraisal.

**4. Lack of the enabling environment to develop the market for municipal bonds**

- The State Budget Law allows local governments to issue municipal bonds; however, the current appraisal procedure is not sufficient to increase and improve municipal bond issuance. The procedure requires MOF's approval for the sub-national government's whole plan for capital mobilization, which lengthens the overall bond issuance process.
- The centralized approval for bond issuance does not enhance the autonomy, accountability and capacity of the local governments that will issue its own municipal bonds.
- There are a few experiences in municipal bond issuance that meets international standards such as sufficient information disclosure to investors. The information disclosure increases the transparency of bond issuance and comfort for investors. The current municipal bond framework does not stipulate detailed requirements of information disclosure and does not encourage the use of ratings agencies.

**5. Land-based infrastructure scheme needs to be fine-tuned**

- The land use planning process established in the Land Management Decree is very long, normally taking two years or longer to complete the preparations and negotiations.
- In general, the Land Management Decree can generate certain constraints in the implementation of BT projects:
  - process is not standardized, creating some transparency concerns;
  - price of land use rights is set before the project is developed, which does not allow the local governments to capture the additional value from the land; and
  - Lack of a support mechanism to cover the high costs associated with the clearance of land.
- The Government is currently working on a new decree to address some of these shortcomings.

## III. Financing Instruments Available for Municipal Infrastructure Development and Current Issues

### A. Bank Debt Market

Banks in Vietnam are governed by the Law on Credit Institutions (LCI), which defines banks as credit institutions that can receive on-call deposits for lending and provide payment services. Other laws govern the activities that are associated closely with the credit operations of banks, such as the Law of Land in what pertains to the various provisions regulating the mortgage of land use rights and of the property attached to the land. There is also a large number of regulations including resolutions and decrees of the Government, decisions of the Prime Minister, circulars of the State Bank of Vietnam (SBV) and relevant ministries and decisions of the SBV's governor and relevant ministers.

In a centrally planned economy, the banking sector has been instrumental in financing infrastructure needs, often directed by Government. The State-owned Commercial Banks (SOCBs)[16] have been an important source of financing. In 2007, more than half of the infrastructure loans were made to the State-owned Enterprises (SOEs), and of these, the majority were in the power sector. In recent years, the GOV has taken additional measures to strengthen bank regulations to catch up with international standards and further curtailed directed lending. The GOV has also made the institutions responsible for their own lending portfolio. Bank lending to infrastructure is done on a relatively more 'commercial basis'. A new Law on Credit Institutions (LCI) was issued in 2010 and is in force since 2011. However, there are several key factors constraining the performance of the banking sector.

**Limited investment appraisal capacity.** The past policies of "directed lending" for infrastructure and other sectors have led to the accumulation of non-performing loans (NPLs). Because of these policies, the banks had limited incentives to develop the technical capacity to evaluate, select and monitor projects along commercial principles. Indeed, the banks conducted little to no technical and risk assessment of competing projects, and the repayment capacity of the projects and the borrowers was rarely considered because the loans implicitly assumed the guarantees by the local or

16 Six SOCBs comprising: Bank for Agriculture and Rural Development (Agribank); Mekong Housing Bank (MHB); Vietnam Bank for Social Policies; Bank for Investment and Development (BIDV); Bank for Foreign Trade (Vietcombank); and Industrial and Commercial Bank (Vietinbank).

central government. Collateral was rarely secured even in cases where the projects were subject to various Government interventions that could directly impact cost recovery and financial returns.

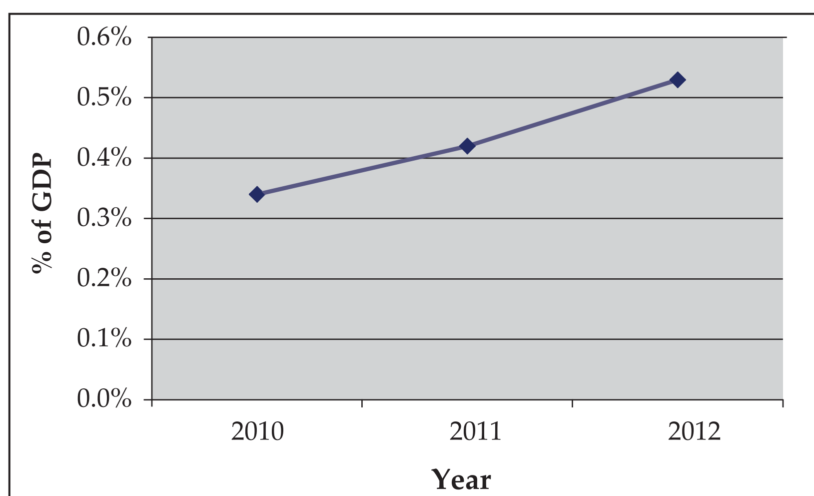
**Absence of an effective risk management and asset liquidation framework.** Because of the directed lending policies and Government interventions limiting cost recovery for borrowers, banks were routinely faced with borrowers' inability to repay within the fixed term. As a result, loans were often restructured and extended. Responsibility and accountability for any issues that arose were inadequately assigned. As a result, the motivation of management and staff to improve the portfolio was not very strong. In addition, delays in the judicial system resulted in slow progress toward true restructuring of problem loans. As a result, even the loans that were backed by collateral were in effect equivalent to project financing without recourse to the sponsor. When debtors are SOEs and their assets actually belong to the government, banks will find difficulty in bringing delinquent debtors to foreclosure and seize their assets. Many countries permit and incentivize banks to assess projects and take initial steps to finance some of them, and shift the assets off the balance sheet of the banks through a securitization program once the loans are in place. The current legal framework of Vietnam does not have a clear set of provisions relating to securitization of loans.

**Mismatch between long-term assets and shorter-term liabilities.** The commercial banks in Vietnam do not generally mobilize funds beyond a term of one to three years. SBV has reported that only one third of all deposits mobilized by the banks have terms longer than 12 months. The disparity between the short-term deposits held by banks and the long-term financing needs for infrastructure projects has resulted in banks having asset-liability maturity mismatches on their balance sheets when making infrastructure loans.

**Banks are reluctant to finance infrastructure projects because they view the lack of assurance for tariff increases, as well as recourse mechanism, as too risky.** In the Water Supply Sector, tariff increases are legally feasible, and technically affordable to low income families. However, increases are held in check by the PPCs, which hold decision-making power and are keen to avoid politically unpopular measures. Banks do not have sufficient capital base to finance long term sizable infrastructure projects, which usually requires large amount of funding. As a result, commercial banks have not been active in financing infrastructure projects.

**In the commercial banking market, sub-national lending is also underdeveloped.** Commercial banks are also reluctant to finance local governments as they are not experienced in lending directly to local governments. Only DBV has lent to local governments, however very limited numbers of lending have been done in the past. The development of sub-national lending market is often promoted by the establishment of a specialized second tier facility providing loans to commercial banks to make lending to local governments and a supporting legal and regulatory framework. However, the current banking market in Vietnam lacks such a second-tier lenders, the relevant legal and regulatory framework and financial resource for improving bank lending to local governments. There has been an increase, however small, in borrowings from local government. Figure A1.4 below reflects this trend.

**Figure A1.4. Outstanding debts of local governments (including bonds)**




*Source*: Consultant estimate

## B. Capital Markets

### 1. Equity Capital Markets

Decree No.48 of 1999 was the first legislation to govern capital markets in Vietnam. Given its limitations, Decree 48 was replaced by Decree No.144/NDCP of 2003, and then by the Law on Securities of 2006. Currently, the Law on Securities is the center of the legislation on capital markets in Vietnam. Since the Law was issues, the Government has issued multiple guidance documents to regulate its implementation. They include decrees of the Government, decisions of the PM and the circulars of the MOF. Under the Law on Securities, the MOF is responsible for the state administration of securities and the securities market, while the State Securities Commission (SSC) regulates securities markets.

Vietnam's capital markets are characterized by an imbalance between an underdeveloped bond market and a highly speculative equity market that is at the risk of overheating or overcooling. In general, there are three factors that are perceived as being key constraints to the development of an efficient capital market in Vietnam including: lack of alternative investment vehicles; lack of transparency and adequate rules of disclosure such as substantial trading in unlisted stocks; and deficiencies in capital market infrastructure, such as *lack of credible credit-rating system*, and fragmented and erratic payment and settlement system. Regarding these general issues, both equity market and bond market has specific issues.

There are limited investment opportunities for institutional investors, which has led to an unrealistically high valuation of stocks. The average P/E ratio of the 20 firms that accounted for 99 percent of the market capitalization stood at about 73 in January 2007, whereas average P/E ratios in other Southeast Asian markets ranged from 10 to 20. The markets slowed down remarkably in 2009-2012, when the main equities index was only less than half of what it was at its peak in 2007.

There is also a sizeable market of unlisted stocks, which are traded alongside the regulated market and are left largely unregulated. Both public companies and non-public companies issue unlisted stock. The Law on Securities mandates the registration and disclosure of financial statements for approximately 3,000 public companies, but only 738 public companies were registered as of 2007. Despite the mandates, the unlisted stock market continues its intense activity and was even estimated to reach a size equivalent to four times the regulated market in terms of trading volume. Unlicensed brokers intermediate transactions among investors under the unregulated form.

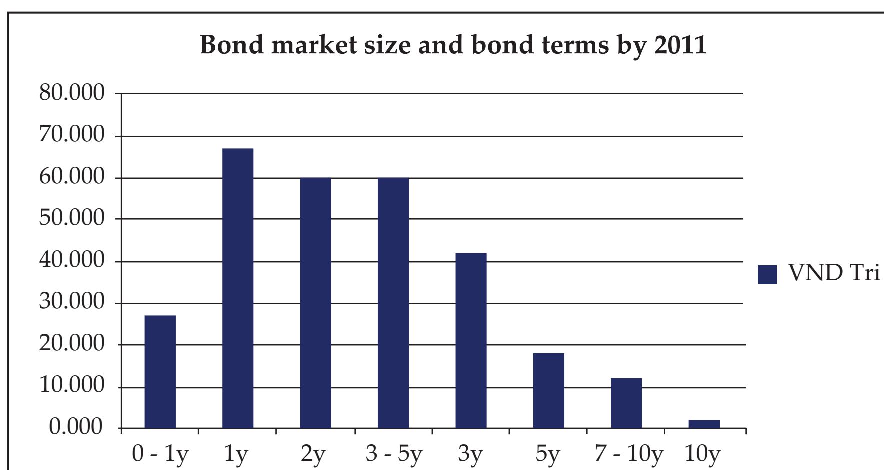
In addition, until recently, the securities market did not allow for the development of securitization. One form of sharing risk in the financing of infrastructure is the use of securitization. The process of securitization usually requires several steps through financial engineering. However, most securitization is informal and over the counter because of the nascent securities market.

With the purpose of further developing this instrument, in 2007 the GOV issued a securitization law along with other significant legal and regulatory frameworks for audits, credit insurance, commercial banks and financial inspections. The new securitization regulations expanded the legal regime of securities, providing a more certain system of registration and enabled the development of specific securities, such as lease receivables.

**2. Debt Capital Markets**

In bond markets, there are also several constraints as indicated in figure A1.5 below. Bonds are useful to provide long-term financing to infrastructure. However, the bond market in Vietnam is underdeveloped, particularly non-government (corporate and municipal) bonds. Government bonds dominate, with the outstanding balance of government bonds to GDP at 18 percent compared to 3 percent for that of publicly offered corporate bonds and 0.3 percent for that of municipal bonds in 2007. The principal purchasers of bonds have been SOCBs and insurance companies. Both types of institutions are directed to invest in bonds by the GOV, seeking to ensure full subscription. The demand for bonds is also constrained. There are not many investors, especially institutional investors such as pension funds and mutual funds.

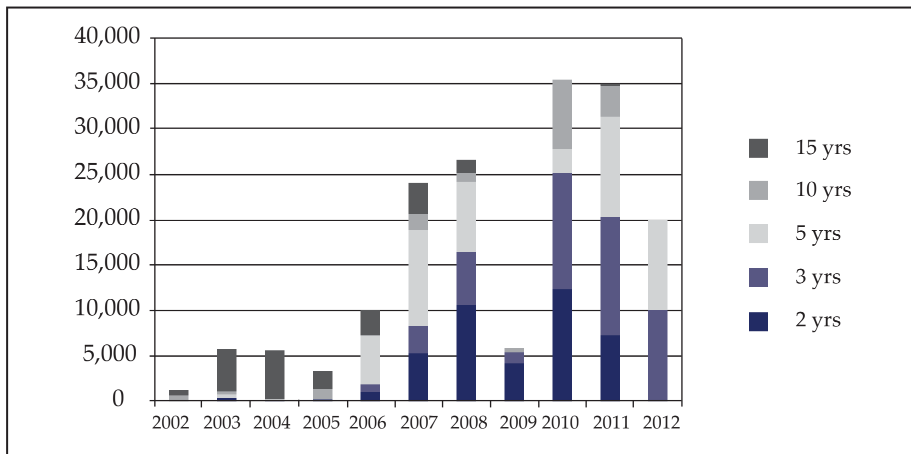
**Figure A1.5. Total bond market size and bond terms**




*Source*: Ministry of Finance 2012

The government and local market participants have begun to undertake some action to address the problem of bond market underdevelopment, however the bond market continues to be plagued by the impediments identified above because of the small scale of offers, irregular issuance of government bonds, and a lack of quality in non-government bonds on the supply side. Deficiencies in market infrastructure, including a lack of market makers for government bonds and of a credible credit rating system, as well as a fragmented and erratic payment and settlement system, add to the weaknesses (see figure A1.6).

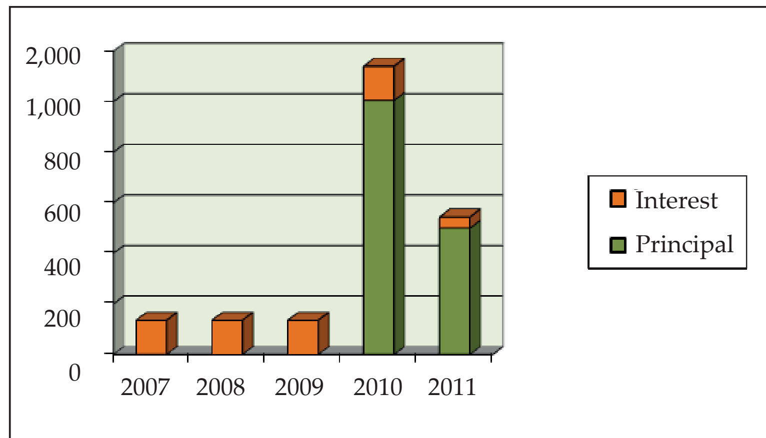
**Figure A1.6. Government-guaranteed bonds issued by VDB**




*Source*: MOF

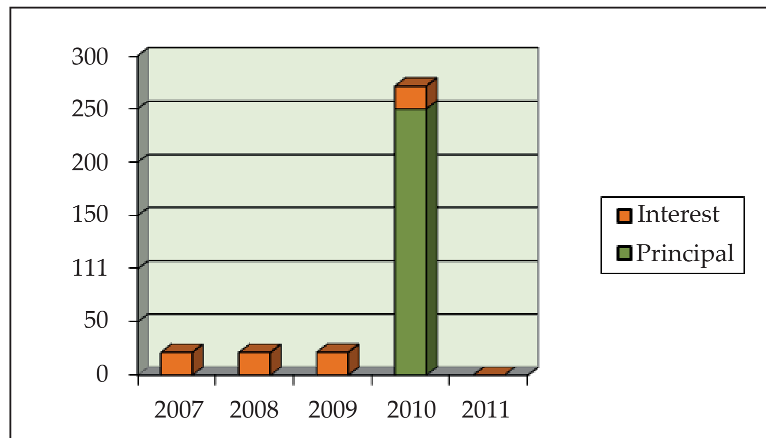
As mentioned earlier, so far only four large provincial governments -- namely: Hanoi (see figure A1.7), Dong Nai (refer to figure A1.8), HCMC (indicated in figure A1.9) and Da Nang -- have been able to issue municipal bonds, largely due to an underdeveloped capital market and low capacity in most provinces, as well as a policy and legal framework for local finance that needs substantial improvement. These four provincial governments' bond issuances were implemented when the local budgets were under pressure for funding availability. Among four local governments, only HCMC was able to issue municipal bonds more than once. The maturity of the bonds was always less than 5 years because of existing market constraints. The gaps in the current framework that require remedy fall into two broad categories: (a) measures that would permit the use of project revenue bonds of various types and other structured finance products such as securitization, and (b) measures that would improve any type of bond issue, including general obligation bonds.

## Figure A1.7. Bonds issued by Hanoi



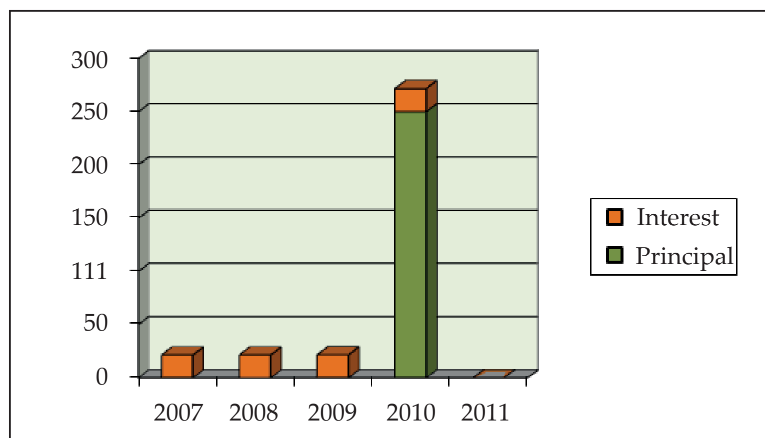

*Source:* Consultant estimate

## Figure A1.8. Bonds issued by Dong Nai




*Source:* Consultant estimate

## Figure A1.9. Bonds issued by HCMC




*Source*: Consultant estimate

Under the latter category, a previously proposed measure would be to eliminate constraints to pooling by multiple municipalities. Such pooling would provide wider market access, particularly for smaller municipalities. Many of Vietnam's provinces have little prospect of issuing bonds in their own name in the medium to long term. Most of these provinces are small, financially and institutionally weak, and have relatively small borrowing needs. Bond issuance entails high upfront fixed costs and thus it is typically not cost effective to issue bonds unless the size of the issue is sufficiently large to make the upfront cost a small share of the total. With bond pooling, the resulting economies of scale reduce the average cost of borrowing.

At the same time, bond pooling requires effective collaboration and cooperation among provinces. Vietnam's provinces have thus far been unable to successfully coordinate such bond issuance. ***A local specialized financing institution*** must be created and charged with the responsibility to periodically canvas its sub-national clients for borrowing needs over specific periods. The local institution would then aggregate the needs of multiple municipalities and issue one large bond. Bond proceeds would be on-lent to local authorities in the pool based on a size of participation that must be pre-agreed upon. In addition, while it is not necessary for local authorities to form a pool to be credit rated, the local pooling institution must conduct a credit analysis of potential members in order to determine their ability to repay.

## C. Land for Infrastructure

"Land for infrastructure" is widely used as a financing mechanism in all provinces, especially in larger cities, and is usually done on a negotiated basis in the form of Build-Transfer (BT) contract. In short, the contract defines certain land provided by the Government for provision of specific infrastructure by private sector.

The transfer of land use rights for real-estate development projects constitutes an important resource for the most dynamic provinces and can be the main source of funds for infrastructure investment. In extreme cases this source of funding can be up to 30 percent of the local capital expenditure budget in a few fast developing cities. However, there is no reliable information on how much Vietnam has actually mobilized through this mechanism, although its success as a financing mechanism is apparent given the level of infrastructure that has been financed in this way.

However this approach raises concerns in terms of the transparency of the land valuation process, as well as the level cities actually benefit from the land value increase resulting from improved infrastructure. Also, representatives from the governments of the Quang Ninh Province and Ho Chi Minh City indicated that there is room for improvement in the planning of land-based infrastructure financing schemes. In addition to planning, one of the hurdles has to do with resettlement costs, which have to be assumed by the public sector and considerably add to the cost of mobilizing land resources.

Recently, two private sector led road construction and urban development projects have been implemented using the BT scheme. These projects were executed by POSCO and GS Consulting & Engineering Corporation (GSEC), both of South Korea. In the scheme, road construction is executed and funded by the company granted with the concession rights from the Government of Vietnam, with the road later transferred to the government after completion. In addition, the company receives land development rights in return for bearing the cost of construction on which

it constructs residential properties and commercial buildings. The company then uses revenues realized from the sale of these properties to recover the cost of construction. Specific projects include HCMC's Belt Road No. 1 project led by GSEC (10 km) and a road development project led by POSCO that connects Hanoi with the northern Hong river area.[17] However, the order and procedure of "Land for Infrastructure" are not clearly defined in the regulatory framework for land.

This "Land for Infrastructure" approach is less popular in smaller cities where land is not very attractive to the private sector. The type of infrastructure used under this BT form of contract is another issue, because the private sector is often reluctant, or not allowed, to provide public infrastructure and services being managed by public utilities, such as water or sanitation services. Quality of infrastructure provided by private sector is another concern, especially for strategic infrastructure, given its large scale, complexity and significant investment requirements. Private sector investors often find it difficult to raise financing for long term infrastructure in the local market when the revenue from the sale of land provided under the BT contract has not been realized due to the absence of infrastructure needed to service the land. The large amount of investment required for land development constrains the use of this instrument.

Furthermore, there are still some gaps in the current legal and regulatory framework for land-based infrastructure finance. The Land Management Decree (Decree 181 of 2004) states that the order and procedures for auction of land use rights, biddings for works involving land use shall comply with the regulations promulgated by the PM. However, the decree does not specify which regulations should be followed. Furthermore, in terms of the land valuation under the "Land for infrastructure" scheme, the law and decree do not state a particular process or procedure.

The Government is currently working on a new Decree that is expected to clarify the procedures related to land-based infrastructure financing. This Decree is currently being analyzed by the MOF.

## D. Local Development Investment Funds (LDIFs)

Local Development Investment Funds (LDIFs) are special finance institutions created at the provincial level in order to mobilize capital and enter into contracts with the private sector for the development of municipal infrastructure. LDIFs are expected to operate as commercial-oriented entities, raising medium and long term capital and investing in municipal infrastructure projects that offer cost recovery. They have the legal status of a sub-national State Financial Institution, undertaking financial and development investments.

The Ho Chi Minh City Fund for Urban Development Fund (HIFU) was the first LDIF established in June 1996. With the successful operation of HIFU, the 2001 Public Administration Reform Master Program (2001-2010) gave permission to all provincial governments to establish their own LDIFs. Since then, twenty eight other provincial governments have established LDIFs with the approval and support of the GOV. HIFU remains by far the most financially viable and operationally successful LDIF in Vietnam. HIFU is recognized as a model LDIF in terms of internal policy and procedures, subproject appraisal, social and environmental safeguards and partnership with the private sector. Financially viable and sustainable LDIFs will contribute significantly to reducing

17 Study on PPP Infrastructure Projects in Vietnam, Draft Final Report, Japan Economic Research Institute, April 2011.

the municipal infrastructure financing gap in economically important provinces in Vietnam. The establishment of the initial LDIFs as successful models of financially sound, competent, and professionally independent institutions will also contribute towards the development of more LDIFs in the country.

Between 2005 and 2011 the average annual growth rate of the operational capital in the LDIFs system was high at 40 percent. In 2004, the total charter capital of LDIFs in Vietnam was approximately USD 200 million; in 2011 it was estimated to be approximately USD 450 million, with the top-seven LDIFs investing approximately USD 100 million per year, accounting for an investment increase of 118 percent for these funds over the 2002 level.[18]

The LDIFs that have qualified for ODA funding have good financial positions, including very low Non-Performing Loan (NPL) ratios and acceptable profitability and balance sheet strength. The MOF carries out an annual qualification process to ensure the financial, operational and institutional soundness of LDIFs before they can receive ODA funding. The qualified LDIFs have a proven track record of building major infrastructure, which is currently operating adequately. LDIFs operate under a legally binding Credit Statute of the Provincial Government that mandates investment analysis to ensure cost recovery and provides guidelines for investment monitoring and workouts when necessary. LDIFs also have an internal appraisal and investment monitoring system, with the decision-making authority resting with the LDIF staff. These LDIFs also price their loans at market rates, maintain annual audited financial statements based on accepted accounting standards and are financially self-sufficient.

LDIFs also engage in short-term borrowing, on a roll-overs basis from State-owned Commercial Banks and other State-Owned Enterprises. These short-term borrowings can lead to short-term oriented investments, potentially re-allocating LDIF capital away from long-term infrastructure development. Inappropriate borrowing by the LDIFs can also have a negative effect on the developing banking sector.

## E. Other Financing Instruments

### 1. Development Bank of Vietnam

The Development Bank of Vietnam (DBV), the government owned development bank does offer favorable terms to local authorities including longer tenor, but only under national target program approved by the Government.  DBV has only limited funds available at favorable terms and it is often difficult to get access to such lending. Lending by DBV is also registered in the balance sheet of the central government and is therefore less attractive for the government relative to lending by state-owned commercial banks. So far total outstanding lending of DBV to local governments is very small.

### 2. Local Public Sector Companies

The provinces and cities also finance and execute public infrastructure projects off-budget through public sector companies. Public sector companies manage and operate urban services in cities, including street cleaning, public lighting, road maintenance, waste management and sanitation.

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18 World Bank, PAD on Proposed Loan to LDIFs (2009), p.3.

The provincial government appoints their senior managers, defines user fees and subsidizes their operations if user fees are insufficient. Local public companies can receive loans from state-owned commercial banks and from the DBV. Some of them can operate in other areas of economic activity (industry, commerce and the financial sector) as a way to obtain additional resources to fund the activities that are not self-sustainable.

The most advanced public sector companies are those located in the larger cities and some of these companies have even been partially privatized. According to recent study, in 2009, Ho Chi Minh City had 381 public sector companies. These companies operated in various sectors, including construction, transport and tourism. The same study pointed out that approximately 80 percent of the public investments of HCMC are made by these companies, while only 20 percent of them are made by the Provincial Government.[19]

**3. Public-Private Partnerships (PPPs)**

Given high and rapidly increasing demand for infrastructure services, and expectations of lower levels of ODA in the near future, mobilizing private sector investment is necessary to fill the financing gap. In this sense, PPPs are recognized as one of the most effective ways of financing infrastructure development.

Compared with other East Asia countries, private participation in Vietnam's infrastructure development has been relatively limited. Together with the rapid economic growth in Vietnam, the number of private equity funds has increased in the area of finance, real estate, information technology and infrastructure. However, the presence of private equity funds specializing infrastructure investment is not as prevalent. Though many private investors are interested in investing infrastructure development, there are key constrains that discourage them from doing so.

As explained in the regulations sections of this report, Decree 78 enacted in 2007 (previous BOT decree), Decree 108 enacted in 2009 (new BOT decree) and Decision 71enacted in 2010 (PPP pilot regulation) constitute the current institutional framework for the development of PPPs.

Private investors need to manage complicated project implementation procedures that involve many authorities from central to local level such as MOF, concerned ministries and provincial peoples committees. There is also lack of effective and transparent government policy and regulations for infrastructure projects. In addition, the use of competitive bidding procedures for concessions is limited. Concession contracts are often considered based on negotiations and unsolicited proposal from SOEs at an early stage to projects. There are several factors that discourage private sector participation in infrastructure projects in Vietnam:

- dominance of SOEs in projects seeking private investments. SOEs significantly dominate current infrastructure projects; however, their governance structures are weak to provide the adequate commercial incentives that are required in a PPP-type project;
- small number of foreign investors. Foreign investors have shown relatively less interest because of difficulties in accessing domestic capital and the absence of private investors in infrastructure PPP projects;

19 Urban Development in Vietnam: The Rise of Local Authorities, Resources, limits and evolution of local governance, French Development Agency, 2010.

- absence of commercial biddings. Most private infrastructure projects have been undertaken without competitive bidding. The absence of competitive bidding causes sub-optimal outcomes for the assigned state agency and the inadequate allocation of risk;
- inadequate project preparation prior to bidding. Most projects do not undergo sufficient preparation before they are bid out. Private sector bidders need information regarding the risks associated with the projects and possible financial support for the projects including tariff structures and government support, in order to prepare detailed proposals. However, there is lack of adequate project preparation in the feasibility stage before bidding out. This low quality of project preparation and FS also brings difficulties in determining for the government if a project should be implemented as a PPP or a pure public project;
- need for subsidies to make financially viable private infrastructure projects. Given the factors explained throughout the report, under the current circumstances most projects require subsidies to become financially viable. Though the government offers subsidies to BOT projects in a number of ways including capital grants, land use rights and other subsidies, these are not provided in a structured and transparent way; and
- foreign investors are discouraged by limitations on currency conversion and exchange rate risks.

In order to promote private investment, the government needs to establish appropriate institutional mechanisms that provide explicit and clear capital subsidies to projects for improving financial viability; and ensure adequate project preparation and competitive biddings. Such a mechanisms need to contain clear and transparent rules.

**4. Short Term Advances from State Treasury**

From 2012, State Treasury is allowed to provide budget advances, in the form of short term loans to local governments, mainly for cash flow purposes. This practice is being monitored and reviewed by the Government, and is not considered a financing instrument for local governments, because of its short term characteristic.

## IV. Government Policy Agenda

### A. Public Investment Efficiency

In recent years, Vietnam has experienced great success in mobilizing tremendous levels of investments to support its rapid growth. Over the past two decades, the Vietnamese economy has grown by an average of 7.5 percent annually, one of the fastest rates in the world. This growth has been largely due to rapid factor accumulation—physical and human capital—with productivity growth playing a secondary role. Mobilization of investment, including domestic, foreign, and government, has been strong. Indeed, growth has been underpinned by high levels of public and private investment (16 and 26 percent of GDP, respectively).

More recently, however, the country has struggled to maintain these high levels of growth and macroeconomic stability. This slowdown is partly due to the economy's deeper integration into global markets following the World Trade Organization (WTO) accession in 2007 and the recent global economic problems. Yet a more pertinent cause is Vietnam's reliance on public investment, channeled primarily through a weak state-enterprise sector and financed by massive credit expansion,

to generate growth. Recent levels of public investment have been 12 to 15 percent of GDP, which is among the highest worldwide. Alongside this reliance have been an accommodating macroeconomic policy stance, inefficient public investments, and a highly indebted state sector. Thus the quality of growth and efficiency of public investment has become a major concern.

Vietnam's investment regime, in particular its public investment component, is increasingly seen as unaffordable, inefficient, and unsustainable. For one, because the public-investment strategy has relied almost solely on raising the level of investment rather than improving its efficiency, the amount of financial resources required to meet Vietnam's needs—including in infrastructure—has reached an unaffordable level. With government debt at 57 percent of GDP and domestic credit at 120 percent of GDP, the concern is that continuing the current public investment trend -- often using borrowings from expensive sources -- will be fiscally unsustainable and contribute to macroeconomic instability.

An additional consideration relates to the generally held expectation that there be a strong positive correlation between investment rates and growth over a sustained period. This relationship appears to have weakened in Vietnam in recent years. During the last five years, there has been a steady increase in the investment rate, initially boosted by an increase in foreign direct investment (related to WTO accession) and later by stimulus spending in response to the global economic slowdown. However, this is also the period when growth began to decelerate. A significant reason for the deceleration, initially, was the drop in global demand and exports. Yet, exports have since rebounded, while growth has not. The lessened responsiveness of growth to investment—especially to public investment, which accounts for as much of 30 to 40 percent of total investment—has become a key concern for policymakers.

In light of these realities, the GOV has recently appeared more determined to make public investment effectiveness a top priority. With few clear improvements in the external environment and continued macroeconomic uncertainty domestically, the realization has emerged that the country has to do more with less. Consequently, the GOV has cut the target investment rate for the next five years from the previous 40 percent to 35 percent of GDP, while maintaining a GDP growth rate of 6 to 6.5—with the implication that a efficiency must play a larger part in the growth. The Central Party Commission reflected this view in a recent statement:

> *"To renew the thinking on investment, gradually adjust the public investment structure in the direction of reducing the proportion of public investment and improving the efficiency; resolutely overcoming the widespread investment and promoting the capital mobilization for development. In 2012, to strictly implement the conclusion of the third Central Conference and the instruction of Prime Minister on strengthening the management of investment from the state budget, public bond, strictly controlling investment of state enterprises. To renew the mechanism of investment allocation; focus capital on urgent projects to finish soon, quickly putting into use to promote the efficiency. Put priority on funding the project already completed and put into use, the projects planned to be completed in 2012 and reciprocal capital for ODA [Official Development Assistance] projects. The new projects and construction must be strictly controlled; the capital resources must be clearly identified, ensuring efficiency and investment procedures."*

Accordingly, since early 2011 the GOV has been implementing Resolution No. 11, a comprehensive program to reestablish macroeconomic stability. In October of 2011, a plenum of the Community Party reaffirmed the GOV's commitment to sustaining economic stability and highlighted three

aspects of economic restructuring as priorities for the following five years—among the three was the improvement of effectiveness of public expenditure. The actions detailed in Resolution No. 11 are presented in the context of the GOV's understanding of the domestic and global macroeconomic challenges facing the country, and include a main section on "Implementing tight fiscal policies, cutting public investment, and reducing the state budget deficit." Responsibility for carrying out the plans is assigned widely, to the Ministry of Finance, Ministry of Planning and Investment, and other ministries, agencies, and localities. The plans include:

- targeting a state budget revenue increase of 7 to 8 percent over the 2011 budget estimate;
- rearranging spending tasks to save 10 percent of regular expenditures in the 2011 estimate;
- reducing the 2011 state budget deficit to below 5 percent of GDP;
- not advancing 2012 state budget capital and government bond capital for projects unless in urgent cases; and
- setting up inspection teams to scrutinize all state budget or government bond-funded works and investment projects.

In addition, the Prime Minister issued Directive 1792 in October of 2011 on "Strengthening investment management from state budget capital and government bond capital". The Directive acknowledged that while mobilization of government funds had led to overall development and improvement of lives through infrastructure investments, some shortcomings in management led to sub-optimal performance of use of resources. Coupled with a limited budget, and consistent with the approach laid out in Resolution No. 11, the Directive outlined measures to "enhance the management of investment from the state budget capital and Government bond capital." The three areas highlighted were:

- principles of management and decentralization of investment from the state budget capital and government bond capital;
- capital allocation, synthesis, or assignment of investment capital plan from the 2012 state budget plan; and
- capital allocation, synthesis, or assignment of government bond plan of 5 years from 2011 to 2015 and the 2012 plan.

Under this Directive, ministries, departments and local governments are obliged to revise the funding structure of ongoing investment projects and diversify capital sources with an emphasis on attracting capital from other sources into viable socio-economic infrastructure projects. The Directive authorized the Ministry of Planning to review and summarize the investment project portfolios of diverse ministries, sectors and local governments. As part of this exercise, ministries and local governments had to identify all of the projects under their jurisdiction that received funding from central Government bond capital and submit these for review by the Ministry of Planning. According to the directive, limited bond capital will be allocated first to projects with expected completion dates falling in the 2011-13 period according to progress in investment decisions and expected ability to perform. Remaining capital will be allocated to projects falling into two categories: those for which conversion to other forms of investment involving the private sector (i.e., BOT, BT, and PPP) is feasible; and projects that cannot be converted into other forms of investment.

Implementation of Resolution No. 11 has had some shortcomings. For instance, attempts to rein in the investment budget have not been sufficiently spelled out. The pace of structural reforms has been slow, partly because the country has been in a period of transition in the past year, as part of the 5-year political cycle. Several key policy actions and pieces of new legislation were also held up until adoption of the new five-year Socio-Economic Development Plan (SEDP) in November of 2011. At the same time, the stabilization achievements to date illustrate the country's ability to address its macroeconomic challenges. The GOV has indicated its continued commitment to implementing Resolution No. 11 and to supplementing it with additional reforms to address areas of weakness.

## B. Public-Private Partnerships (PPPs)

In spite of recent gains, the reliability and adequacy of infrastructure in Vietnam remain key concerns for the country's development. Most demand forecasts show that the total investment in infrastructure will have to significantly increase relative to the current levels if Vietnam is to maintain its desired growth trajectory. The full amount of resources required in order to fill this infrastructure gap far exceeds what the public sector can provide— and at around 9 percent of GDP, the public sector investment in infrastructure in recent years has already been at a very high level—so private sector participation stands as an important component of any strategy that seeks great efficiency of investments and resource mobilization.

However, to date, Vietnam has not been able to sufficiently leverage private capital into infrastructure development; progress toward involving more private sector financing and management of new infrastructure has thus far been limited. Although there is significant potential in Vietnam for increased private investment in infrastructure, the country currently lags behind comparator countries in East Asia in both number of projects and dollars invested. In addition to the limits of public investment, a recent estimate showing that 35 percent of investment in infrastructure is financed through concessional ODA—which may not be as readily available in the coming years as Vietnam enters the middle-income country realm—further points to the critical need to seek alternative financing models and diversified financing sources that can leverage private funding into infrastructure.

In conjunction, policy reforms and improvement in planning and management of infrastructure assets are needed. Vietnam has yet to establish sound investment channels for attracting private financing, nor the institutional and regulatory frameworks to involve the private sector in infrastructure provision. Public sector agencies have also been slow to undertake the necessary sector policy reforms—including tariff increases and cost recovery—to improve the quality and increase coverage of infrastructure delivery. Key institutional, governance, and financing issues constraining the attraction of private finances into Vietnam's infrastructure development include:

- lack of a comprehensive market-oriented infrastructure finance system, along with clearly defined roles and responsibilities for GOV ministries and Assigned State Agencies, and detailed implementation guidelines for each step of the project cycle;
- lack of a clear and transparent system to determine the magnitude of GOV financial support to make them financially viable, given that most projects in Vietnam are not commercially viable based on their own cash flow;
- lack of understanding of the financial obligations and fiscal risk stemming from PPPs;

- inadequate quality of project preparation prior to bidding (with the possible exception of some projects in the power sector), making it difficult for the government to determine if a project offers better value as a PPP or as a 100 percent publicly financed project;
- dominance of State Owned Enterprises (SOEs) in current PPPs, with the appropriate role of SOEs as yet undefined and institutionalized in practice;
- lack of sufficient local currency debt financing, constraining the ability of domestic private firms elected for PPPs to arrange for appropriate financing packages;
- absence of competitive selection of private sector investors;
- noticeable absence of private foreign investors in projects that have been financed or are currently under preparation (with the exception of a few projects in the energy sector); and
- provincial governments' lack of institutional capacity and clear policies to deal with private capital and participation in municipal infrastructure development.

The GOV has recognized these challenges and has stated its intention to pursue the development of PPPs as the strategic option to leverage private financing into Vietnam's infrastructure in a systematic and sustainable manner. Within this objective is an aim to scale up public investment by mobilizing private funds for infrastructure development, including through the establishment of a sustainable framework for an implementation of pilot PPP projects. The latest five-year Socio-Economic Development Plan (SEDP 2011-2015), which focuses on policies needed to achieve high quality and sustainable economic growth, highlights the need to develop favorable conditions for the private sector's contribution to economic development.

Accordingly, the GOV has introduced, including with World Bank support, important measures to improve the development of PPPs, including the issuance of Decision 71 on PPPs, and the development pilot PPPs first in expressway sector. More PPP projects are being identified and will be further prepared, with assistance of the World Bank and other Development Donors. However, overall progress has been slow and inconsistent.

## C. Infrastructure

Over the last two decades, Vietnam's economy has grown by an annual average of 7.5 percent, and the per capita income has almost quintupled. This rapid expansion of the economy has also been accompanied by strong development of life-sustaining infrastructure such as paved roads, electricity, piped water, and housing. A key to this trend has been Vietnam's ability to translate high levels of investment into basic infrastructure services, making the development process highly inclusive. For example:

- rural-households connected to electricity grids rose from 14 percent in 1993 to near-universal access in 2010;
- between 2000 and 2010, total length of paved roads quadrupled from 30,000 to nearly 120,000 km; and
- households with access to a piped water network increased from 12 percent in 2002 to 76 percent in 2010

However, concerns have risen about the quality of growth in the face of unreliable infrastructure. Despite the aforementioned gains, the reliability and adequacy of infrastructure—reliability of

energy, quality of water, reliability and efficiency of transport network, and demand-responsiveness and effectiveness of public agricultural support service—rank among the main constraints to Vietnam's competitiveness, quality of life, and future growth. *Along with macroeconomic instability, weak infrastructure has presented an impediment in the business environment*. Investors have cited lack of adequate and reliable electricity, congestion on the roads and at seaports and airports, and poor quality of infrastructure in industrial areas, as main constraints to operating in Vietnam.

*Under a recent Resolution issued in January 2012, the Party Central Commission has identified reform in policy for infrastructure development is a key priority*. Key problems facing many infrastructure projects in Vietnam include:

- the practice of use of non-market means to allocate resources, especially land;
- poorly specified and enforced property rights;
- weak coordination among governments, line agencies, and state-owned enterprises;
- poor mobilization of non-budgetary resources;
- lack of impartial regulating agencies; and
- weak implementation and enforcement of existing law.

According to the Ministry of Planning and Investment (MPI), Vietnam needs approximately USD 25 billion of annual investment in infrastructure (greater than 20 percent of GDP), while the annual funds available from both public and private sectors are less than USD 16 billion.

While the GOV recognizes these challenges, the existing public investment regime reflects parts that do not add up to a complete whole. Due to decentralization, the development of infrastructure is the responsibility of local governments. By placing its provincial governments in charge of screening, appraising, selecting, and implementing their own projects, the country has created a dynamic and competitive environment among local governments. *While this has been a positive dynamic, the downside is that there has been an absence of connecting the infrastructure to the strategic priorities of the country—such as improving overall competitiveness—or using the market as a means of allocating resources. As the provinces have worked in isolation, the result has been sub-optimal and fragmented infrastructure at the local level (much of which has become idle) that does not always contribute to an effective national system of infrastructure*.

At the same time, while the development of life-sustaining infrastructure (e.g., electricity, roads, water supply) throughout Vietnam has been successful, the move to build growth-enhancing infrastructure (e.g., airports, seaports, industrial parks) broadly among the provinces has been problematic at times. Vietnam pursued the life-sustaining approach from around the 1990s to early 2000s, then subsequently—and particularly following the Law on Investment of 2005 and transfer of investment decisions to local governments—extended to growth-enhancing infrastructure. The latter approach has ultimately faced headwinds in the reality that: (a) nearly 70 percent of Vietnam's output is generated around the Red River and Mekong Deltas; and (b) most provinces have neither the financial capacity to build globally competitive infrastructure nor sufficient demand for full utilization.

Although Vietnam has lately strained its public investment by pursuing many fragmented, suboptimal infrastructure projects that lack market demand, the GOV has recently begun to take corrective actions, including:

- formulating a new law to improve the legal framework for public investment and public procurement;
- tightening the oversight and supervision procedures for existing projects, giving MPI a larger role in screening the projects, especially on the availability of resources;
- significantly reducing the level of public investment in SEDP 2011-2015;
- issuing a Resolution on Land Use Master Plan to 2020 and Land Use Plan to 2015, aiming to tighten land use for sustainable development; and
- enacting a recent ban on approval of new industrial parks.

## V. International Experience

There is a wide range of international experience on municipal infrastructure financing frameworks. Each country has the responsibility to design its own particular legal framework and approach, consistent with its constitution and intergovernmental fiscal arrangement. There is however a consensus of an effective framework, that:

- provides access to long term funding sources for infrastructure, and at the same time puts in a place a clear accountability system on local governments;
- integrates well with intergovernmental fiscal arrangements, as budgetary source and discipline always play a key role; and
- improves investment planning and appraisal capacity of local governments, as well as their capability for risk management.

A separate report presenting international experience has been prepared and presented to the MOF. This report includes selection of successful international models that could be applicable to the Vietnamese context. These models included municipal development funds: public funding intermediaries in Tunisia and market-oriented financial intermediaries in Colombia, Czech Republic and South Africa; credit enhancement entities in the Philippines and Indonesia; land-based infrastructure financing schemes in China, Brazil and Colombia; and PPPs in Brazil.

The World Bank and the MOF have conducted an initial review of these international models for the financing of infrastructure projects at the sub-national level. Given the growing decentralization and demand for infrastructure services, the MOF recognizes the need to improve the existing framework. The MOF has identified the potential for establishing a mechanism that could provide technical assistance and support the financing of sub-national governments.

PPPs require a lot of preparation and can only be executed successfully if the public sector partner has sufficient capacity. Furthermore, they can only be used for certain projects. On the other hand, land-based infrastructure schemes are not sustainable in the sense that the land resource is limited and only attractive in some provinces / municipalities. As a result, a suitable alternative for the short to medium term may be the establishment of a Municipal Development Fund. This fund could take on multiple functions, including direct intermediation of government funding, indirect intermediation through the financial system and credit enhancement in the form of guarantees. A more precise definition of the scheme will require review of the existing framework and the assessment of the municipal finance situation at the local level.

## Attachment 1: List of Legal Documents and previous work reviewed

### A. Legal Documents Reviewed

- Law on Public Debt Management of June 17, 2009 (Law 29/2009/QH12)
- Decree on the issuance of government bonds, government-guaranteed bonds and municipal bonds (Decree 01/2011/ND-CP)
- Decree detailing and guiding the implementation of the State Budget Law of June 6, 2003 (Decree 60/2003/ND-CP)
- Decree regulating investment on the basis of BOT, BTO and BT Contracts of November 27, 2009 (Decree 108/2009/ND-CP)
- Directive on Strengthening Investment Management from State Budget Capital and Government Bond Capital (Directive 1792/CT-TTg)
- Decision approving the regulations on pilot investment under the form of Public-Private Partnership of November 9, 2010 (Decision 71/2010/QD-TTg)
- Decree on On-lending of the Government's Foreign Loans of July 14, 2010 (Decree 78/2010/ND-CP)
- Decree on Public Debt Management Operations of July 14, 2010 (Decree 79/2010/ND-CP)
- Decree on the Provision and Management of Government Guarantees of February 16, 2011 (Decree 15/2011/ND-CP)
- Other Legal documents referenced to throughout this report
- Law on Land (Law13/2003/QH11)
- Decree on the Implementation of the Land Law (Decree 181/2004/ND-CP)

### B. Previous Work Reviewed

- Urbanization Review, World Bank, 2012
- Vietnam Infrastructure Finance, World Bank, 2008
- A Comprehensive Framework for Sub-National Debt Financing in Vietnam, USAID, 2007
- Urban Development in Vietnam: The Rise of Local Authorities, Resources, limits and evolution of local governance, French Development Agency, 2010
- Reviewing the Legal and Regulatory Framework on the Capital Market in Vietnam, World Bank, 2008
- Reviewing the Legal and Regulatory Framework related to the Banking Sector in Vietnam, World Bank, 2008
- Project Appraisal Document on Proposed Loan in the Amount of US$50 Million Equivalent to the Socialist Republic of Vietnam for a Ho Chi Minh City Investment Fund for Urban (HIFU) Development Project, Report No. 38504-VN, World Bank, 2007
- Nguyen-Hoang Phuong and Schroeder Larry, An Analysis of Quasi-Decentralized Budgeting in Vietnam, International Journal of Public Administration 33, 2010

# Appendix II – International Experience Review

## I. General Overview of Municipal Infrastructure Finance Vehicles

### A. Municipal Development Funds

Municipal Development Funds are financial intermediaries that provide financing to local government development projects. These funds have been set up in many countries around the world to respond to the increasing financing needs brought about by growing decentralization and urbanization in countries where local governments lack direct access to the financial markets. The funds are generally intended as transitional instruments to prepare the way for self-sustaining municipal finance systems that allow direct issuer access to the capital markets. The ownership of the funds can be public, private or mixed.

i. **Government Funding Intermediaries**: These funds supply financing at below-market rates, often combining subsidized loans with grants. The funds are normally introduced in environments where there is no private lending to local governments and where private markets cannot be developed in the short-term. The funds can eventually evolve into institutions that compete freely with private-sector lenders. The Tunisian Municipal Development Fund is an example of this type of intermediary.

ii. **Bridge to the private credit market**: These funds prepare municipal and financial sectors for private lending to municipalities. The funds lend at market rates, allocate capital through arm's-length decisions of commercial banks or other private lenders, require that private lenders assume credit risk and seek to establish a track record of municipal creditworthiness. Examples of these funds include FINDETER in Colombia and MUFIS in the Czech Republic.

**Table A2.1. Types of Municipal Development Fund**

| Name of MDF/country | Function of MDF | Lender | Borrower |
|---|---|---|---|
| *Caisse des Prets et de Soutien des Collectivites Locales* (CPSCL)/Tunisia | Financial intermediary providing loans to sub-national governments | CPSCL | Sub-national governments |
| FINDETER/Colombia | Financial intermediary providing loans to commercial banks | Commercial banks | Sub-national entities (local governments or corporate entities under the control of a local government) |
| Municipal Infrastructure Financing Company (MUFIS)/Czech Republic | Financial Intermediary providing loans to commercial banks | Commercial banks | Sub-national governments |
| Infrastructure Finance Corporation Limited (INCA)/South Africa | Financial Intermediary providing loans to sub-national governments | INCA | Sub-national governments |

| Name of MDF/country | Function of MDF | Lender | Borrower |
|---|---|---|---|
| Tamil Nadu Urban Development Fund (TNUDF)/ India | Financial Intermediary providing loans to sub-national infrastructure projects | TNUDF | Urban Local Bodies (ULBs), private investors |

## B. Pooled financing for small projects/municipalities

In the pooled financing scheme, the financing requirements of several projects or municipalities are pooled together in a single debt issuance in order to reduce transaction and borrowing costs. Pooled financing is suitable for smaller municipalities with lower debt requirements and lower creditworthiness. Credit enhancements (generally in the form of Debt Service Reserve Funds (DSRFs or guarantees) are used to facilitate market access. Examples of this type of intermediary include the Tamil Nadu Urban Development and Water and Sanitation Pooled Fund (WSPF) and the Bangalore Water Supply and Sewerage. The scheme was used in the United States for the funding of small infrastructure projects in the water and sanitation sector: State Revolving Funds (SRFs) for Water and Sanitation.

## C. Credit enhancement entities

Several countries have set up innovative local credit enhancement entities and mechanisms (Guarantee Agencies / Funds) to help mobilize commercial debt for sub-national infrastructure finance. These entities include the Philippines' Local Government Unit Guarantee Corporation (LGUGC), Indonesia's Infrastructure Guarantee Fund (IIGF) and the Republic of Korea's Infrastructure Credit Guarantee Fund (KICGF). The objective of the credit enhancement provided by these entities is to mitigate the credit and liquidity risk that are common to sub-national government borrowers. The ownership structure can be of public or mixed nature. These entities were widely used in the United States pre-financial crisis: Monoline Insurance Companies. Credit enhancement entities do not have to be seen necessarily as transitional mechanisms, but rather as permanent fixtures in a robust capital market.

## D. Land-based financing of infrastructure

Land-based financing has already been used in Vietnam. There are successful examples in the Da Nang Province. The techniques of the land-based financing include: (a) long-term lease of land in exchange for an up-front payment (China): (b) land sales: (c) sale of land development rights (Brazil), and (d) betterment levies (Colombia). Transparency of negotiations with private land developers is often an issue.

## E. Sub-national PPPs

PPPs can relieve municipalities of the financial responsibility of up-front capital costs and allow them to build facilities without incurring in debt. PPPs also serve to improve the efficiency and effectiveness of service delivery. PPPs can be used as a financing vehicle by municipalities that cannot

issue debt. However, there are limiting factors: (a) limited institutional capacity on the part of the public sector partner to prepare the projects and manage the PPP process: (b) long gestation period, and (c) costly project preparation and limited funds to carry out required studies.

### F. Municipal bonds

Municipalities can mobilize financial resources from the capital market by issuing municipal bonds. Municipal bonds are the most straightforward and cost effective way to provide long-term financing to infrastructure at municipal level. However, a few developing countries have experienced municipal bond issuance due to their underdeveloped bond market. In Asia, several municipalities in India have issued municipal bonds as a result of improvement of their financial management, and development of India capital markets.

### G. Sub-national debt management

Sub-national debt management has been commonly implemented in many countries, in order to effectively manage and promote sub-national borrowing. As part of sub-national debt management, several countries adopt rule-based control of sub-national borrowing by applying indicators for debt limit based on repayment capacity.

## II. International Experience

### A. Municipal Development Funds

#### 1. Tunisia

a. ***Background***

Tunisian municipalities play an important role in implementing the country's development strategy. Municipalities coordinate development efforts with the region and the ministries to come up with an investment plan that best serves the country's development objectives and represents the contract a municipality establishes with the government. The five-year municipal development plan (*Programmed Investissement Communal* or PIC) represents the sum of all municipal investment programs.

Most municipalities are small and lack sufficient managerial and financial capacity. Municipalities are heavily reliant on central government transfers and face difficulties in mobilizing the resources needed to carry out investments, meet debt service obligations and maintain existing infrastructure. In addition, local government officials lack the sufficient capacity to make the most use of the existing financial and operational management mechanisms. Finally, the centralized management of local authorities does not set the right incentives for municipalities to enhance their financial management practices. Decision making follows a top down scheme in Tunisia and municipalities have limited power. Municipalities' responsibilities are limited to urban planning, construction and maintenance of urban streets and drainage networks, street lighting, construction and maintenance of parks, municipal buildings and social infrastructure, and cleaning and solid waste collection. All other services, such as transportation, water and sanitation, waste disposal, electricity, housing provision and urban upgrading, are managed at the central level.

Since the nineties, decentralization has been on the political agenda with slow but steady progress. The Government efforts have focused on the establishment of an enhanced municipal planning system, increasing the volume and efficiency of resource mobilization and on strengthening the institutional capacity of municipal governments. Tunisia has no local government bond market in which sub-national governments can issue debt, although it does have long-term credit markets for central government and corporate debt.

***b. Caisse des Prets et de Soutien des Collectivites Locales (CPSCL)***

The central government plays a major role in allocating resources and credit to sub-national governments. Borrowing by sub-national governments has occurred almost exclusively through a specialized financial intermediary: Fund for Loans and Support to Local Communities (*Caissede PrêtsetSoutien aux Collectivités Locales*, or CPSCL). The CPSCL is a completely public institution created in 1992 with the objective of financing Tunisian local authorities through loans and government subsidies as part of the Tunisian state's five-year development plans. CPSCL's board of directors is chaired by the Ministry of the Interior and its management is appointed by the government and reports to the Ministry of the Interior. All credit decisions are subject to approval by a senior credit committee comprising representatives of the minister of the interior, the minister of finance and the head of CPSCL, who is appointed by the president of the Republic. Since CPSCL is not a bank per se, it is not subject to Tunisian banking regulations.

The institution's strength lies in its capacity to appraise municipal projects and to provide technical assistance to municipalities in procurement and financial management. The institution's main weakness has to do with its limited autonomy, which constraints its ability to: (a) reject funding requests based on its appraisal of the related risks; (b) propose different lending products; and (c) diversify its external financing and expand its portfolio of clients. There are high obligor concentrations in CPSCL's loan book due to the concentration of infrastructure projects in a small number of local authorities

Ultimately, the most important factor constraining CPSCL's ability to scale up its activities is the weak financial capacity of its clients: the municipalities. CPSCL's weak asset quality ratios reflect the local authorities' poor repayment capacity and historical lack of discipline in servicing their debts. CPSCL's financial performance is mainly dependent on lending volumes, which is in turn a function of the progress made in the implementation of the government five-year development plans. Improving local authorities' poor financial state has been a priority of the Tunisian government. In this context, in 2007 the Tunisian Government restructured CPSCL's past due loans to ease the debt burden of local authorities and put in place a plan to improve the efficiency of tax collection

Transforming CPSCL into an autonomous, commercially viable specialized financial institution may offer better results. For a long time, CPSCL has been considering changing its status to a wholly state-owned limited liability company from a public establishment. This change could give CPSCL greater autonomy in its day-to-day operations and enable it to extend lending to a broader client base. CPSCL's sustainability would be further enhanced by diversifying capital sources, broadening the range of services to local borrowers, and expanding its client base.

## 2. Colombia

### *a. Background*

In Colombia, the decentralization was begun in 1983. The 1991 Constitution committed the central government to expanding the revenue sharing system to ensure adequate provision of services. The constitution also defines three types of sub-national territories including departments (states), districts (municipalities with the status of departments) and municipalities.

- **Sub-national government revenue.** The Constitution commits the central governments to providing compensating resources when it imposes spending or service requirements on sub-national governments. As a result, the central government had to transfer almost 47 percent of its total revenue to sub-national governments. This heavy demand caused fiscal problems for the central government.
- **Sub-national borrowing.** All levels of government, including sub-national units, rely heavily on domestic debt markets to fund their deficits. Until 1997, the central government required prior approval from the Ministry of Finance for any sub-national borrowing. In 1997, Law 358 was enacted to curb the excessive use of credit by sub-national governments. Under this law, the Ministry of Finance analyses the indicators of indebtedness before approving sub-national borrowing. Based on the indicators, the sub-national governments might be free to borrow or might face restrictions.

### *b. Findeter*

- **General Description.** FINDETER, which stands for Financiera de Desarrollo Territorial (Local Government Development Finance Company), is a legally independent and quasi-public financial institution established in 1989 and in operation since 1991. FINDETER finances sub-national governments' investments through a rediscounting mechanism and it channels other public resources allocated to sub-national governments by other Governmental institutions. By the beginning of the 1990s, municipal governments in Colombia had no experience in obtaining credit from banks. At the same time, commercial lenders had no municipal finance experience and lacked the long-term funds required to provide the long-tenor debt needed to finance infrastructure investments. FINDETER enhanced commercial banks' willingness to lend to municipal governments by lowering the cost of funding the loans to sub-national governments and providing a clear credit evaluation framework.
- **Ownership.** The Republic of Colombia owns around 90 percent of FINDETER's shares, with the remaining ownership interest spread amongst Colombia's local governments. According to its statues, FINDETER does not distribute profits. Consequently, all profits are transferred into statutory reserves, used to increase the capital or disbursed as contributions to special programs.
- **Corporate Governance and Bylaws.** FINDETER's highest authority is the Board of Directors, which has six members representing the Central government and sub-national entities. The president of FINDETER leads senior management, including six senior executives in charge of the institution's main operational areas. In addition, as a financial institution, FINDETER is supervised by the relevant control entities such as the bank regulator (*Superintendencia Financiera*), which monitors the Colombian financial system.

**FINDETER is governed by the following decrees, regulations and laws:**

**Table A2.2. Decrees, regulations and laws governing FINDETER**

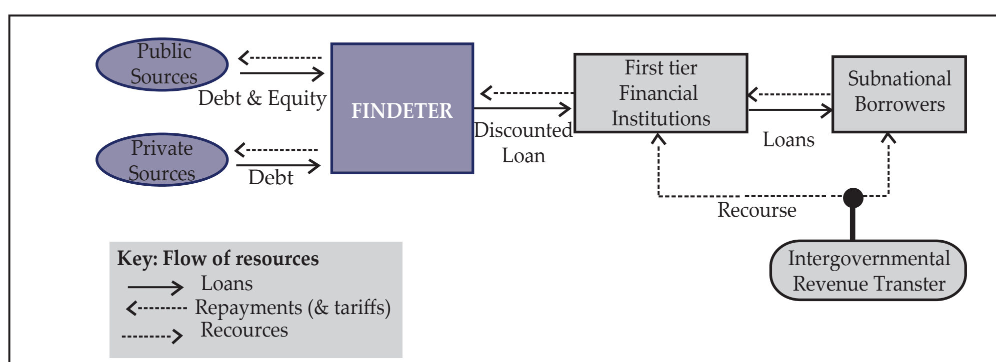
| The name of regulations | The area governed by each regulation |
|---|---|
| Writing 00071, 2012 | States legal statutes of FINDETER |
| Decree 4167, 2011 | Changes the legal nature of FINDETER |
| Decree 4611, 2010 | Authorizes FINDETER for rediscount operations |
| Decree 3411, 2009 | Regulates Article 1 and paragraph 5 of Law 57 0f 1989, which authorizes the creation of FINDETER |
| Law 1328, 2009 | States standards on financial matters, insurance, stock market and other provisions. |
| Law 1151, 2007 | Approves National Development Plan 2006-2010 |
| Circular 007, 1996 | Basic legal circular issued by the Financial Superintendence of Columbia |
| Circular 100, 1995 | Basic accounting and financial circular issued by the Financial Superintendence of Columbia |
| Decree 663 of 1993 | Updates the Organic Statue of the Financial System |
| Law 57 of 1989 | Authorizes the creation of FINDETER |

- **FINDETER's multiple roles:** FINDETER primarily acts as a second-tier lender, encouraging first tier lenders (commercial banks) to enter into direct relationships with local entities. Local entities can be local governments or corporatized entities under the control of a local government. FINDETER rediscounts loans that commercial banks make to local borrowers, making it more financially attractive for commercial banks to lend to local entities. In addition, FINDETER also channels funding from other Governmental entities at the central level that have the mandate of funding projects at the local level. Finally, an important role of FINDETER is the provision of technical assistance to local governments in the areas of finance and management. In July 2010, FINDETER entered into an investment agreement with a private equity fund specialized in the infrastructure sector: Ashmore I FCP. The Fund committed investments of about USD 22 million in local infrastructure projects in the transport, energy, waste and water and sanitation sectors.
- **Rediscounting process.** FINDETER rediscounts loans and leasing contracts through first-tier financial companies or commercial banks. In general, a municipality applies for a loan to a commercial bank. The commercial bank conducts the loan appraisal based on FINDETER's credit evaluation guidelines and if this assessment is satisfactory, it lends directly to the municipality. FINDETER lends all or part of the loan provided to the sub-national entity at a discounted rate. The commercial bank is responsible for servicing the loan and fully absorbs the credit risk. The operational terms are as follows**:**
  - **Discount range:** between 50 percent and 100 percent
  - **Tenor:** up to 15 years
  - **Repayment term:** up to 15 years when there is no grace period
  - Annual discount rate: can be expressed in fixed or variable terms. The variable rate is based on different base rates: DTF (index of bank deposit rates), LIBOR, prime rate. The spread over the variable rate is established by the institution's Executive Committee.

- **Borrowing interest rate:** it is freely agreed between the intermediary (first tier lender) and beneficiary (local entity)
- **Grace period:** up to 3 years
- The lenders are free to determine the amount of the loans, disbursement characteristics, interest rates and fees, maturity and grace periods and repayment frequency based on their own credit evaluation and the project's useful life.

• **Automatic rediscounting process:** FINDETER also has an automatic intermediation system under which rediscounting is automatically authorized. Loans for less than USD 2.6 million can qualify for the expedited system. At first, the first-tier banks are responsible for confirming that candidate loans meet FINDETER guidelines. FIDETER conducts only an ex-post review of the approved loans. Larger loans still entail the traditional in-house review procedure.

**Figure A2.1. FINDETER flow of funds**




*Source:* Local Financing for Sub-sovereign Infrastructure in Developing Countries: Case Studies on Innovative Domestic Enhancement Entities and Techniques, World Bank, 2005.

• **Recourse mechanism.** The commercial banks' loans to sub-national governments are mostly secured by constitutionally mandated transfers from the central government. The sub-national borrower has to set up a special account into which intergovernmental payments flow. The bank has a senior right to intercept revenues if loan payments are due. The bank in turn endorses these liens to FINDETER. Thus, if a participating bank becomes insolvent, FINDETER can still collect its dues using this recourse mechanism.

• **Allocation of municipal credit risk.** FINDETER's own credit risk is based on the credit risk of the banks whose loans it acquires. This second-tier role distinguishes FINDETER from most municipal development funds, which lend directly to local governments and assume credit risks. The first-tier lenders assume all credit risks of the loans provided to sub-national governments with the proceeds from FINDETER's funding and are responsible for actions to recover such loans. The commercial bank remains responsible for honoring its obligations under the loan provided by FINDETER, regardless of its own repayment experience with the local borrower. The commercial bank thus absorbs 100 percent of the sub-national government credit risk.

• **Criteria for first-tier lender eligibility.** FINDETER has defined its own first-tier lender eligibility criteria and is also subject to financial regulations limiting the exposure of financial institutions. Authorized lenders include those specified in the Financial System Act, decentralized institutions of sub-national government that finance the activities described in FINDETER's

charter and others as allowed by law. FINDETER's Board of Directors defines a exposure ceiling or limit for each of the eligible financing institutions. These ceilings are adjusted every six months, based on the financial statements published by the bank regulator, risk rating agency reports and such other information as FINDETER deems relevant. Colombian law also requires financial institutions such as FINDETER to maintain ratio of equity to total funding of 9 percent. In 2010, FINDETER maintained a ratio of around 16 percent.

- **Donor Support and current financial situation.** In 1998, the World Bank (WB) and the Inter-American Development Bank (IADB) jointly supported FINDETER by providing loans in the amount of USD 125 million in total. The WB provided a USD 75 million loan for the financing of urban infrastructure investments**.** The objectives of the project were fully met. FINDETER used the loan to finance 60 projects by local service providers (water and sanitation companies). In parallel, the IADB supported the FINDETER's institutional strengthening and other intermediation programs. Although FINDETER relied on international financial institutions at the start, FINDETER's revenues from existing loans now finance most of its activities. In 2010, FINDETER had total disbursements of USD 1 billion, total revenue of USD 181 million, total capital market issuance of USD 1.1 billion and net income of USD 15 million. In that same year, FINDETER financed projects in multiple sectors, including transport (28 percent of disbursements), housing and water (21 percent of disbursements) and energy (15 percent of disbursements)
- **Developmental Impact.** FINDETER has succeeded in establishing itself as a viable financial institution. FINDETER has encouraged commercial banks to operate in the local debt market and to offer local borrowers long-term loans at attractive rates. FINDETER funded loans can offer maturities of 8 to 15 years, whereas loans to municipalities without FINDETER support would usually not exceed 5 years. Where appropriate, there can be a capital grace period of up to 3 years and an interest grace period of up to one year. From 1990 to 2003, FINDETER has financed about USD 2 billion in loans to more than 700 municipalities while maintaining low levels of bad debt (under 2 percent in 2003). In 2010, transportation and water and sanitation investments represented about 28 percent and 21 percent of these loans respectively.
- **FINDETER financial sustainability and credit rating.** FINDETER has achieved an AAA local credit rating (from Duff & Phelps), which has helped accessing less expensive financing.

## 3. CZech Republic

### *a. Background*

The Czech Republic began its transition to democracy and a market economy in 1989. Immediately after the end of the communist regime, the country administration was structured into two levels of government: the central government and 6,191 municipalities. Under the decentralization reforms enacted in 1991, local governments inherited the responsibility for providing municipal services. However, municipalities had no capacity to raise revenue other than collecting local fees and charges because of the highly centralized government structure. Sources for financing capital improvement project were severely limited. A single institution, the former State Savings Bank was the sole supplier of municipal credit. However, in 1993, the government adopted a new tax and local government financing system, which provided municipalities with a variety of stable and shared taxes, solidified local governments' budgets, and diversified municipal credit system.

- **Growth of Municipal debt.** During the 1990s, all forms of municipal debt expanded substantially: loans, bond issues, and other forms such as concessional loans from the Ministry of Finance. The debt outstanding of commercial bank credit in municipal sector had increased from 2,500 million Czech Koruna (CZK) in 1993 to CZK 11,600 million in 1996. Following the commercial bank lending, the municipal bond market developed quickly. The same banks that made municipal loans typically served as municipal bond underwriters. Both domestic and foreign currency bond debts had grown sharply: from CZK 30 million in 1993 to CZK 3,300 million in 1996, and from 0 in 1993 to CZK 8,610 million in 1996 respectively.
- **Access to borrowing by municipalities.** Most local governments have had access to bank loans and credit. Large municipalities have had access to all financial markets and have issued bonds for financing their investment projects such as public works and transport systems. On the other hand, small municipalities have had access only to local banking and noncommercial credit sources such as the State Environmental Fund, which provided loans at zero percent interest for targeted environmental projects including gas and water supply system, sewerage, and wastewater treatment plants. This difference indicated that large municipalities were more creditworthy than small municipalities because of the following reason. Large municipalities had substantial assets and buoyant tax bases; however, small municipalities had insufficient assets, revenue and tax capacity.

***b. Municipal Infrastructure financing Company (MUFIS)***

The above-mentioned competitive credit market environment has been supported by the activities of a municipal development fund, which is known as Municipal Infrastructure Financing Company (MUFIS). MUFIS was established in 1994 with the express purpose of enhancing commercial bank lending to municipalities as a regular part of the banking industry's business. The purpose also included eliminating the monopoly that the State Savings Bank had on municipal credit. MUFIS is owned 49 percent by the Ministry of Finance, 49 percent by the Czech and Moravian Guaranty and Development Bank (jointly owned by the Czech government and private commercial banks), and 2 percent by the Union of towns and cities.

- **The MUFIS financing.** MUFIS provides commercial banks with long-term funding at market rates for on-lending to local governments. Commercial banks conduct financial evaluations and accept all credit risk for their loans. Commercial banks typically collateralized their loans with municipally-owned property or contractual access to municipal deposit accounts.
- **The MUFIS functions.** Under the MUFIS financing system, municipalities develop projects on their own and commercial banks conduct credit analysis and assume repayment risks. MUFIS' function is to support this system with long-term funds. MUFIS lends at fixed-rates and with maturities of between 8 and 15 years.
- **Growth in the credit market by MUFIS activities.** MUFIS's activities have promoted the rapid municipal credit market growth and competition among commercial banks in the municipal sector. Through MUFIS's intermediation, the number of banks lending to municipalities increased from one bank in 1993 to eight banks in 1996. With this competition, real interest rates in the municipal sector have declined and average loan tenors have been extended. The structure of bank lending to municipalities has shifted dramatically to long-term lending (more than four years) from short-term lending (less than one year). While the ratio of long-term loans

to the total commercial bank credit had increased from 27 percent in 1993 to 69 percent in 1996, those of short-term loans had decreased from 32 percent in 1993 to 6 percent in 1996. Municipal bank loans outstanding increased from CZK 2.5 billion in 1993 to CZK 13.5 billion in 1996. The amount of municipal bonds outstanding also increased to CZK 13.2 billion in 1996 up from no volume only three years before.

- **The dissolution of MUFIS.** As the Czech municipal credit market matured, commercial banks began lending from their own resources rather than accessing credit lines at MUFIS. The municipal sector was recognized as the lowest risk raking, after national government debt, by the Czech National Bank. In view of this successful transition, MUFIS stopped making new loans to commercial banks in 2003, 10 years after its creation, with its external loans paid.
- **MUFIS funding sources.** MUFIS has raised funds through long-term, fixed rate borrowing in the US market by utilizing the Czech government guarantee. Foreign exchange risk is covered in part by a loan fee included in the on-lending rate and in part by the Ministry of Finance's agreement to reimburse MUFIS for foreign exchange losses in case the losses are larger than projected.

MUFIS has not only stimulated competition among commercial lenders to municipalities but also expanded access to finance by municipalities. Medium and small sized cities meet their funding needs through commercial lending, either directly or with the support of MUFIS for longer tenor loans, while large cities finance their investment through bond issues.

**4. South Africa**

***a. Background***

Prior to 1994, South Africa had a history of municipal borrowing and issuance of municipal bonds by white local authorities backed by implicit central government guarantees. However, as a result of the financial and political uncertainties that followed the ascent of the African National Congress to power in 1994, commercial banks and other traditional lenders and purchasers of municipal bonds withdrew from the market. This transitional period of time was characterized by the following factors:

- **Dilution of creditworthiness arising from restructuring of the local government sector:** The post-apartheid regime amalgamated different local government structures, integrating the resources of the wealthy white communes with those of the much lower income black communes. The process changed expenditure priorities, weakened management capacity and diluted the resources to provide for them. Localities were also struck by large-scale refusals to pay utility bills and taxes, a tactic carried over from the resistance during apartheid, and one which further limited resources at the local level.
- **Lack of a well-defined intergovernmental financing system:** South Africa had yet to establish either its general revenue support grant or its municipal infrastructure grant, reducing the funds available to local authorities.
- **Inexistent municipal credit assessment skills**: The system of implicit government guarantees eliminated the need to scrutinize local creditworthiness. However, after 1994, the South African constitution explicitly prohibited government guarantees for Private-Sector lending to public authorities, making it more difficult for lenders to assess municipal risk.

The above factors retarded the development of the municipal bond market and created a niche for a specialized intermediary

### *b. Infrastructure Finance Corporation Limited (INCA)*

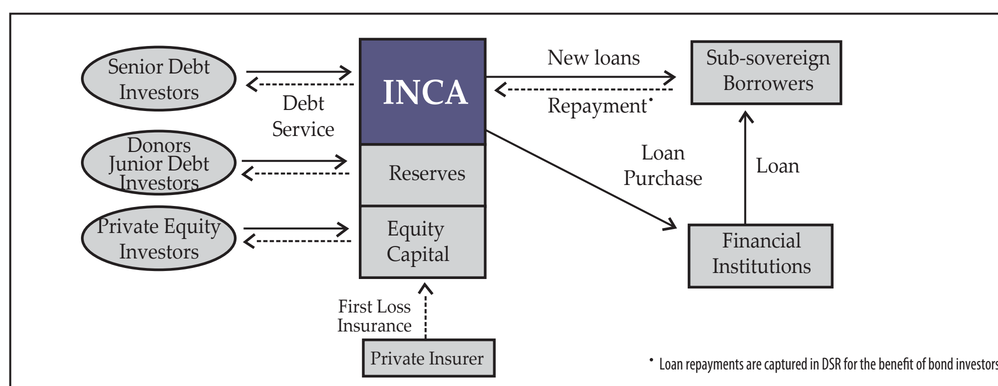
Established in 1996, the Infrastructure Finance Corporation Limited (INCA) was the first privately owned and operated sub-national finance intermediary in the developing world. INCA was managed as a for-profit entity and conducted a classic intermediary role: it raised wholesale financing from the capital markets, utilized its specific know-how to assess and manage municipal credit risk and lent to local governments with small margins and in high volumes. INCA allowed investors to get municipal exposure without having to build up specialized risk management platforms.

INCA lent to top-rated local authorities at a spread of 50 to 70 basis points above its cost of funds and was able to meet its operational costs and return on equity targets. In order to provide attractive pricing and remain profitable, INCA maintained a highly-leveraged structure made up of a relative small fraction of equity and a larger portion of subordinated and senior debt. Despite the challenges imposed by the environment in South Africa, INCA managed to be successful due to the relative high level of development of the South African debt market, the country's legal environment and the company's shareholder base, which encompassed well-known and credible institutions including commercial banks, development banks, social groups and the international development community. INCA also developed specialized skills in financing the municipal sector in South Africa, managing to sustain a low level of loan delinquencies, and maintained a significant market share (of approximately 10 percent). In its initial years of operation, INCA increased the supply of funds to the municipal sector and indirectly helped augment municipal investment.

Nonetheless, in recent years INCA's business model deteriorated significantly due to multiple factors: high levels of price competition from other commercial lenders and from the Development Bank of Southern Africa (DBSA); improved financial capacity of municipalities; and higher funding costs and limited access to long-term funding in the capital markets following the global financial crisis. Despite INCA's efforts to diversify into other markets, the financial crisis and economic recession compromised INCA's ability to raise funds at profitable rates and led to declining earnings against a background of higher funding costs, tight margins and increasing competition. As a result of these factors, INCA's credit ratings were downgraded in 2009 and 2010. In 2011, INCA's Board of Directors decided to effectively cease operations and run down the existing portfolio. As a result of this decision, INCA has been deleveraging the balance sheet by not extending new loans, selling assets to increase liquidity and repaying bonds.

The main lessons from INCA have to do with the factors that allowed it to be successful initially: ownership structure independent from central government, alignment of risks with rewards, high debt-equity ratio and strong credit risk management capabilities. Nonetheless, INCA is best viewed as a transitional institution. It fulfilled a critical role when no other intermediary was willing to take on the task of risk evaluation and management for the municipal infrastructure sector. Now that this task has been commoditized, there is less need and less reward for INCA's specialization and its developmental role has been substantially completed.

**Figure A2.2. INCA financial structure and flow of funds**




*Source:* Local Financing for Sub-sovereign Infrastructure in Developing Countries: Case Studies on Innovative Domestic Enhancement Entities and Techniques, World Bank, 2005.

## 5. Indiaa

### *a. Background*

India has a three-tiered structure of government comprising the center, the states, and the local governments including rural local bodies and urban local bodies. The Indian Constitution has allowed considerable fiscal decentralization to the state level under the constitutional amendments of 1992. Despite the amendments, fiscal decentralization has not gone further. Local governments have very little revenue generating capacity, thus rural and urban local bodies in India face significant financing gaps.

- **Government borrowing.** Both the central and the state government are given borrowing power under the Constitution of India. However, while the central government may borrow from both domestic and overseas sources, the state governments are restricted to borrow within the country. In addition, the central government controls the overall borrowing of state governments. If a state government has an outstanding loan made by, or guaranteed by, the central government, the state government cannot borrow additionally without the consent of the central government. Local governments, with the exception of municipal corporations, are not given borrowing power by the Constitution. Instead, they are fully dependent on the state governments for capital loans. Municipal corporations may raise loans from banks and financial institutions and from government agencies with the approval of the state governments and with the state guarantees for the debt.
- **Domestic debt Market.** Compared to the equity market in India, the debt market remained immature; however, interest and participation in the market has significantly increased in recent years by involving a variety of investors such as pension funds, insurance companies, banks and others. As the debt market develops, municipal bonds have emerged as important instruments for mobilizing resources for local governments' development spending needs. The Ahmadabad Municipal Corporation issued the first municipal bond, which is recognized as a model for municipal bond issues. Since then, several cities have raised funds from the capital market through municipal bonds. However, municipal bonds are not the only means to access to credit markets for local governments in India. There are also innovative mechanisms that bundle

underlying loans and involve greater private sector participation. One such mechanism is the Tamil Nadu Municipal Urban Development Fund (TNUDF).

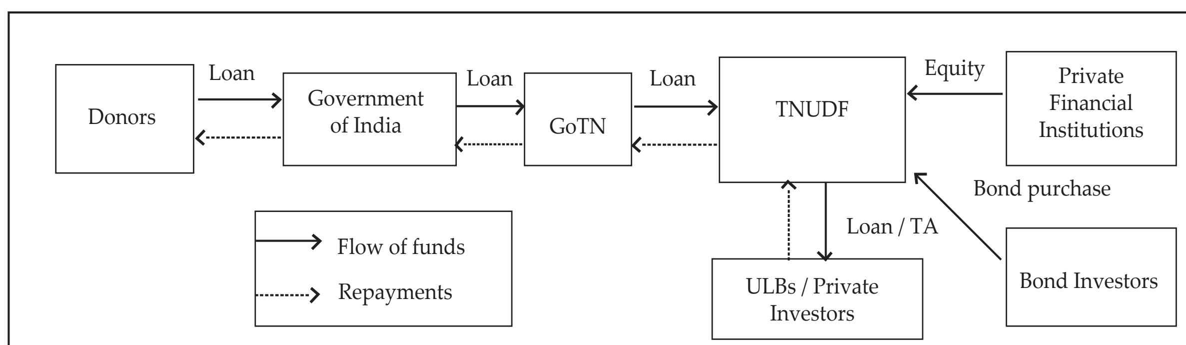
### *b. Tamil Nadu Urban Development Fund (TNUDF)*

TNUDF is the first public-private partnership providing long term finance for urban infrastructure on a non-guarantee mode. It began lending operations in 1997. Until then, there were urban finance shortfalls in India because of huge urban financing needs and municipalities' limited operating surpluses. In order to meet the financing shortfalls, in 1988, the Government of Tamil Nadu (GoTN) established the Municipal Urban Development Fund (MUDF) which provided municipalities with subsidized loans combined with grants. However, it was recognized that the MUDF and public funds were not enough to resolve the urban finance shortfalls; therefore, mobilizing private sector capital was necessary.

In November 1996, MUDF was converted into the TNUDF as an autonomous financial intermediary. The GoTN and private investors participated in the conversion to the TNUDF. The private investors included three Indian financial institutions (FIs): ICICI Bank Limited, Housing Development Finance Corporations (HDFC), and Infrastructure Leasing and Financial Services Limited (IL&FS). The GoTN's contribution wasRs 1.2 billion (70 percent of the total capital) and the FI's total contribution amounted to Rs. 510 million (30 percent of the total capital).

- **TNUDF has four objectives**: (a) to finance urban infrastructure projects which improve the living standards of urban population; (b) to facilitate private sector participation in infrastructure through joint venture and public private partnership; (c) to Improve the financial management of urban local bodies enabling them to access debt finance from the market; and (d) to operate a complementary window, such as a grant fund, to assist in addressing the problem of the urban poor.
- **Direct lending to urban infrastructure.** TNUDF provides direct lending for the development of urban infrastructure projects. The eligible borrowers include urban local bodies (ULBs), statutory boards, public undertakings and private investors. Financing packages depend on the characteristics of the projects. The fund provides loans for revenue generating projects such as toll roads and a mix of loans and grants for basic environmental infrastructures.

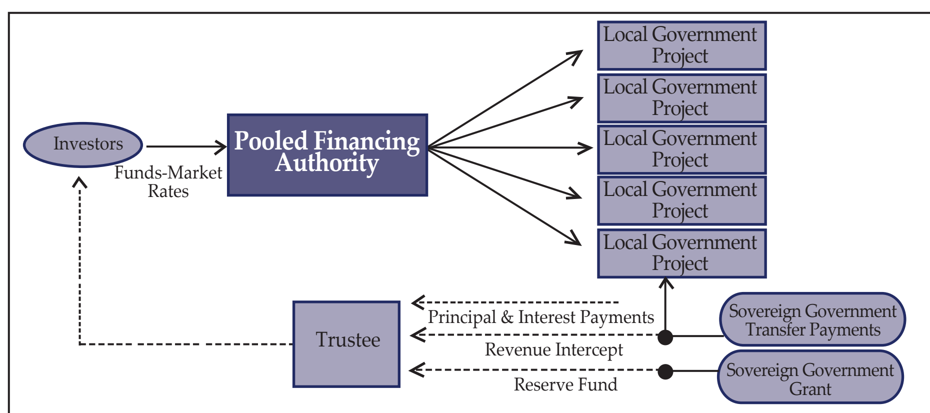
**Figure A2.3. TNUDF flow of funds**




*Source:* Project Appraisal Document on Proposed Loan in the Amount of US$105 Million Equivalent for the Second Tamil Nadu Urban Development Project, Report No. 18400-IN. World Bank, 1999.

- **TNUDF's track record for financing.** TNUDF has succeeded in financing and supporting urban infrastructure development. For the first five years from 1997 to 2002, the TNUDF approved 179 investment projects at the total project costs of Rs.6.7 billion and was able to disburse about Rs. 3.4 billion in loans to ULBs and to joint public-private investment projects at the local level. The repayment rate was close to 100 per cent. TNUDF has played the catalytic role for promoting urban infrastructure financing by financial advices and project preparation, in addition to traditional on-lending activities. TNUDF has provided several different types of innovative financing schemes to mobilize private sources of capital.
- **TNUDF's Innovative financing support.** TNUDF has mobilized private capital by facilitating innovative financing schemes such as credit pooling, securitization and public-private financings.
  – **Pool financing:** TNUDF facilitated a credit pooling facility for financing smaller ULBs with limited financing capacity. In this scheme, small water and sanitation projects were pooled together in a single bond issuance, to be repaid through project revenue. The issuance received rating of AA by Fitch Ratings.

**Figure A2.4. TNUDF pooled financing authority flow of funds**




*Source:* Local Financing for Sub-sovereign Infrastructure in Developing Countries: Case Studies on Innovative Domestic Enhancement Entities and Techniques, World Bank, 2005.

  – **Securitization:** TNUDF structured refinancing of the Madurai Bypass, the first toll road project based on user charge. After the facility began generating revenues, the ULB issued bonds to refinance the loan made by TNUDF at lower interest rates. The bonds were fully subscribed by banks and TNUDF.
  – **PPP financing:** TNUDF assisted the refinancing of the Karur Bridge, the first BOT toll bridge in India, via a PPP financing. The bond issue was backed by a contract that allowed the builder/owner to increase the toll at eight percent a year. The project included a substantial equity contribution by the builder/owner.
- **Donor support for TNUDF.** The TNUDF has received support from various donors including the World Bank, USAID, Japan's International Cooperation Agency (JICA) and the German Development Bank (KfW). The World Bank provided USD 105 million loan for TNUDF development under the TNUDF II project and another $300 million loan under the TNUDF III project.

- **Bond issuance.** By late 2000, TNUDF had succeeded in issuing domestic bonds with a LAA rating. The LAA rating indicated high safety and moderate risk due to TNUDF's strong financial position. This was the first non-guaranteed and unsecured bond issuance by a financial intermediary in India.
- **TNUDF has successfully played a variety role in the area of sub-sovereign finance**. The fund manages providing finance, grants and assistance to local bodies as a typical municipal development fund. The fund also provided innovative financial support to mobilize private capital. The TNUDF operates within a regulatory and institutional framework that is supportive of municipal finance, which allows for effective escrow and revenue intercept mechanism and permitting self-liquidating facilities such as toll roads.

## B. Credit Enhancement Entities

### 6. The Philippines

#### *a. Background*

The Philippines is a unitary state with a hierarchical system. Local governments are directly controlled by the national government with certain constitutional protections. The local sector consists of three levels; the provinces and major cities, the municipalities, and the barangays. The country has more than 1,600 local governments including 78 provinces, 82 cities, and 1,525 municipalities.

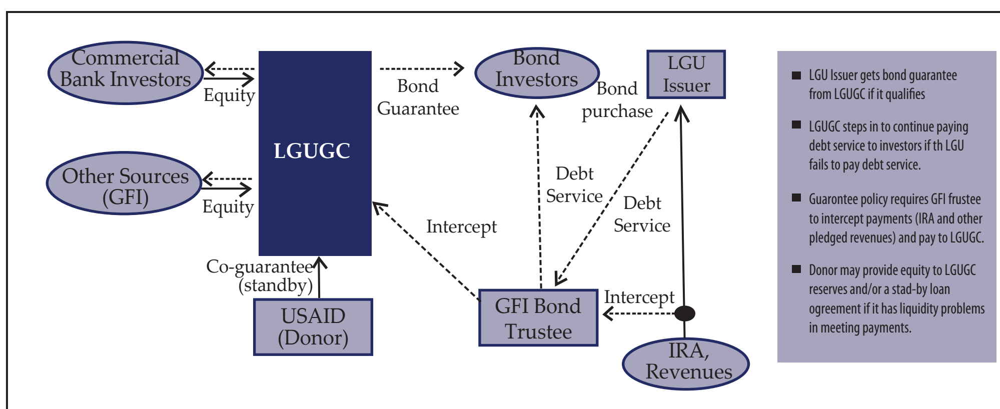
- **Local governments' responsibility under the Local Government Code of 1991.** The code provides greater responsibilities for service provision to local governments. The local governments are entitled to receive 40 per cent of the state's income and value added tax revenues. These revenues are distributed on the basis of a formula and are commonly called internal revenue allotments (IRA). The code also gave local governments expanded powers for setting local tax rates and collecting own-source revenues such as property tax, business tax, and tax on vehicles.
- **Sub-national borrowing.** The code also provides substantial borrowing power to local governments; however, there are some restrictions such as a limit on local governments' borrowing capacity. The code stipulates the appropriation for debt service should not exceed 20 percent of their regular income. Local governments are allowed to access credit finance from bank credit and other similar forms of credit and also from bonds and other securities. Local governments can use credit financing for two purposes including liquidity and capital projects. The main sources of credit financing are two government-owned financial institutions: the Landbank of the Philippines and the Development Bank of the Philippines. Private commercial banks carry out almost no direct lending to local governments. A regulation restricting local governments' depository account to government financial institutions have precluded their access to private banks.
- **The bond market in the Philippines.** The bond market is dominated by the central government and its need to finance its deficit. There are a few corporate bonds. The Local Government Code of 1991 authorizes local governments to issue taxable, revenue-based municipal bonds subject to any applicable rules issued by the Securities and Exchange Commission and the Central Bank. Local governments must use bonds for self-liquidating and revenue-generating purposes. Municipal bonds were expected to become a major source of infrastructure capital. Revenue-based municipal bonds were promoted by several governments and private institutions such as local government officials, private banks, the Central Bank, and the Department of

Finance; however, only five small municipal bonds issues took place in the mid-1990s because the securities markets were inexperienced in lending to local governments. In addition, private Banks are cautious about underwriting bond issues for local governments.

***b. Local Government Unit Guarantee Corporation (LGUGC)***

In 1997, the Department of Finance facilitated the creation of the Local Government Unit Guarantee Corporation (LGUGC) in order to develop a municipal bond market. The LGUGC was formed as a private financial service corporation that served as a guarantor of bonds and loans of local government unit (LGUs). The LGUGC is owned38 percent by the Bankers Association of the Philippines (BAP), 37 percent by the Development Bank of the Philippines (DBP) and 25 percent by the Asian Development Bank (ADB). BAP is the umbrella association of chief executives of all commercial and universal banks in the country, both private and government. The LGUGC was started in 1998 with an initial stock subscription of PhP 250 million (about USD 7 million). LGUGC guarantees the indebtedness of local government units (LGUs), water districts (WDs), electric cooperatives, renewable energy technology providers and state universities and colleges.

**Figure A2.5. LGUGC flow of funds**




*Source:* Local Financing for Sub-sovereign Infrastructure in Developing Countries: Case Studies on Innovative Domestic Enhancement Entities and Techniques, World Bank, 2005.

- **The LGUGC guarantee coverage and policy.** The LGUGC guarantee is a straight insurance of the periodic debt service payments (both principal and interest payments) of the borrower. The guarantee is irrevocable and immediately payable in the event of a notice of default on payment by a bondholder. Upon guarantee call and payment, the bondholder's rights in the guarantee transaction are subrogated to the LGUGC, which then steps in to enforce the bondholder's claims against the security provided by the borrower. All LGUGC guarantee policies to date have involved the assignment of the project revenues, project assets and the internal revenue allotments (IRA).
- **Recourse mechanism.** The debt service of the bond issued by LGUs is implemented through Government Financial Institution (GFI) Bond Trustee. GFI trustee has a right to intercept LGU's revenues and IRA and pay to the LGUGC if the LGU fails to pay debt service.
- **LGUGC risk assessment.** The LGUGC has operated on a commercial basis to provide guarantees which have added liquidity and credibility to the growing LGU bond market. To

do so, the LGUGC developed its own credit assessment criteria and rating system to write guarantee policies and set its premiums. The premium for the guarantee depends on the rating and the scale of the transaction with around 1.0 to 1.5 percent of the outstanding principle.

- **Performance.** The LGUGC had closed on eight bond issues involving its guarantees by March 2001. As of October 2011, LGUC had an outstanding guaranteed amount of PhP 5.9 billion (equivalent to approx. USD 137 million). PhP 2.3 Billion (USD 54 million) in LGUC-guaranteed debt has been redeemed. The total loan volume guaranteed is 17x LGUGC's paid in capital. LGUGC maintained its PRS "Aa+" (corporate) issuer credit rating from the Philippine Rating Services Corporation for the period November 2011 to November 2012 which enables LGUGC to maintain the 20percent risk weight granted by the *Bangko Sentralng Pilipinas* to all LGUGC-guaranteed debts.
- **Donor support.** LGUGC's guarantees are co-guaranteed by USAID/ Development Credit Authority (DCA). In 1999, the LGUGC entered into the first agreement with USAID-DCA, which backstops 30 percent of LGUGC guarantees issued for qualifying projects up to a maximum exposure of USD 8.5 million dollars. The second agreement with USAID-DCA signed in 2008 is to co-guarantee up to 50 percent of LGUGC's exposure to water projects with a cap of USD 12.75 million.

The LGUGC can be seen as an example of successful commercially based guarantee company for purposes of expanding private financing of infrastructure. The LGUGC has operated on commercial basis and has added liquidity and credibility to the small but growing municipal bonds market. By reducing economic risk on individual transactions, the LGUGC has succeeded in channeling private capital into local government financing and build a small nexus between private sector institutions and local governments.

### 7. Indonesia

#### *a. Background*

Indonesia is a unitary state, which is divided into about 30 provinces and more than 360 local government units, including cities and rural regencies or districts. Provinces, cities and districts are referred to as regional authorities. In 2001, the government of Indonesia initiated decentralization, which aimed at transferring spending responsibilities, resources, assets, and some 2 million of its employees to the local level. The following is the local government and overall country context in Indonesia for the last decade.

- **Local governments' revenue and expenditure.** The decentralization process enabled local governments to define their capital investment needs and to strengthen their revenues through the general allocation grant from the central government. The law allows local governments to decide how best to use these resources. In principle, operating surpluses could be used for their capital investment. In practice, however, more than half of the resources are used for employee salaries and benefits.
- **Sub-national government borrowing.** Until recently, local governments including locally owned enterprises have borrowed only small amounts from the banking sector and capital markets as Indonesia's economy including these sectors were hurt severely by the 1997 financial crisis. Local governments have mainly borrowed through two government mechanisms; Regional Development Account (RDA) used for lending states budget funds to regional governments; and Subsidiary Loan Agreements (SLAs) used for regional infrastructure projects. Despite the

concessional terms and conditions, RDA and SLA lending has problems with the unacceptably high level of arrears. This high level of arrears taints the creditworthiness of the entire local government sector and discourages the formation of a sub-national government credit market.

- **Financial Sector and infrastructure sector context.** Indonesia's economy has currently recovered from the 1997 financial crisis. The banking sector has reduced balance sheet vulnerabilities and its performance remains sound despite the impact of global slowdown in 2008. On the other hand, after the 1997 financial crisis, infrastructure investment declined from 7 percent of GDP to over 2 percent in 2001. Since then, infrastructure investment has risen to over 3 percent of GDP, and public spending on infrastructure has increased. However, it is insufficient to meet the growing demand of infrastructure. Given limited fiscal space, encouraging substantial private sector investment in infrastructure is one of the government's highest priorities. However, Indonesian banks cannot make long-term loans to infrastructure projects as over 85 percent of Indonesian bank deposits are less than one month maturity. Even if infrastructure projects are well structured, private commercial banks in Indonesia are unable to provide long-term domestic currency financing to the projects.

The above background and factors led Indonesia to create a financial institution providing long-term financing for infrastructure projects.

***b. Indonesia Infrastructure Finance Facility (IIFF)***

In April 2010, the government of Indonesia officially launched the Indonesia Infrastructure Finance Facility (IIFF) as a non-bank financial institution. The IIFF assists in the development of, and provide long-term local currency financing to commercially-viable infrastructure projects. The IIFF aims to address the lack of long-term financing for infrastructure projects and to mobilize and lead private capital into commercially-viable infrastructure projects at the national and local level. The IIFF is also expected to improve the enabling and regulatory environment for infrastructure projects, especially those structured as public-private partnerships.

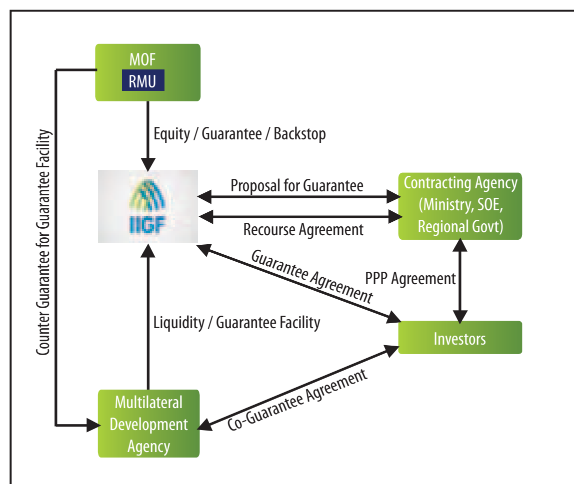
- **Capital structure.** The IIFF was established by the government and together with donors support led by the World Bank. The facility is funded by its founding shareholders comprising of USD 100 million from the Government of Indonesia through *PT Sarana Multi Infrastruktur* (Persero) (PT SMI), USD 40 million from Asian Development Bank (ADB), USD 40 million from International Finance Corporation (IFC), and USD 20 million from *Deutsche Investitions und Entwicklungsgesellschaft* (DEG). The World Bank provided USD 100 million loan to the government for back-financing capital contribution to the IIFF.
- **Instruments and financing scheme.** The IIFF can offer a number of financing instruments including senior debt, mezzanine finance, equity and technical assistance for supporting infrastructure projects.
- **Sector focus.** The IIFF focuses on energy and mining, oil and gas, and transportation including roads, highways, railways, port, waterways, and shipping.

***c. Indonesia Infrastructure Guarantee Fund (IIGF)***

In addition to the IIFF, the government also developed other institution to support infrastructure financing. In 2009, Indonesia Infrastructure Guarantee Fund (IIGF) was established with support from the World Bank, in order to ensure the availability of government money to honor guarantees

made to private infrastructure projects. IIGF serves as the Government's single window for the appraisal and processing/structuring of risk guarantees for PPP projects.

**Figure A2.6. IIGF guarantee arrangement**



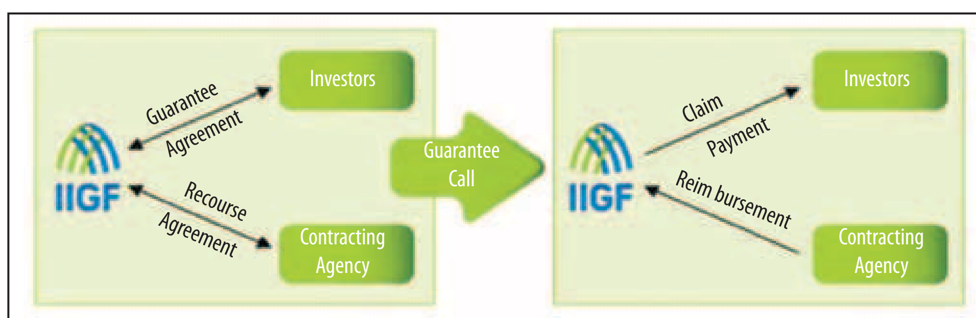

*Source:* IIGF

IIGF's guarantees provide coverage against the risk of non-performance by a public Contracting Agency (CA). The CA is the Government's representative or partner in the PPP (ministry, government institution, local government, SEO or local government), which is responsible for providing infrastructure in accordance with the law.

The covered risks may include: Land acquisition delays; delays associated with licensing / permits; change in law; breach of contract (tariffs, contracted revenues); and contract termination.

The recourse arrangement between IIGF and CAs is essential to ensure IIGF's financial viability, sustainability and credibility: encourage discipline and improve CAs' accountability. IIGF has the right of recourse to CA for every claim it disburses to investors. The amount of recourse that can be claimed by IIGF to CA is the disbursed claim including the time value of money. The rights of IIGF and obligations of CA are stated in the Recourse Agreement between IIGF and CA, which is signed before IIGF signs the Guarantee Agreement with private companies.

**Figure A2.7. IIGF recourse arrangement**




*Source:* IIGF

## C. Land-Based Financing of Infrastructure

"Land for infrastructure" is widely used as a financing approach for infrastructure in all provinces, especially in larger cities, in Vietnam. The approach usually works on a negotiated basis between the government and private sectors. In short, the government exchanges certain land for provision of specific infrastructure developed by private sector in a contract form. In an extreme case, this approach brings funding up to 30 per cent of the local capital expenditure budget for specific infrastructure. Although there is no reliable information on how much Vietnam has actually mobilized funding through this approach, it seems to be successful as a number of infrastructures have been financed in this way. However, this approach raises concerns in terms of the transparency of the land valuation process, as well as the number of cities which actually benefited from the increase of land value by the improved infrastructure.

This "land for infrastructure" scheme has also been known as land-based financing in developed countries for long time. Land-based financing uses land values to help pay for investments in urban infrastructure. The basic rationale for using land-based financing is the principle of capitalization of benefits into land values. It means that the value of the benefits of specific infrastructure investment can be capitalized into land values and will increase land values. As a result, a public or private developer of the infrastructure will be able to capture the land-value gain at the time it sells the land parcel or developed lots. Many land-financing techniques have been employed for tapping land values to help finance urban infrastructure investment. The techniques include land leasing, land sales,sale of development rights and betterment levies. Land-based financing is also becoming an important element of urban infrastructure finance in developing countries, especially in locations where cities are growing rapidly, such as larger cities in China, Brazil and India.

### 8. China: Land leasing

In China, all urban land is owned by the municipal government. Many cities have financed half or more of their very high urban infrastructure investment levels directly from land leasing. The purchaser of a land leasing acquires land rights for a period of 40-70 years. Municipalities usually transferred land rights to developers primarily by private negotiations until the mid-1990s; however, such negotiations with developers caused corruption with consequent revenue loss to government. In 2002, the central authorities promulgated a new circular which instructs municipalities to conduct all land leasing through public biddings at auction.

Urban highway construction in China leveraged land values. The process of land-based financing can be illustrated by the construction of the outer ring road encircling the region around Changsha, the capital of Hunan province in Central China. To finance the project, the municipality transferred to a public-private agency, the Ring Road Investment Corporation, leasing rights for strips of land 200 meters wide on the both sides of the highway that was to be built. In all, 33 square kilometers of land were transferred. Of this total, 12 square kilometers were finished land, possessing infrastructure access and development approvals. In its original states, without access to roads or development approvals, the remaining land had little market value. However, the plan was to sell off parcels of land once the highway was built. The total cost of the highway was USD 730 million. Approximately, half of this amount was financed directly from sale of leasing rights to the land already having infrastructure services. The other half was financed through borrowing from development banks and commercial banks against the future anticipated value of improved land. To meet debt service, the

Ring Road Investment Corporation pledged to sell off land parcels in the future after the highway was completed.

**9. Brazil: Development rights**

As an alternative to the sale of land to capture incremental land value generated by public infrastructure projects, public authorities can sell development rights. Development rights fall into two categories: the right to convert rural land to urban use and the right to build at greater densities that normally would be allowed by zoning rules or highest restrictions. At urban growth poles like underground stations or other locations where high-density development is appropriate, the latter meaning of development rights is appropriate. This process of sales of development rights is illustrated by the case in Sao Paulo, Brazil. Under Sao Paulo's development regulations, developers do not pay a density fee for buildings that fall within the normal limitations on floor space; however, the municipality charges a preset fee for additional floor space beyond the normal maximum density in locations authorized for higher-density development. Resources are dedicated to a special fund that can be used only to finance investment in works approved under the law establishing the respective urban operation.

The *Faria Lima* Urban Operation utilized land values of the extension of Faria Lima Avenue and other public investments. Land values in the area reportedly have risen from USD 300 per square meter, before public development, to USD 7,000 per square meter afterward. The municipality offered to sell development rights for additional construction of 2.25 million square meters of floor space within the 410-hectare development area. Over the period of implementation, development rights have been sold for as much as USD 630 per square meter of allowable floor space. Investment projects authorized under the urban operation include street improvements, an integrated drainage system for the area, public open space, and assistance for the construction for social housing.

**10. Colombia: Betterment Levies**

Betterment levies are charges levied directly on the increments in land value created by public works. Although most countries have experienced with adopting betterment levies in variant forms, the basic form of betterment levies charges on land value gain caused by public works at one time and on upfront basis. The concept of betterment levies is straight forward; however, in practice, it is difficult to identify the land values created by public works with precision and parcel by parcel. For this reason, betterment levies have not been considered as a significant source of revenue for urban infrastructure financing in developed countries. However, Colombia has been successfully using a form of betterment levy through several times of the modifications, in order to finance urban infrastructure. The form of betterment levies in Colombia is known as *contribucion de valorizacion*.

The new version of *valorizacion*, which took effect since 1997, has introduced the principle that the betterment levy charge on urban planning authorization. The land parcels within a special planning district for the conversion into urban use authorized by the municipal government could be subjected to a betterment levy of 30 to 50 percent at municipal discretion. The betterment levy was applied to the price increment enjoyed by the landowner as a result of planning authorization. Payment of the betterment levy was due on the realization of the land-value gain at the time of sale or development. Proceeds are to be used for infrastructure investment to support the newly urbanized territory. In the period 1997-2007, through *varolizacion*, Bogota financed 217 public

work projects (mostly street, bridge and drainage improvements) in all parts of the city. As a result of the modifications, *valorizacion* has been transformed into an up-front, land-based infrastructure tax, used to finance a substantial part of the municipal capital budget.

## D. Other Regional Experience

### 11. China

#### *a. Background*

China began a process of fiscal decentralization reform in 1980 with the purpose of giving sub-national governments more financial autonomy. Initially, decentralization took the form of a contracting system whereby the central and local authorities split revenues and expenditure responsibilities. This system incentivized provincial governments to underreport their revenues and as a result, the central government's share of revenue fell and the richer provinces increased their bargaining power and ability to get more favorable contracts at the expense of other provinces.

In 1994 the Government enacted the Tax Assignment System Reform, which established a principle for the assignment of fiscal revenues between the central and sub-national governments: Taxes concerning national interest or macroeconomic adjustment were given to the central government, while those that related to local economic development are under the jurisdiction of sub-national governments. At this time, an intergovernmental transfer system was also put in place consisting of two types of transfer: one consisted of a rebate equivalent to a certain percentage of the increment in the total amount of taxes collected; and another consisting of a grant defined by a formula designed to account for the difference between a province's standardized revenues and standardized expenditures.[20] These transfers are made from the central to the provincial level and the provinces then transfer revenues to the local level, generally following grant arrangements that resemble the central-to-provincial scheme.

Since the practice of sharing revenues with the provincial government was eliminated, the reforms had the effect of increasing the amount of revenues going to the central level of government. Further changes in the revenue-sharing rules have resulted in a faster rate of growth in central government revenues relative to provincial government revenues. Provincial governments have also retained a high portion of the revenues generated within the provinces, not transferring enough resources to sub-provincial (local) governments.

Despite the progressive reduction in the revenues available to local governments, their expenditure responsibilities remained unchanged. In China, local governments are in charge of a disproportionately large share of expenditures, including those that make up the "social safety net" (education, health and pensions), and major physical infrastructure, including transportation, electricity and transportation. This has caused a mismatch between the financial capacity of local governments and their investment needs. Furthermore, local governments are not allowed to borrow directly.

20 Standardized revenues are calculated according to the regional tax base and the tax rates for sub-national and shared taxes. Standardized expenditures consist of the provincial government outlays for employees, education and administration calculated at normalized rates.

### *b. Urban Development Investment Corporations (UDICs)*

The existing fiscal and financial systems such as prohibition of sub-national borrowing give local governments little room to assume their responsibilities directly via their own budgets. As a result, local governments have resorted to off-budget schemes in order to fulfill their growing urban infrastructure needs. Formal budgetary resources have played a declining role in infrastructure finance in recent years, while the use of government-owned enterprises and various public-private arrangements, including concessions and joint ventures, has surged.

Off-budget mechanisms are funded through self-raised funds, including special fees, charges, taxes on enterprises that are owned by local governments, leases of land, and profit distributions from local government owned businesses. These resources have been complement with a combination of bank lending and bond issues by local government-owned companies.

These entities which were set up for off-budget sub-national borrowing are often named Urban Development and Investment Corporations at the municipal level. They act on behalf of the local governments in funding for infrastructure and other investments. Currently, around 8,000 UDICs exist in China where this kind of financing accounts for 80 to 90 percent of urban infrastructure finance. UDICs help account for off-budget sub-national liabilities that are estimated to equal up to 34 percent of GDP and accounted for 30 percent of record on new bank lending in 2009.

Consequently, the central government officials have become concerned about contingent liabilities that might be lurking among the massive amount of UDICs debt. While UDICs in large coastal cities raise capital from the markets and rely less on bank loans because of their well financial conditions, UDICs in the poorer areas of northern and western China rely more heavily on bank loans backed by local governments' guarantees rather than assets or future project revenues. In addition, those loans were issued at time when the central government seemed to be encouraging lending for infrastructure projects. As a result, credit analysis by banks was not adequately conducted. Thus, there is an estimation that a quarter of this borrowing may go into default and 25-30 percent default rate would wipe out the paid-in capital of many China's largest banks.

Accordingly, the central government intends to prohibit local government guarantees for UDIC borrowing and to establish a comprehensive regulatory framework for sub-national finance.

### *c. Urban Infrastructure investment and Financing in Shanghai*

The municipality of Shanghai is one of four cities in China that have provincial-level status. It has a population of approximately 23 million people. Shanghai exemplifies the use of off budget sheet mechanisms for the financing of urban infrastructure.

The first step in the process to diversify the sources of funding for urban infrastructure in Shanghai was the establishment of the Shanghai Chengtou Corporation (a UDIC). This Company was given the mandate to implement new financing approaches, including bond issuances and off-budget financing vehicles, such as joint ventures and concessions. The corporation also issued some debt in the capital markets, as it was not subject to the limitations imposed on the sub-national governments.

In addition, since the 1990s, Shanghai has taken the lead in land leasing in China, generating more than USD 12 billion from up-front payments and land leasing rights. The city has invested these resources in urban infrastructure and housing projects. Leasing land at market values has also

allowed the city to rationalize the spatial layout of the metropolis, by encouraging the relocation of industries outside of the city and leasing the vacated land to higher value users that can take better advantage of a central location.

For the development of revenue-generating infrastructure, Shanghai has sought to attract investments from international and local investors through concession contracts, joint ventures and competitive biddings. For example, Shanghai Chengtou and Veolia water entered into a joint-venture (Pudong Water Works), which was successful in mobilizing external investment of RMB 2 billion. Initially, private investors in these joint ventures were guaranteed a specific rate of return achieves in some instances by supplementing tariffs with other sources of revenue available to the city. Eventually, government guarantees were greatly reduced or eliminated and more emphasis was placed in cost-recovery. Lastly, the City of Shanghai has also opted to develop some non-profit projects, such as bridges and tunnels, on the basis of contracts tendered out to private companies selected through market-based competition This has allowed the City to have access to best practices from private companies.

## E. Sub-national PPP

### 12. Brazil

#### *a. Background*

Sub-national finance in Brazil has evolved in tandem with the financial situation of the Federal Government. In the 1960s and 1970s, states and municipalities borrowed heavily through domestic and foreign bonds issues and from state-owned banks. The bulk of the debt was concentrated in a small number of states and was provided by publicly-owned banks that did not have the incentives or capacity to perform rigorous credit evaluations and lacked independence from political interference. Additionally, the absence of the private sector from sub-national lending eliminated a potential source of evaluation and control. As a result of excessive borrowing and lack of fiscal controls, Brazil suffered from multiple episodes of macroeconomic instability, starting with debt defaults by the central government in the1980s. This instability also affected municipal finances and required three Federal bailouts of sub-national borrowers.

In recent years, Brazil has implemented several reforms aimed at stabilizing the fiscal situation. Firstly, under the mandate provided by the 1988 Constitution, in 1998, the Senate adopted several new measures to control sub-national debt in the form of Resolutions. In 2000, these measures were better defined and formalized in the Law of Fiscal Responsibility. This law imposed certain fiscal principles and borrowing restrictions to states and municipalities: restrictions on personnel expenses, a cap limiting the stock of debt and a debt service coverage requirement. Despite tighter regulations, the share of sub-national government debt as a percentage of total public sector debt has been rising nonetheless, standing at about 30 percent in 2010.

Currently, Brazil has a large and developed financial market that is not used as a source of funding by States and municipalities. Instead, sub-national borrowing is dominated by State-owned and Federal banks as well as by various specialized funds that lend at subsidized rates. Municipalities have relied mainly on funds provided by the Federal Housing and Savings Bank (*Caixa*) and Federal Development Bank (*Banco Nacional do Desenvolvimento* – BNDES) and by municipal development funds established with grants from the World Bank and the Inter- American Development Bank.

There are multiple factors behind the lack of commercial funding for sub-national governments. States and municipalities borrow funds from public sources with conditions that cannot be matched by commercial lenders: subsidized interest rates, grace periods, and long tenors.

In the absence of market-based rules, there are administrative rules controlling sub-national debt. The Central Bank prohibits public sector banks (Caixa and BNDES) and financial institutions from having more than 45 percent of their equity in the form of loans to or investments in public sector entities. Municipal development funds are not subject to this rule, but their lending is limited by the provisions of the Fiscal Responsibility Law explained above. Every sub-national borrowing request must be directed to the Central Bank, which analyzes each case and makes a recommendation to the Senate. External borrowing by states is largely exempt from federal regulation unless it requires a federal guarantee, in which case the Ministry of Finance has the authority to grant or deny federal backing. Nonetheless, the National Monetary Council of Brazil controls the external credit operations of states and municipalities.

Access to finance has been limited by the inability to tap a wider spectrum of capital providers, as well as by budget rigidities that do not permit governments to reorient expenditures towards large infrastructure projects. Given the large infrastructure needs of Brazil and the limited capacity to mobilize financing in a large scale, the Brazilian Government has resorted to PPPs at all levels of Government, including states and municipalities.

***b. Sub-national Public-Private Partnerships (PPP)***

Brazilian law establishes a division of attributions between Federal, State and Municipal governments regarding the provision of utilities and infrastructure services: the Federal Government is in charge of interstate roads, power and telecommunication projects; state governments have responsibility over gas distribution; and municipal governments have responsibility over water and sanitation and other social services.

The Brazilian Constitution allows local governments to delegate to the private sector, often through concessions, the provision of local services such as urban transportation, water and sanitation

In 2004, the Brazilian Government adopted a PPP Law that applies to all levels of government and complements existing legislation, including the Procurement and Concessions Laws. The Law includes a safeguard for public finances, limiting total public financial commitments to PPP projects to a maximum of 1 percent of the local government's net revenue. If a sub-national government exceeds this limit, the Federal Government is authorized to withhold fiscal transfers. In order to address the Government counterparty risk and reduce financing costs, the Law provides for the creation of a Guarantee Fund (*Fundo Garantidor*) where public assets are contributed to backstop government obligations under PPPs. The law also allows for the earmarking of government payments to honor obligations under PPPs.

Multiple state governments have also passed PPP legislation: Goiás, Minas Gerais, Rio Grande do Sul, Santa Catarina and São Paulo. PPPs have helped sub-national governments to improve the delivery of public services and have freed resources to invest in other areas. The most active states to date are *Minas Gerais, Sao Paulo* and *Bahia* and the predominant sectors include roads, water and sanitation, health and education. The modality adopted for the provision of government financial support vary across the states: While *Minas Gerais*, *Santa Catarina* and *Rio Grande do Sul* have

opted for the creation of fiduciary funds along the lines of federal legislation, *São Paulo* and *Goiás* have created public companies linked to the state treasuries to manage state guarantees.

The Federal Government is providing assistance to sub-national entities in the structuring of PPPs. The Federal Ministry of Planning has entered into technical cooperation agreements with the states of *Bahia, Ceará, Manaus, Maranhão, Piauí* and *Rio Grande do Norte*. Since there is some expertise in managing the procurement of public works, the training has been mostly focused on creating a culture of using output based contracts and on developing the legal and financial expertise required to structure complex PPP projects. The Federal government is also helping sub-nationals to create standard legal documents for PPPs.

The Federal Government (through its development bank) has also contributed to the set up two facilities to provide PPP project structuring support. The first if the PSP Development Fund, sponsored by the BNDES, the International Finance Corporation (IFC) and the Inter-American Development Bank (IADB). The PSP Development Fund consists of a revolving fund to pay for the costs of project development and is incentivized to prepare bankable projects since an important form of its remuneration is in the form of success fees. In addition, multiple commercial banks,[21] in conjunction with the BNDES, formed EBP – *Estruturadora Brasileira de Projetos*, a private company that develops traditional and social infrastructure projects for federal, state and municipal governments. EBP focuses on projects that involve investments ranging anywhere between USD 265 million and USD 1 Billion and terms of up to two years for signing a concession contract/PPP. EBP contracts and coordinates the environmental, engineering, legal and financial feasibility studies always in coordination with the relevant government entities. The expenses with these studies are financed by EBP on its own account and risk. When the concession contract/PPP agreement is signed, EBP is reimbursed for its expenses by the new concessionaire, pursuant to the terms of Article 21 of the Law of Concessions (No. 8987 of 1995).

## F. Municipal Bonds

### 13. India

In 1998, Ahmedabad Municipal Corporation (AMC), an urban local body, issued Rs. 1,000 million (USD 25 million) municipal bonds to partly finance a water supply and sewerage project. This was recognized as a remarkable achievement since it was the first municipal bond issuance without a state guarantee in India. It was also the first step forward towards market-based system of sub-national finance as municipal bonds are now available as an option for financing urban infrastructure in India.

- **Fiscal and management reforms for bond issuance.** Since 1994, as the groundwork for bond issuance, AMC had instituted significant fiscal and management reforms, including improved tax collection, computerizing accounting system, strengthening AMC's work force and financial management. AMC especially launched a major effort to improve collections of octroi tax, a tax on various goods brought into town. Due to these measures, AMC's financial position has significantly improved with closing cash surplus of Rs. 2,142 million (USD 54 million) in March 1999.
- **Capital investment planning.** AMC prepared a capital investment plan of Rs. 5,973 million (USD 150 million) for 1996-97 to 2001/02, including Rs. 4,393 million (USD 110 million) for

21 Commercial banks include the Banco do Brasil, Banco Espírito Santo, Banco Votorantim, Bradesco, Citibank, Itaú, Santander and Unibanco.

a water supply and sewerage project. AMC proposed to meet 30 percent of the total investment by funding with internal accruals and the remaining 70 percent by mobilizing a municipal bond and loans from financial institutions. The financial viability of the investment was determined on the basis of the AMC's overall financial position rather than on the viability of the water and sewerage project.

- **Improved credit rating.** In 1996, AMC received an initial credit rating of "A+" for Ahmedabad's municipal bond issuance by CRISIL, an independent rating agency. Following this initial rating, AMC revised the financial structure of the bond offering and added several credit enhancement features by setting a escrow account of octroi taxes collected at ten collection centers and a sinking fund for principal repayment. AMC also pledged all octroi taxes and other income to bondholders in the event of revenues from the ten collection centers were insufficient to make debt service repayments, thus the issuance was in reality a general obligation bond. With these efforts to the bond financing structure, AMC received an improved rating of "AA".
- **Improving transaction documents.** In municipal bond transactions, the disclosure (prospectus) document and trustee indenture are the important financial documents. In the prospectus, in addition to a general overview of the economic, environmental and fiscal condition of the AMC, AMC has provided sufficient details of internal and external risks for investors, in accordance with international norms. However, in the trust indenture, a legal document between an issuer and a trustee acting on behalf of the bondholders, AMC lacked substantial information to fully inform circumstances of the bond offering and to properly secure the financial interest of the bondholders. In order to enhance investors' comfort, these information need to be included in the trust indenture.

## G. Sub-national Debt Management

Sub-national debt management has been commonly implemented in many countries, in order to effectively manage and promote sub-national borrowing. Approaches on sub-national debt management, especially on the amount of debt, are different in different countries. While some countries allow sub-national governments to have unlimited borrowing authority under relevant laws, others adopt rule-based control of sub-national borrowing by applying indicators for debt limits, such as debt service ratio and borrowing-to revenue ratio. The limit on sub-national borrowing is often set based on the repayment capacity of each municipality rather based on the ratio of local government borrowing to its capital investments.

### 14. Colombia

In Colombia, the central government required prior approval from Ministry of Finance for any sub-national borrowing until 1997. However, a new law, Law 358 was enacted for regulating sub-national debt due to the excessive use of credit by sub-national governments. Under the law, the Ministry of Finance analyzes two indicators of indebtedness before approving sub-national borrowing: (a) capacity to pay; measured by the ratio of interest payment to operating surplus; and (b) sustainability of debt; measured by the ratio of debt outstanding to current revenues. Based on the indicators, sub-national governments are controlled for borrowing. This is called traffic light system as show in the table below.

**Figure A2.8. Traffic light system for regulating sub-national borrowing**

| Rating | Indicator | Restrictions on Borrowing |
|---|---|---|
| Green | Interest as % of operationalsavings * <40% & debt stock as % of current revenues <80% | No restrictions |
| Yellow | Interest as % of operational savings 40 - 60% & debt stock as % of current revenues <80% | Lending only with Ministry of Finance authorization |
| Red | Interest as % of operational savings >60% & debt stock as % of current revenues >80% | No lending, unless agrees to adjustment plan |

* Operational savings are the surplus from the operating budget (i.e., what is left over after operating expenditures are subtracted from current revenues), carried over to the capital budget where it can service debt.

*Source:* Local Financing for Sub-sovereign Infrastructure in Developing Countries: Case Studies on Innovative Domestic Enhancement Entities and Techniques, World Bank, 2005.

### 15. Eastern European Coutries

Transition economies in Eastern Europe have restricted debt services to a percentage of budgeted revenues. For example, Poland holds annual debt service ratio to no more than 15 percent of budgeted revenues. Debt carried beyond the current year may not be greater than 60 percent of budgeted revenues. The limit on annual debt service fall into 12 percent when public debt hits 55 percent of GDP, and further borrowing is prohibited when the total hits 60 percent of GDP. Romania limits the annual debt service ratio of sub-national government to 20 percent of total current recurring revenues. Lithuania holds borrowing to 10 percent of current revenues.

**Table A2.3. Municipal debt limitations in selected Eastern European countries**

| Country | Debt service ratio limit | Borrowing-to-revenue ratio limit |
|---|---|---|
| Hungary | 70 percent of own current revenues (local taxes, fees, interest revenues, environmental fines).<br>Debt service includes potential liability under guarantee commitments. | None |
| Lithuania | 10 percent of total revenue, excluding earmarked grants. | Borrowing cannot exceed 10 percent of total revenue in approved budget (excluding earmarked grants); there is a sub-limit of 5 percent for short-term borrowing. |
| Poland | 15 percent of total revenue (debt service includes potential liability under guarantee commitments) | None |
| Romania | 20 percent of current revenues | None |

*Source:* Sub-national Capital Market in Developing Countries (2004).

### 16. ASIan Countries (The Philippines, India, South Korea)

In the Philippines, the Local Government Code of 1991 provides substantial borrowing power to local governments; however, there are some restrictions such as a limit on local governments'

borrowing capacity. The code stipulates the appropriation for debt service should not exceed 20 percent of their regular income. Local governments are allowed to access credit finance from bank credit and other similar forms of credit and also from bonds and other securities. Local governments can use credit financing for two purposes including liquidity and capital projects.

In India, among local governments, only municipal corporations (urban local bodies) are given borrowing powers under the Local Authorities Loans Act of 1914. However, municipal corporations must obtain prior approval of their state government to borrow. Municipal corporations are required to submit the detail of the loan such as the purpose of the loan, the amount of the loan, information about the loan security, the schedule for loan disbursement, loan terms, revenue receipts, and expenditure profile. The limits on borrowing are determined by annual ratable value (a measure of the value of a property), the value of municipal properties and assets, own revenues, and the general financial position of the municipal corporation.

In South Korea, sub-national borrowing are regulated under several laws; the Local Autonomy Act, the Local Financial Act and the Enforcement Decree of the Local Financial Act. The local borrowing is tightly controlled by the central government. The borrowing procedures involve multiple approvals by both local and central government agencies. The central government determines whether local governments can borrow by applying the following conditions under a set of regulations:

- the ratio of its average annual debt service in the past four years to its annual local revenue in the past four years does not exceed 20 percent;
- the ratio of its general fund balance (revenue minus expenditure) in the past fiscal year, minus its local fund balance carried forward to the next fiscal year, to its local revenue in the past fiscal year is greater than -10 percent; and
- its local tax revenue in the past fiscal year is more than 90 percent of that in the previous fiscal year.

**Table A2.4. Municipal debt limitations in select Asian countries**

| Country | limits on sub-national borrowing | Prior approval |
|---|---|---|
| The Philippines | Debt service should not exceed 20 percent of their regular income | None |
| India | The limit on debt borrowing are determined by annual ratable value (a measure of the value of a property), the value of municipal properties and assets, own revenues, and the general financial position of the municipal corporation | Prior approval from the state government of municipal corporations |
| South Korea | The ratio of its average annual debt service (principal and interest payments) in the past four years to its annual local revenue (local taxes, general shared taxes, current revenue, and grants) in the past four years does not exceed 20 percent<br>The ratio of its general fund balance (revenue minus expenditure) in the past fiscal year, minus its local fund balance carried forward to the next fiscal year, to its local revenue in the past fiscal year is greater than -10 percent<br>Its local tax revenue in the past fiscal year is more than 90 percent of that in the previous fiscal year | Multiple approvals by both local and central government agencies |

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# Appendix III – Diagnostic and Action Plan Report

## 1. Introduction

### 1.1. Background

1. In the previous phase, The World Bank (WB) and the MOF have set up a common team to develop the Study "*Assessment of the Financing Framework for Municipal Infrastructure in Vietnam*" where the key outputs include: (a) the Synthesis Report **("SR");** and (b) the International Experiences Assessment Report ("**IEAR"**), which provide an insight to the overall framework for infrastructure financing in Vietnam as well as some relevant international success stories in infrastructure financing with intention for possible applicability to Vietnam.
2. As a continuing element of the previous work of WB and MOF team, the Consulting Team of Vision and Associates has recently undertaken an in-depth analysis of the municipal finance system in three selected local governments, namely: Ho Chi Minh City, Quang Nam Province and Quang Ninh Province. That analysis is an important part of the Study to understand the current infrastructure financing practices in Vietnam in general and the municipal finance system in three selected local governments in particular. Such selected locations were jointly agreed to by MOF and WB and include one in the North East of the country (i.e., Quang Ninh province), one in the center (i.e., Quang Nam province) and one city in the South (i.e., HCMC), representing a wide cross section of locations, different sizes and different financial/ fiscal positions. The overall objective of the Study was to evaluate the existing constraints and opportunities for enhancing sub-national governments' capability to access financing for infrastructure development.
3. In conformity with the terms of reference (TOR), the Consultant Team did complete three Local Government Finance Assessment Reports ("the Assessment Reports"), separately and specifically for HCMC, Quang Ninh and Quang Nam province. As a next step, based on those three Assessment Reports and on the WB previous reports of SR and IEAR, the Consultant Team has formulated this Diagnostic and Action Plan Report.
4. This Report is prepared within the context that Vietnam prepares to meet the demand for increased investment while reducing its reliance on the state budget. There is an already recognized need to prepare for the transition away from concessional donor financing for urban infrastructure services. The necessary transition strategy presumably must involve diversification of financing sources focusing on increasing the role of the private sector as a source of finance for infrastructure and as a developer of infrastructure. The strategy must also recognize the increasing role of local governments and use of decentralization plans in promoting infrastructure investments.
5. The Vietnamese Government has indicated that there will be increased participation of the private sector in financing infrastructure in coordination with local governments to support decentralization to improve the efficiency of infrastructure investments. However at the same time it is recognized that the success of this new trend will rest critically upon continued improvements in the corporate governance environment at the local government level. Budget

resources, which currently are for the most part passed on as grants, will have to be used more strategically in the future and used only for investments with a high social rate of return for which full cost recovery is not feasible or for social equity. But even in these cases, budget resources should, to the extent possible, be used to leverage other sources of finance.

## 1.2. Objectives

6. This Diagnostic and Action Plan Report ***('the Report")*** is an integral part of the Study, which aims to provide specifically a road map of implementable actions for the Vietnamese Government as well as for the local government of the three selected provinces, to improve access to local financing and, as appropriate, bring in relevant international experience which can be implementable either under the existing legal framework of Vietnam or with some necessary regulatory changes thereof.

## 1.3. Report structure

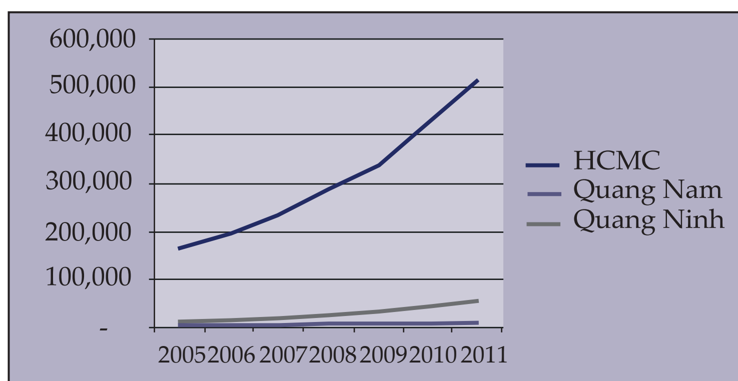
7. Driven by the TOR, this Report has been structured in seven sections, detailed as follows:
    - *Section 1* is an introduction part, providing background information to the Study as well as outlining the key objectives of the Diagnostic and Action Plan Report and its structure.
    - *Section 2* is designed to present*:* a brief description of the current state of municipal infrastructure; and summarize investment needs or plans in the coming period for municipal infrastructure development in three selected provinces as well as funding gaps as identified and assessed by the Consultant Team in the Assessment Reports.
    - *Section 3* is aimed at providing the recommendations of the Consultant Team for the improvement of the current legal and regulatory framework for municipal infrastructure finance and investment planning and appraisal.
    - *Section 4* presents the assessment and recommendation of the Consultant Team on the regulatory changes needed in order to implement the financing mechanisms identified by the joint MOF-WB team in their previous reports (i.e. SR and IEAR).
    - *Being a core part of the Report, Section 5* aims to present and analyze the need for sequencing of regulatory changes and other procedural considerations for the implementation of the recommendations as presented and assessed in Sections 3 and 4 hereof.
    - *Section 6* provides information on the capacity building/training required to implement the recommendations as presented and assessed in Sections 3 and 4 hereof; and
    - *Section 7* is the last but the most important part of the Report, which provides an Action Plan or road map of implementable actions for the central and local governments to improve access to local financing, with focus on the latter.

## 2. Brief description of the current state of municipal infrastructure and summary of municipal infrastructure investment plans in three provinces with assessment of the funding gaps

**Figure A3.15. The geographic locations of the selected provinces (Quang Ninh, Quang Nam and HCMC)**

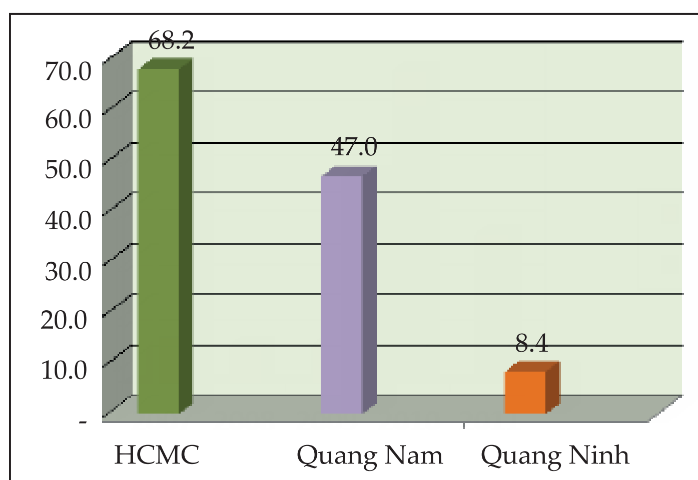
8. As men tioned above, the selected locations include one in the North East of the country (Quang Ninh province), one in the center (Quang Nam province) and one city in the South (HCMC), representing a wide cross section of locations, different sizes and different financial/fiscal positions (Figure A3.1).
9. HCMC, Quang Ninh province and Quang Nam province are also located in the Vietnam's Northern Key Economic Region, Central Key Economic Region and Southern Key Economic Region, respectively. While HCMC is an economic driver of the Southern Key Economic Zone and Quang Ninh is a strongly growing province in the north, Quang Nam is still amongst the poorest provinces in Vietnam.
10. The 2011 HCMC population is 7.52 million, while the population of Quang Ninh province and Quang Nam province are 1.16 million and 1.44 million, respectively.
11. In terms of economic size, in 2011 HCMC generated 20.2 percent of the national GDP, while Quang Ninh province and Quang Nam province generated 2.2 percent and 0.4 percent, respectively. The GDP of HCMC is much higher than that of Quang Ninh province and Quang Nam province (Figure A3.2).

**Figure A3.16. GDP of Quang Ninh, Quang Nam and HCMC (VND billion)**




*Source:* Statistical Yearbook of HCMC, Quang Nih and Quang Nam Provinces

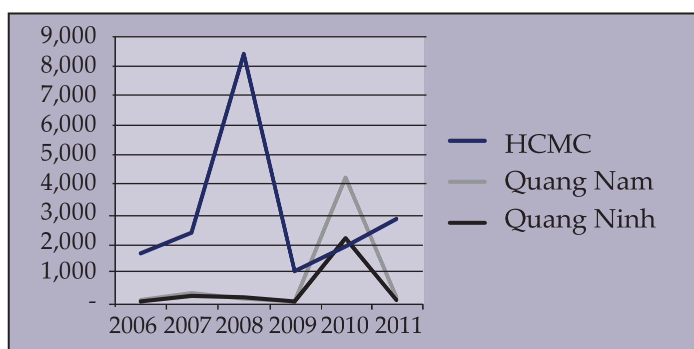
**Figure A3.17. GDP per capita of Quang Ninh, Quang Nam and HCMC (VND Million)**




*Source:* Statistical Yearbook of HCMC, Quang Ninh and Quang Nam Provinces

12. The 2011 GDP per capita also varies substantially between HCMC, Quang Ninh province and Quang Nam province. Amongst the three locations, the HCMC's 2011 GDP per capita ranks on top place (VND 68.2 million), with Quang Ninh's in second place (VND 47.0 million) and Quang Nam's in third place (VND 8.4 million) (Figure A3.3).
13. The 2011 licensed foreign direct investment (FDI) of HCMC reached USD 2.8 billion, while Quang Ninh and Quang Nam reached USD 51.8 million and USD 164.8 million, respectively –far below the level for HCMC. There is a large variation of FDI between years in all three provinces over the period 2006-2011 (Figure A3.4).

**Figure A3.18. Licensed FDI in Quang Ninh, Quang Nam and HCMC (USD Million)**




*Source:* Statistical Yearbook of HCMC, Quang Ninh and Quang Nam Provinces

14. Being the largest municipality in Vietnam, HCMC is one of the few municipalities in Vietnam where market factors are available for the land/housing market, which is a key success factor for the "land-for-infrastructure" mechanisms. Such market factors are less readily (or not at all) available in Quang Ninh and Quang Nam provinces. At the same time, the recent downturn in the real estate market seems to negatively impact such mechanisms -- and this problem exists in all provinces including HCMC. As a result, there will be fewer opportunities for the land-based financing projects with private participation especially in the municipal infrastructure sectors.
15. In terms of the fiscal position, HCMC and Quang Ninh province are the net fiscal contributors while Quang Nam province is a net fiscal recipient.
16. This report has been made in conjunction with the three local government assessment reports (i.e., Local Government Finance Assessment Report of HCMC, Local Government Finance Assessment Report of Quang Ninh province and Government Finance Assessment Report of Quang Nam province). For this purpose, the Consultant has carried out extensive consultations with different central line ministries such as MOF and MPI, as well as undertaken a number of visits to the local governments of three provinces and all their concerned line departments for consultations/data collections.
17. The above three local government assessment reports were prepared such that after drafting, the Consultant has sent the draft reports to the respective local governments for the purpose of data reconciliation and additional comments by the local governments and then the reports have been updated, refined and finalized by the Consultant. Such arrangements would ensure the accuracy of information/data provided and achieve the local government's concurrence for key findings and conclusions in such reports.
18. It is, however, noted that there might have been some data constraints due to: (a) some required information on the municipal infrastructure of three provinces was either unavailable from the existing record system or not publicly disclosed; (b) some information/data gathered from different sources seemed to be inconsistent with each other; and (c) some data/information gathered by desk study was unverifiable.
19. Below are the brief description of the state of current municipal infrastructure and the summaries of the financing plans in the coming periods for municipal infrastructure development in each of the three selected provinces and the funding gaps as identified and assessed by the Consultant Team in the three Assessment Reports. *For more specific data/information and details which could*

*justify the rationale of the information and the view of the Consultant Team as cited or presented under each sub-section of this Section 2, please refer to the respective three Assessment Reports.*

## 2.1. HCMC

20. Established in 1623, HCMC is considered a young city but the city development has been bound up with many historic milestones of the country. At the moment, HCMC is the largest municipality and also the biggest economic hub of Vietnam.
21. Located in the South and with the fast growing population of 7.52 million, HCMC is facing hard pressure for municipal infrastructure developments such as transport, water supply, drainage and wastewater treatment, solid waste disposal, housing, schools and medical services etc. It is clear that the further growth of HCMC depends largely on its successful municipal infrastructure development.
22. The common transport congestion becomes a more serious problem in HCMC with a fast increase in the number of vehicles, at 1,300 motorbikes and 500 automobiles newly registered per day. With the increasing middle income class and driven by the WTO commitments, where the car import tax from the WTO members and ASEAN countries is to be removed by 2018, it is anticipated that the number of automobiles in Vietnam in general and in HCMC in particular will rise thereafter. This is a big challenge for the HCMC transport sector; in order to respond to that, as a key sensible solution (amongst others), HCMC plans to develop a mass rapid transit (MRT) system with a hope to increase its public transport capacity in the near future. Some starting works for this system are underway.
23. With the consistent and high economic growth achieved during the last two decades, the HCMC population has experienced a high growth due to the migration from rural areas to HCMC. The official statistics show that the HCMC population has increased from 4.7 million by 1995 to 7.2 million by 2011. The HCMC real population may be higher, as some additional 2 million people living in HCMC are not registered with the local authorities.
24. In terms of terrain, HCMC is located on a low level area with more than 50 percent of the land lying just 2m above the sea surface; the eastern and south-eastern parts are the lowest areas, and are susceptible to potential inundation. The low sea level of land in HCMC also means less effective drainage for both wastewater and storm water and a threat of flooding becomes more apparent in HCMC. It is known that during the recent times the residents in the outskirts of HCMC have become well familiarized with tidal flooding.

### 2.1.1. Transport Sector

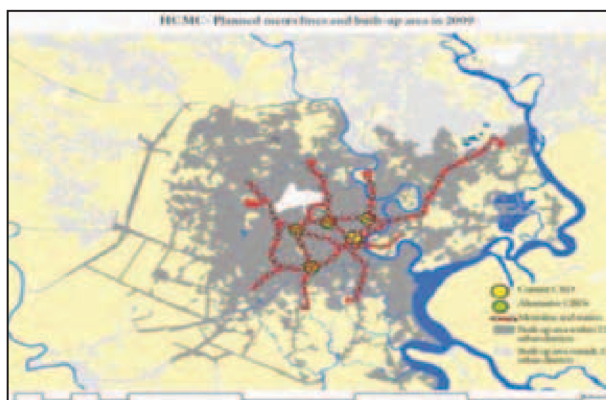
#### *a. Brief description of the current state of the transport sector*

25. The total area of road surface in the current municipal road traffic system of HCMC is approximately 26 million $m^2$ and most of the routes in HCMC are narrow: only 14 percent are wider than 12m where buses can run; 51 percent are 7-12m wide, which is only suitable for small cars; 35 percent are less than 7m wide, which is suitable for two-wheel vehicles. The total current land area for traffic in HCMC is 17.01$km^2$, accounting for 1.29 percent of natural land, compared to the range in developed countries of 18.5-25 percent. The rate of road area density over land area of the city is 1.2 percent, which is much lower than the standard rate of a large-scale city (at 15 Percent).

26. In the five-year period 2006-2010, there was intensive investment in the road system in the city with construction of some important radial roads and large bridges on such roads -- including repaired, upgraded and widened bridges and roads totaling 523.5km of length; the increased area of bridges was 4,204,800m$^2$ supplied by 84 additional bridges.

27. The master transport system planning for HCMC has the following key features:
    - In accordance with "*the Planning on Transportation Development in Ho Chi Minh City to 2020 and Vision after 2020*" approved by the Prime Minister under Decision No. 101/QD-TTg dated 22 January 2007 (referred to as "Planning 101"), the multimodal transport network is still in the planning stage. This includes Urban Mass Rail Transit (UMRT), Light Rail Transit (LRT) and monorail. Planning for such railways is expected to alleviate growing traffic jams and accidents resulting from over rapid development of HCMC, while at the same time promoting the development of areas along railways to achieve the goal of modernization as stated in Planning 101.
    - The planned transit system of HCMC shows that it has a length of 110 km, and will serve only part of the metropolitan area. While feeder buses could extend the catchment areas of the planned stations, trips involving several transfers are unlikely to be competitive with motorcycle trips, especially if many job and commercial areas are located out of walking distance from stations (Figure A3.5).

**Figure A3.5. Planned HCMC transit system**



*Source:* World Bank Vietnam Urbanization Review

    - In the master plan on the municipal railway system, seven UMRT routes, one LRT route and two monorail routes are expected to be completed in 2025. Among the seven UMRT routes, Route No.1 (Ben Thanh – Suoi Tien) and Route No.2 (Tay Ninh coach station – Thu Thiem) are under construction. According to the master plan, all UMRT routes have underground sections (i.e., metro) in the inner city and aerial sections in the outer city.

28. The system of rivers and canals in Ho Chi Minh City is dense with a length of around 8,000 km and water surface area accounting for 16 percent of the area of the city, where many river routes, such as canals of Te, Tau Hu, Tan Hoa – Lo Gom are convenient for the development of waterway transport and tourism.

29. Currently, in terms of the system of ports and inland river ports, there are about 320 ports and wharves, and four big ports being Sai Gon, Tan Cang, Ben Nghe and Nha Be. Sai Gon port is one of the biggest ports in the country regarding goods storing capacity. There are 50 piers

of all sizes qualified for the development of passenger transport services. Rivers in the city also allow ships and boats over 20 tons to travel easily, which is a huge advantage compared to other provinces in the Mekong Delta.

***b. Summarized investment plan***

30. According to Decision No.25/2011/QD-UBND[22] there are a total of 103 urban transportation works to be implemented in the coming years, with total investment capital of VND 324,869 billion and estimated needs for capital in the period 2011 – 2015 of VND 216,379 billion. Among 103 projects, there are: (a) six beltway projects; (b) 16 projects on outward traffic arterial roads; (c) 29 inner city/regional transportation projects; (d) eight urban railway projects; (e) two projects on express highway; (f) four parking lot projects; and (g) 34 bridge projects.
31. As far as the financing sources for implementation of the projects above projected, according to such Decision No.25/2011/QD-UBND: (a) 62 projects (beltways, roads, bridges) totalling VND 17,329 billion will be financed by the HCMC budget during the 2011-2015 period -- and in the view of the Consultant on HCMC, such a plan is workable; (b) eight projects (metro lines, beltways) totaling VND 56,387 billion are expected to be financed by ODA funds and of which only 55.6 percent (or VND 31,387 billion) might be likely mobilized; and (c) 31 projects (beltways, roads, urban railways, bridges) totaling VND 127,763 billion are expected to be financed by way of BOT/BT, however, no financing interests and commitments are readily available.
32. The current planning practices in HCMC for the infrastructure sectors in general, and in the transport sector in particular, show that fragmentary planning is a key issue causing the difficulties in generating revenues for the municipal infrastructure projects in their post-investment phases. Ideally, infrastructure planning should take into consideration both the infrastructure project and the potential benefits drawn from this project at later stages. For example, when developing a project for a new road, the road planning should have a broader view as to estimate also the increased values of surrounding land lots which have access to such road as the increased land values are important financing sources for the later road upgrading/expansion phases.

### 2.1.2. Water Supply Sector

***a. Brief description of the current state***

33. First built by the French in 1879, the city's pipe network has expanded over time to its current length of 3,350 km, of which 700 km has been used for over 30 years and is in need of repair thus being a main cause for the high water loss rate. Many contaminated water reservoirs have been used for many years without regular maintenance, while lack of public awareness also contributes substantially to the loss of 38.4 percent of total water supply.[23]
34. In the period 2006 – 2010, HCMC did accomplish some goals including: installing new pipes with total length of 955.63 km (i.e., double the expected target of 450km); and repairing and replacing rotten pipes with total length of 196km (i.e., equivalent to 130 percent of the target of 150km). Also during this period, many large-scale projects have been completed, increasing the volume of supplied clean water to the city, such as through the Tan Hiep Water Plant project, with capacity of 300,000 $m^3$/day and the Thu Duc Water Plant project, under BOO form,

22 Decision No.25/2011/QD-UBND dated 14 May 2011 of the PC of HCMC on promulgation of the plan to implement the 9th Congress of HCMC Party Committee's Resolution on Scheme to Reduce Traffic Jams during 2011 – 2015 with vision to 2020.

23 According to a report of the Saigon Water Corporation (SAWACO).

having capacity of 300,000 m$^3$/day. According to the HCMC Master Plan on Water Supply to 2015,[24] by the end of 2010, the city's water supply system includes seven water plants with the combined total capacity of 2.14 million cubic meters per day (m$^3$/day).

35. Some key resistance factors for developing the urban water supply sector of HCMC include: (a) the high rate of piped water loss (38.4 percent), which results in decreased water business margin for operators/potential investors; and (b) a substantial part of such loss rate (29 percent) is being factored into water tariffs and passed on to water consumers, which impedes new initiatives to reduce such loss rates.
36. The HCMC water tariffs are regulated by the HCMC People's Committee and adjusted every year in line with the approved roadmap, which varies for each type of water user. For instance, the HCMC current piped water tariffs[25] are: (a) households: VND 5,300 – VND 11,400/m$^3$; production activities: VND 9,600/m$^3$; Government offices: VND 10,300/m$^3$; and trading and service sector: VND 16,900/m$^3$ (all VAT exclusive). As a result of the increased water tariffs, the profit and loss accounts of some water companies in HCMC may show some profit for the recent years. However, it is believed that the overall business results of water businesses could have been distorted due to the fact that the assets of water plants are commonly underestimated due to some limitations of the accounting practices in Vietnam. For example the value of assets are based on the original price;[26] however, the land-use right value is much lower than market value and the inflation factor has not been well factored into assets value, which would make the company asset value lower than it might actually be. Therefore, the sector would well cover O&M but not provide full cost recovery which would affect the sustainability of the water supply service in the long run. This is consistent with the Ministry of Construction's opinion that, on average, the tariffs approved by Provincial People's Committees reach only 60-70 percent of the level that would be required to cover capital and operating costs and to service debt obligations.

***b. Summarized investment plan***

37. As identified by the HCMC Water Supply Master Plan to 2025, during the period 2010-2015: (a) two new water plants with the total capacities of 600,000 m$^3$/day will be constructed; and (b) some projects on development of pipes network will be implemented. The Master Plan has also indicated: (a) the estimated investment costs for construction of Thu Duc III Water plant, Tan Hiep Water Plan Phase II, and water distribution pipes network, amount to about VND 15,000 billion; and (ii) funding sources include State budget, ODA, foreign donor funds, investment credit and capital from domestic and foreign investors. Nevertheless, detailed information on the proportions of those capital sources as well as capital for each projects are not covered in the Plan.
38. As assessed by the Consultant Team, the mobilization of VND 15,000 billion for HCMC in the 2011-2015 period (equivalent to VND 3,000 billion mobilized per year on average) is not workable taking into account the following factors:
    - The average investment and development expenditure of the city on the water sector in the past three years (2010-2012) has only been VND 347 billion/year.[27] In other words, the city's budget could only accommodate about 10 percent of the city's annual capital needs;

24 Issued together with Decision 729/QĐ-TTg of the Prime Minister dated 19/6/2012

25 Based on Decision No.103/2009/QD-UBND dated 24/12/2009 by HCMC PC on water tariffs for the 2010-2013 period.

26 Article 7.1, Accounting Law 2003 requires that the asset's value shall be based on its original price.

27 Source: Consultant's calculation from information provided by HCMC Department of Finance.

- Funds committed by donors (e.g., ADB) are still limited (nearly VND 3,000 billion); and
- ODA funding for Thu Duc Water Plant Phase III, which is only about VND 3,000 billion, is still under the process of approval.

39. Thus, during 2011-2015, a maximum amount of VND 8,000 billion may be mobilized by the HCMC from State budget and ODA sources. Then, the city has to mobilize another amount of VND 7,000 billion from other sources including investors, investment credits, commercial lending, etc. -- which could hardly be achieved.

**2.1.3. Drainage and wastewater treatment sector**

***a. Brief description of the current state***

40. The HCMC drainage system is a "half-separate" system, combining drainage and sewerage system for all domestic wastewater, industrial wastewater and rain water, which become separate in case of heavy rains. There are about 1,200 canals within the city area which are affected by the irregular semi-diurnal tide pattern of the East Sea, causing difficulties for drainage of the whole sewer-canal-river network. Due to sediment deposition at the bottom of the canals, the natural drainage capacity of this network is limited to about 50 – 60 percent.
41. The underground drain pipe network was laid out in the year 1890, then partially improved during the late 1960s for collection of both wastewater and rainwater and continued to be improved unsystematically up to now with uneven distribution over the city area, largely concentrating at the central districts. The network is now under new construction. As for new areas such as Districts 2, 9 and 12, the sewer network is still limited. In many residential areas at outlying districts and even downtown, there have been no sewers installed yet. Wastewater is discharged directly into the ground, freely spreads out and then is absorbed into the ground, contaminating the environment. According to statistics of the Planning Institute, 100 percent of central districts (e.g., Districts 1,3 and 5) have drainage systems while in the new districts the rates of drainage coverage is rather low, especially for Binh Chanh with the rate of 0.3 percent. The combined area of land served with the drainage system, accounts for about 12 percent of the total city area.
42. The total length of the city's sewer network is about 931 km, including nearly 200 sewer outlets, for the total area of 650 $km^2$ that needs drainage service (comprising of 140 $km^2$ of downtown area and 510 $km^2$ of outside area). The average density of the network is 0.142 m/hectare. In general, sewers are of poor quality due to age and often get clogged except for pipes which are newly built.
43. Total number of sewer holes for the whole sewer network is 65,106. Currently, performance of these holes only reaches 70–80 percent of capacity. Flooding is the most serious problem regarding urban drainage that the city experiences.
44. Flooding in HCMC has been an issue with urbanization planning and development since the early 2000s. Situated in the lower section of the two rivers Sai Gon and Dong Nai, more than half of HCMC is low land and a complex network of rivers and canals lacks a full drainage system. Therefore, many districts of the city are susceptible to flooding induced by tidal fluctuation or inundation from big rivers or a combination of heavy rainfall, inundation and high tide.
45. Currently, as reported 500,000 $m^3$/day of industrial wastewater and some more than 2 million $m^3$ of municipal wastewater are discharged in the HCMC area. There are three operating water treatment plants in HCMC, which are: (a) Tan Quy Dong Plant with capacity of 500 $m^3$/day; (b) Binh Hung Hoa Plant with average capacity of 26,500 $m^3$/day; and (iii) Binh Hung Plant

with capacity of 144,000 $m^3$/day (510,000 m3/day in phase II). The total wastewater volume treated, by all of these plants taken together, is about 180,000 $m^3$/day; this accounts for less than one-tenth of total wastewater discharged every day.

46. In terms of wastewater treatment tariffs, HCMC charges the environment protection fees for municipal wastewater at 10 percent on the invoiced tapwater (VAT exclusive) based on Decision No. 88 /2010/QĐ-UBND dated 24/12/2010 by HCMC PC. From 1/7/2013, with Decree No.25/2013/ND-CP, the environment protection fees for industrial wastewater treatment increased to 10 times higher than the previous tariffs regulated by Decree 67/2003/ND-CP. However, up to now, as reported, the performance of the wastewater fee collection in HCMC is poor as HCMC achieved only some 20-30 percent of the annual targets.[28] It is believed that there is still a long way for HMCM to go to achieve full cost recovery in this sector.

***b. Summarized investment plan***

47. With regard to the investment plan (with the projected financing sources being HCMC's state budget and borrowing) for implementing the Resolution by the City Party in the 9th session on Flooding Reduction Program for the period of 2011-2015, the PC of HCMC issued Decision No 26/2011/QĐ-UBND dated 14/05/2011, with specific objectives during the period of 2011-2015 to: (a) nearly resolve the flooding situation from rain and flood tide in the center of the city; and (b) strive to reduce by 70 percent the rainfall flooded areas, and by 50 percent the flooding points from tides of five remaining drainage areas. In order to achieve those objectives above, HCMC is and will continue to implement during the period of 2010-2015: (a) 159 water drainage system maintenance and improvement projects; (b) eight waste water collection and treatment system projects; and (c) 16 flood tide control projects; the total investment capital needs amount to around VND 77,305 billion. Table A3.1 below shows this amount broken down by the annual capital requirements for various project classification categories:

**Table A3.1. Summary of annual capital requirement during the period of 2011-2015 for water drainage, flood prevention and wastewater treatment projects**

| No | Project Classification | No of projects | Total Investment | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| A | Water drainage system maintenance improvement | 159 | 9,523 | 368 | 1,134 | 1,518 | 2,527 | 3,977 |
| B | Water collection system and waste water treatment plant | 8 | 52,717 | 9,258 | 10,523 | 10,862 | 10,063 | 6,050 |
| B.1 | Borrowing loans | 5 | 27,615 | 5,068 | 5,523 | 5,862 | 5,063 | 1,570 |
| B.2 | State budget | 3 | 25,102 | 4,190 | 5,000 | 5,000 | 5,000 | 4,480 |
| C | Flood tide control projects | 16[1] | 15,065 | 3,312 | 3,007 | 2,896 | 2,900 | 4,320 |
| | **Total (A+B+C)** | **191[2]** | **77,305** | **12,937** | **14,664** | **15,275** | **15,490** | **14,347** |

*Source:* Decision No 26/2011/QĐ-UBND dated 14/05/2011.

*Notes*: 1. This figure corrected by the Consultant Team due to error in Decision 26/2011 dated 14/05/2011.

2. This figure corrected by the Consultant Team due to error in Decision 26/2011 dated 14/05/2011.

28 http://www.vcci.com.vn/phap-luat/20130512065142959/nghi-dinh-252013ndcp-go-vuong-ve-thu-phi-nuoc-thai.htm

48. Upon evaluating the feasibility of financial plans to implement projects listed in Decision 26/2011/QĐ-UBND mentioned above, the view of the Consultant Team is that is a financing plan which is very close to the total financial resources of HCMC for such activity, of which the main source is State budget (city budget and central budget) and borrowing loans (signed or committed). Therefore, HCMC would likely be capable of mobilizing enough capital to implement the Flood Reduction Program in line with the planned timetable (or be a little behind schedule).
49. In addition to flood prevention and wastewater treatment projects using state budget and city borrowing loans as decided in Decision No.26/2011/QD-UBND and mentioned above, HCMC also issued a list of 14 BOT, BT and combination (BOT and BT) projects in order to mobilize capital of around VND 53,673 billion from private businesses, reducing the burden on the state budget. Upon consideration of the feasibility of executing financial plans to implement these projects, the Consultant Team is of the view that: (a) projects in the form of BOT will be highly feasible and attractive to investors only if HCMC can support compensation/land clearance and assist the investors in arranging favorable lending sources; (b) projects in the form of BT will face many difficulties in implementation and selection of investors because HCMC can neither arrange sufficient budget for in-cash payment method nor have 'clear-land' stock if bidding for construction of works and auction of land use rights in line with regulations are applied; and (c) projects in the form of combining BOT and BT also require the same conditions as BOT projects and face difficulties similar to those of BT projects as mentioned above.

### 2.1.4. Solid Waste Management Sector

#### *a. Brief description of the current state*

50. *Regarding the municipal solid waste*, with more than 9 million people living and working in HCMC, the figure for total municipal solid waste disposed is 7,500 – 8,000 ton/day, calculated based on the solid waste disposal standard (kg/person/day) of the MoC, of which the solid waste to be collected and transported to the landfill is about 6,500-6,700 ton/day, and the rest is sold for recycling. Only a small portion, which is mostly organic waste, is dumped directly to the field in the suburban areas. The annual waste volume growth rate is estimated at 7–8 percent.
51. *With regard to the industrial solid waste and hazardous industrial waste*, there are more than 12,000 active industrial establishments located inside and outside of 11 industrial zones, three processing zones, one hi-tech park and 30 industrial clusters in the city area. Their operation in combination with medical services, commercial and other services has generated a significant amount of 1,500-2,000 tons of industrial solid waste per day and 250-350 tons of hazardous waste per day. The main hazardous waste treatment technology is focusing on burning, solidification and specialized recycling such as recycling of paint, solvent and oil but only on a small scale. Of all current treatment technologies -- such as burning, oil recycling, barrel back flushing, lacquer solvent recycling and solidification -- the most common are burning (which could not process hazardous waste which contains PCBs) and solidification (for such types of waste which could not be processed). The result is that a large volume of hazardous slag and ash is still remaining in the treatment plant. At the moment, there is no secure landfill for industrial hazardous waste for the city and hazardous waste treatment plants still store a large volume of solidified waste with hazardous compositions.
52. *With regard to medical solid waste*, in the period 2000–2010, the collected and disposed volume of medical solid waste (contagious) from the medical establishments (mostly from public hospitals)

has increased from 4.6 ton/day (2000) to 12.86 ton/day (2009) and most of these facilities have contracts for transportation and treatment. In 2010, the collected and disposed volume was 11.54 ton/day. In general, medical waste of the public sector is well-separated at the source (100 percent) as required by the regulations of the health sector. However, waste separation at the source in the private sector is still limited, especially in small private medical establishments. On estimation, only 50-70 percent of the private sector establishment has techniques for separating waste at the source, but even then still incompletely; the rest (30-50 percent) have no separation of waste at the source. In spite of the investment policy, medical solid waste treatment in HCMC is still undertaken by the local government, as this does not attract private investors. At the moment, there are two medical solid waste treatment plants – Binh Hung Hoa and Dong Thanh -- and the former is currently overloaded and will be closed in 2015. Thus, after 2015, waste treatment will face many difficulties if the City does not invest in a new treatment plant.

53. In terms of cost recovery of the solid waste sector, in 2012 the HCMC budget paid VND 1,500 billion for solid waste collection and treatment while receiving total fees of VND 170 billion. It is noted that the current average fees on municipal waste collection and treatment per household in HCMC is VND 20,000/month, which is much lower than the costs of the service. In the next five years, HCMC is going to increase such fees to ensure the full cost recovery in this sector.[29]

***b. Summarized investment plan***

54. In order to achieve the environment protection objectives of the SEDP 2011-2015 Decision No. 43/2012/QĐ-UBND dated 03/08/2012 of the PC of HCMC, the Department of Natural Resources and Environment (DoNRE) of HCMC has already signed contracts with investors to implement the three following projects during the period 2011-2015: (a) municipal solid waste treatment and recycling project (compost and organic fertilizer production) with capacity of 1,000 MT/ day; (b) municipal solid waste treatment and recycling project (compost and organic fertilizer production) with capacity of 500 MT/ day; and (c) landfill construction project No.3 with area of 20 hectares, employing sanitary burial technology and safe solid hazardous and non-hazardous industrial wastes burial technology, with capacity of 2,000 MT/ day.

55. Upon consideration the feasibility of executing financial plans to implement these projects, the Consultant Team is of the view that, excluding the first three projects, which are highly feasible as sources of capitals were defined and contracts signed with investors, it is not likely to mobilize an amount of VND 36,514 billion for the remaining projects during the period of 2011-2015.

### 2.1.5. Social Housing Sector

***a. Brief description of the current state***

56. With the policy of socializing the construction of the social houses for workers, HCMC has basically met the housing needs of the workers. As of the end of 2012, the total constructed floor area is 1,460,530 $m^2$, supplying 457,000 residences for workers, of which, the State and enterprises have invested about 203,535$m^2$ equivalent to 14 percent and about 36,600 shelters, while the remaining is constructed by the private sector (86 percent).

***b. Summarized investment plan***

57. In line with the action collaboration plan for implementing the housing development strategy to 2020 and vision to 2030 signed between the MoC and PC of HCMC on 20 October 2012,

29 Saigon Times Online (http://www.thesaigontimes.vn/Home/dothi/hatang/96101/).

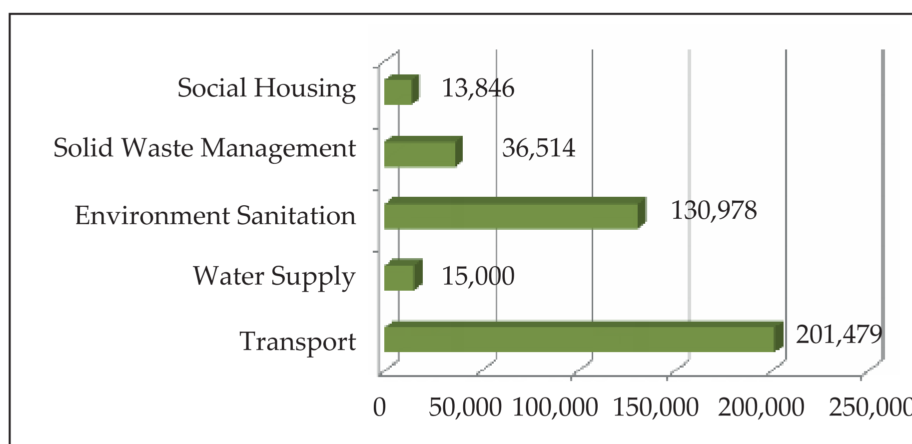
in the period of 2012-2015 HCMC is striving to construct at least 2,700,000 $m^2$ of floor area of social housing (i.e., at an average of 675,000 $m^2$ *per annum*).

58. In line with Decision No.758/QD-TTg dated 8th June 2009 of the Prime Minister, approving the National Municipality Upgrading Programme for the period 2009-2020, the PC of HCMC has assigned the Department of Construction (DoC) to implement the Municipal Upgrading Programme in the period 2013-2020, according to which the HCMC will need to have total investment capital of around VND 13,846 billion (i.e., equivalent to USD 665 million). The expected funding sources include: (a) 40 percent (i.e., around VND 5,538.4 billion) from the local state budget; (b) 46 percent (i.e., VND 6,369.16 billion or USD 305.9 million) from ODAs; and (c) 14 percent (i.e., around VND 19,938.44 billion) from the central budget and investors from different economic sectors.

59. To assess the feasibility of finance source mobilization for implementation of the municipality upgrading and social housing development program above, the Consultant Team is of the view that: (a) the mobilization of VND 5,538.4 billion from the local state budget and Private Sector for the resettlement housing fund could be possibly made provided that the local government of HCMC will apply policies to give preferential treatment to building of the resettlement housing fund and social housing, in line with the decree on development of social housing, which is currently drafted under the leading role of the Ministry of Construction and will be issued in the coming time; (b) it would be difficult to mobilize USD 305.9 million from ODA sources in the coming period as the ODA sources become limited and the HCMC authority has not yet received any commitment from the international donors to finance those projects; and (c) no basis is seen for successful mobilization of VND 1,938.44 billion (or 14 percent of the total financing need), from the central budget and the investors in the different economic sectors.

### 2.1.6. Capital Needs, Effective Financing Demand and the Funding Gaps

**Figure A3.6: HCMC capital needs by sector for the 2011-2015 period (VND billion)**




*Source:* Consultant estimate based on approved investment plans

60. Based on the above analysis (sections 2.1.1 to 2.1.5), the capital needs of the HCMC urban infrastructure sectors for the period 2011-2015 are illustrated in Figure A3.6. It is seen that the capital needs for the transport sector and the environment sanitation sector are much higher than other sectors.

61. The Consultant Team is of the view that the estimation of the funding gap should be based on the "effective financing demand," which would more accurately reflect the real capital needs of the local authorities.

62. A typical public investment management (PIM) cycle involves eight stages;[30] however, it is seen that four initial stages (namely: strategic guidance and screening, formal project appraisal, appraisal review, and project selection and budgeting) are often inadequately carried out at both the local and central levels due to: (a) the common "application-grant" practices in project approval chain; (b) the limitations in local socio-economic development planning process; and (c) the political reasons driven by the election term mindset. Thus, it is reasonable to assume that the effective financing demand for HCMC infrastructure sectors would be less than the projected levels. While the accurate effective financing demand of the HCMC municipal infrastructure sectors is not available, the Consultant Team would, based on the outcome of the discussions with various experts of local line departments, estimate the "effective rate" (which is defined as a ratio between the effective financing demand and the capital needs) for different infrastructure sectors and financing sources, and calculate the funding gaps of HCMC's municipal infrastructure sectors over the period 2011-2015 as detailed in Table A3.2 below.

63. It is anticipated that the above effective financing demand would be more realistic if some new approaches and initiatives in infrastructure financing (e.g., MDF, recourse mechanisms, etc.) are introduced.

**Table A3.2. The current level of investment, effective financing demand, available sources and funding gaps of HCMC's municipal infrastructure sectors over the period 2011-2015**

Unit: VND billion

| | Infrastructure Sector | Current Level of Investment[1] | Financing Needs | Effective rate(%) | Effective Financing Demand | Financing sources arrangeable/ likely available | Funding Gaps |
|---|---|---|---|---|---|---|---|
| A | B | C | D | E | F=DxE | G | H = F-G |
| 1. | **Transport, financed by:** | **16,870** | **201,479** | 84.4 | *170,054* | **46,983** | **123,071** |
| | + Local budget | | *17,329* | 90 | *15,596* | *Local budget: 15,596* | *Nil* |
| | + ODAs | | *56,387* | 70 | *39,471* | *ODAs: 31,387* | *8,084* |
| | + BT, BOT etc. | | *127,763* | 90 | *114,987* | *Amount not yet identified* | *114,987* |
| **2.** | **Water supply** | **5,243** | **15,000** | **80** | **12,000** | **Mixed Sources: 8,000** | **4,000** |

30 Including: (a) strategic guidance and screening, (b) formal project appraisal, (c) appraisal review, (d) project selection and budgeting, (e) implementation, (f) project changes, (g) service delivery, and (h) project evaluation, which is defined in the "Vietnam Development Report 2012".

| | Infrastructure Sector | Current Level of Investment[1] | Financing Needs | Effective rate(%) | Effective Financing Demand | Financing sources arrangeable/ likely available | Funding Gaps |
|---|---|---|---|---|---|---|---|
| **3.** | **Environment sanitation, financed by:** | | **130,978** | 72.1 | **94,481** | **56,016** | 24,153 |
| | • *State Budget and borrowings:* | **335** | | | | | |
| | – *Waste drainage system and maintenance improvement.* | | *9,523* | 90 | *8,571* | Local budget and borrowings: 8,571 | *Nil* |
| | – *Water collection system and waste water treatment plan* | | *52,717* | 90 | *47,445* | Local budget and borrowings: 47,445 | *Nil* |
| | – *Flood tide control* | | | | | | |
| | • *BT, BOT* | | *15,065* | 95 | *14,312* | Local budget and borrowings:14,312 | *Nil* |
| | | | 53,673 | 45 | *24,153* | Amount not yet identified | *24,153* |
| 4. | Solid waste management | | 3 identified projects + | | | Amount not available | Nil |
| | | | **36,514** | 80 | **29,211** | Nil | **29,211** |
| **5.** | **Social housing** | **1,153** | **13,846** | 66.7 | **9,235** | **4,985** | **4,251** |
| | • *Local budget & Socialization* | | *5,538.4* | 90 | 4,985 | *Local budget & Socialization: 5,538.4* | *Nil* |
| | • *ODA* | | *6,369.2* | 50 | 3,185 | *Not yet identified* | *3,185* |
| | • *Central budget* | | *1,938.4* | 55 | 1,066 | *Not yet identified* | *1,066* |
| | **TOTAL** | **23,601** | **397,817** | | **314,981**<br>**100%** | **130,295**<br>**41.4%** | **184,685**<br>**58.6%** |

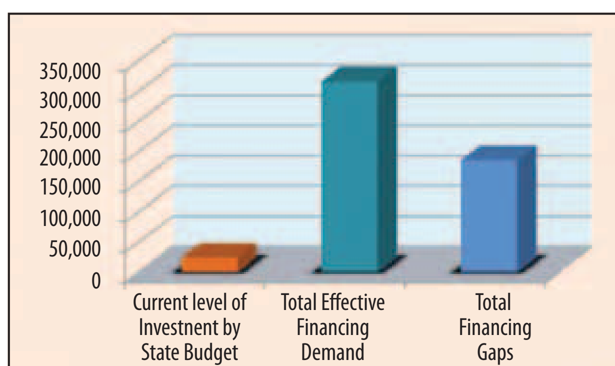
*Source:* Local Government Finance Assessment Report of Ho Chi Minh City and the Consultant's estimations.

*Notes:* 1. Financed by State Budget over the period of 2010- 2012.

64. The figures in Table A3.2 provide a relative comparison between the current investment, the total effective financing demand, and the total financing gaps of the HCMC municipal infrastructure

sector. It is seen that the HCMC total effective financing demand and the total financing gaps over the next period are much higher than its current level of investment by State Budget (Figure A3.7).

**Figure A3.7. HCMC current level of investment, effective financing demand, and financing gap**




*Source*: Consultant estimate based on approved investment plans

65. While the projected financing needs of the key municipal infrastructure sectors of HCMC for the period 2011-2015 would reach VND 397,817 billion (exclusive of the unknown amount for three solid waste treatment projects), the effective financing demand of such sectors is VND 314,981billion. As the funding sources that could be arranged (or are likely available) are limited to VND 130,295 billion (i.e., 41.4 percent of the effective financing demand). Therefore, HCMC is likely facing a capital shortfall of VND 184,685 billion (i.e., 58.6 percent of the effective financing demand) over the period 2011-2015, which needs to be met by other financing sources. Most of the funding gap is in the transport, environment sanitation and solid waste treatment sectors.
66. The in-depth study in HCMC also revealed that the HCMC government has been well aware of these funding gaps and it has proposed to raise funds from other financing sources, for instance, the private financing sources though BT/BOT/PPP and/or the land for infrastructure mechanisms. However it is a challenge for HCMC to achieve this as the success factors of such type of investment depend greatly on having sufficient clean "land-funds" in place as well as having available substantial funds for land clearance and compensation. Also required are the resources to meet resettlement costs; these are scarce resources for HCMC, even though HCMC is the most developed urban area in the country.

## 2.2. Quang Ninh province

67. Located along the northeastern coast of Vietnam, Quang Ninh is a mountainous and coastal province with more than 80 percent of its area being made up of mountains and hills. Quang Ninh province borders the People's Republic of China in the north, and the East Sea on the east with a costal line of 250km. With the total area of 6,102.4 km$^2$ and more than 2,000 islands including the Ha Long Bay, a World Heritage Site, Quang Ninh is considered of strategic importance for both defense and economic development purposes.
68. Quang Ninh has an important role in the pivotal economic region in the North of Vietnam and is also an important part of the economic development triangle in the North (Hanoi - Haiphong - Quang Ninh). Quang Ninh province achieved a high economic growth during the

recent years; for example, the 2011 economic growth in Quang Ninh was 12.1 percent, which well doubled the country's 2011 economic growth of 5.9 percent.

69. Quang Ninh has great resources of various minerals, many of which are of rich deposits and high quality and do not exist anywhere else in Vietnam -- such as coal, kaolin, clay, glass sand, limestone, etc. The fossil coal reserve is about 3.6 billion tons, most of which is anthracite coal with high energy contents. With the annual output of 10-45 million MT, coal mining represents a backbone industry of Quang Ninh province. The mining industry generated 31.6 percent of the province's GDP in 2011 and has been an important revenue source of the Quang Ninh province.
70. Key economic drivers of Quang Ninh province include: (a) the Van Don Economic Zone, which aims to serve as an international trade hub, a major driving force for economic growth, and a high-quality center for marine tourism and entertainment in the Northern part of Vietnam; and (b) the Mong Cai Border Gate Zone, which is one of the most important international border gates on the northern border of Vietnam for trading with the People's Republic of China (PRC) and other countries in the region. This economic zone is being constructed to be a big, modern and versatile city and is expected to be a gateway for PRC to access the South East Asia market.
71. Along with its important economic role, Quang Ninh is also a famous tourism destination with many historical sites and beautiful locations -- especially Halong Bay, which has been recognized as a World Heritage site by UNESCO. The Halong Bay also has high geological value in terms of the history of formations and the karst geomorphology. However, there is concern that the Quang Ninh coal mining industry would negatively affect the long-term development of the tourism sector in Quang Ninh. Quang Ninh faces the challenge of how to balance its economic and environmental values while maintaining the sustainable development for the province.

#### 2.2.1. Transport Sector

##### *a. Brief description of the current state*

72. Road system. There are five national highway routes, crossing over the Quang Ninh province area with total length of 381km, most of which are of grade IV and III road standards, except for 32km of National Highway No. 279 which is of grade V and bituminous macadam surfaced. The district road system includes 12 routes in the province area with total length of 301 km, of which 154km (accounting for 51 percent of total) are grade IV or grade III roads and the remaining ones are lower graded, mostly bituminous macadam surfaced. The district road system comprises 764 km, of which 455 km have been surface-hardened (accounting for 60 percent of total) while the remaining 309 km have not. The commune road system comprises 2,233 km, of which only 24 percent (which is equivalent to 527 km) have been surface-hardened and 1,707 km of remaining road (accounting for 76 percent of the total) have not yet been surface-hardened.
73. Railway system. The national railway section that crosses Quang Ninh province is 65 km long, belonging to the Kep – Ha Long line. In addition, there is a specialized railway network servicing the coal sector.
74. Seaport system. The province has five seaports listed in the port portfolio under the Master Plan of the Vietnam Port System to Year 2020, including: (a) Cai Lan port; (b) Van Gia port; (c) Cua Ong Port; (d) Hon Net Port; and (e) Mui Chua Port.

75. **Airports.** During the war time, there were several military jet airports; however, only Bai Chay and Tuan Chau jet airports are currently exploited for tourism services.

***b. Summarized investment plan***

76. Using state budget. In terms of investment needs, for realization of the Master Plan on Transportation in Quang Ninh to 2020 and Orientation to 2030, issued together with the Decision No. 2738/QD-UBND dated 30/08/2011 of Quang Ninh PPC,[31] Quang Ninh plans to carry out projects on transportation infrastructure in 2012 – 2015 with estimated total investment capital of VND 3,383 billion, covering 11 projects, using local budget and supporting capital from the central budget. Upon consideration of those projects, the Consultant Team sees that the feasibility of their capital mobilization is rather high.
77. Using ODA funding. Under the List[32] of projects expected to mobilize and utilize ODA funding in the 2012 – 2015 period, provided by DPI of Quang Ninh, there are six projects in the transportation sector with estimated total investment capital needs of more than VND 8,600 billion. Since these projects have not been approved by donors yet, the mobilization of such huge amounts of ODA capital would be very difficult to realize due to the current downturn of the global economy as well as the decreasing ODA funding sources for Vietnam.
78. Other financing sources (BOT, BT and PPP). As sourced from the line departments of Quang Ninh province, there are around 10 investment projects envisioned to be implemented in the form of BOT, BT or PPP form, with total capital needs of VND 59,443.6 billion and USD 1,329.1 million.
79. The current planning practices in the Quang Ninh infrastructure sectors in general, and in the transport sector in particular, show that fragmentary planning is a key issue causing difficulties in generating revenues for the municipal infrastructure projects in their post-investment phases. Ideally, infrastructure planning should take into consideration both the infrastructure project and the potential benefits drawn from the project(s) at later stages. For example, when developing a project for a new road, the road planning should have a broader view and also estimate the increased values of surrounding land lots which have access to such road, as the increased land values are important financing sources for the later road upgrading/expansion phases.

**2.2.2. Water Supply Sector**

***a. Brief description of the current state***

80. The centralized water supply system of Quang Ninh province is currently in good condition. The Quang Ninh Clean Water One Member Co., Ltd (QUAWACO) is the supplier for most urban areas in the province (11 among 14 administration units, including Dong Trieu district, Uong Bi city, Quang Yen Town, Ha Long city, Hoanh Bo district, Cam Pha city, Van Don district, Ba Che district, Tien Yen district, Hai Ha district and Mong Cai city). With regards to the remaining urban areas, the process of development by the company is now underway. Currently 91.56 percent of the urban population in Quang Ninh province has access to piped water, and the urban water supply network of the province covers 59 out of 68 wards and towns.

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31 As analyzed in Section B.II of the Local Government Assessment Report of Quang Ninh province.

32 As listed in Appendix 3 of the Local Government Assessment Report of Quang Ninh province.

81. Water sources include surface water and ground water. Currently, there are 12 plants using surface water and 20 wells exploiting ground water. The water quality and water reserves are able to meet the urban demand. However, some constraints remain such as: (a) the quality of water sources in some areas, such as Cao Van lake, is deteriorating due to impacts of coal exploitation activities, waste discharged into the lake, and destruction of protective forests; and (b) the water level of Cao Van Lake in dry season months drops down to the dead level which causes insufficiency of the water source for Ha Long and Cam Pha city.

82. A system of major water plants with large capacity have been built by Quang Ninh province, meeting both domestic and industrial water demands of the province. Those plants include: (a) Dien Vong Water Plant (capacity of 60,000 cubic meters per day; (b) Dong Ho Water Plant (capacity of 20,000 cmd); (c) Mao Khe Water Plant (capacity of 12k,000 cmd); (d) Uong Bi Water Plant (capacity of 8,000 cmd); (e) Mong Cai Water Plant (capacity of 5,000 cmd); and (f) Quang Yen Water Plant (capacity of 5,000 cmd).

83. As reported by QUAWACO,[33] the average water production costs of the company in 2002 were VND 7,265/$m^3$ while the average sale price was VND 6,110, resulting in a loss of VND 1,155/$m^3$. Similar to other provinces in Vietnam, the Quang Ninh water tariffs are regulated by Quang Ninh PPC and from 1/7/2012 the water tariffs have been adjusted to:[34] (a) households: VND 6,200 – VND 9,300/$m^3$; government offices: VND7,800–VND 9,300/ $m^3$; production activities: VND 10,100/ $m^3$; trading and service sector: VND 14,000–VND 19,000/ $m^3$ (all VAT exclusive) which would help to increase the average water sale price to VND 7,800/ $m^3$ which amply covers O&M.

84. While the Quang Ninh water sector is no longer subsidized, the full cost recovery is still an open question as the assets of the Quang Ninh water companies (i.e., similarly to HCMC) used to be undervalued. On the other hand, the water loss rates of QUAWACO for the years 2010, 2011 and 2012 are 26.1 percent, 25.1 percent and 24.2 percent, respectively, which are still high in comparison with the international benchmarks. QUAWACO plans to decrease its water loss rate to 22.5 percent by 2015.

***b. Summarized investment plan***

85. Quang Ninh PPC has issued Decision No. 1439/QD-UBND dated 13/06//2012, approving the Plan for clean water supply and environmental sanitation in rural areas in Quang Ninh in the 2012-2020 period with the specific targets for water supply in Quang Ninh provinces as follows:
    - to 2015: 95 percent of rural population to use hygienic water, of which, 70 percent are to use clean water under the QCVN02/2009 standard of MOH; and
    - to 2020: 100 percent of the rural population to use hygienic water under the national standard with the average volume of 120 liters per head per day.

86. In order to meet the demands for clean water in urban areas from now to 2020, Quang Ninh will carry out implementation of projects involving new construction and expansion of several

33 http://www.baoquangninh.com.vn

34 Based on Decision No.1582/2012/QD-UBND dated 27/6/2012 by Quang Ninh PPC approving the water pricing plan and the water tariffs of Quang Ninh Clean Water One Member Company Limited, effective from 1/7/2012.

water supply facilities in the province area with the estimated total investment capital of VND 606 billion covering six projects including:

- project on improving capacity of water source of Dien Vong Water Plant from 60,000cmd to 90,000 cmd;
- project on improving capacity of water source of Dong Ho Water Plant from 20,000 cmd to 30,000 cmd;
- project on construction and expansion of Mong Cai city's water supply system;
- project on construction of Hai Ha Water Plant to supply for Hai Ha Industrial and Port Services Park. Designed capacity of the Plant in phase I is 30,000 cmd, and phase II is 110,000cmd;
- project on construction of Yen Lap Water Plant with the capacity in phase I of 20,000 cmd and phase II capacity of 80,000 cmd (supplying water to West Ha Long area, some areas of Uong Bi city and Quang Yen town); and
- project on construction of water supply system for Van Don District.

### 2.2.3. Drainage and Waste Water Treatment Sector

#### *a. Brief description of the current state*

87. Currently, two urban areas of the province -- Ha Long city and Cam Pha city -- have invested in drainage and wastewater treatment systems, supported by WB funds. These systems have the following purposes: (a) to rehabilitate and expand the rainwater drainage system to reduce flooding for Ha Long and Cam Pha cities; and (b) to build a new wastewater collection and treatment system for Hon Gai area's center of Ha Long city (Ha Khanh wastewater treatment station) and Bai Chay area (Bai Chay wastewater treatment station). These projects were implemented in two phases, commencing in 2002 and reaching operation from 2011.
88. Regarding the wastewater treatment capacity, currently, the whole province has four domestic wastewater treatment stations in operation, which are: (a) Bai Chay wastewater treatment station (capacity of 3,500 $m^3$); (b) Ha Khanh wastewater treatment station (capacity of 7,000 $m^3$); (c) Vung Dang urban area wastewater treatment station (capacity of 2,000 $m^3$); and (d) Cot 5 – Cot 8 urban area wastewater treatment station (capacity of 1,200 $m^3$). All four stations are located in Ha Long city and their combined capacity is 13,700 $m^3$.
89. In terms of waste water treatment tariffs, currently Quang Ninh applies the environment protection fees on municipal wastewater at 6 percent and 7 percent of the water bill value for households and other entities, respectively, based on Decision No.3313/2010/QĐ-UBND dated 9/11/2010 by Quang Ninh PPC regulating the collection of environment protection fees for municipal wastewater in Quang Ninh province. From 1/7/2013 the environment protection fees for industrial wastewater treatment are applied in accordance with Decree No.25/2013/ND-CP, which increased the tariffs to 10 times higher than the previous ones regulated by Decree 67/2003/ND-CP.

#### *b. Summarized investment plan*

90. The plan on drainage and wastewater treatment in urban areas of Quang Ninh province to 2020 and orientation to 2030 was approved by the Quang Ninh PPC in their Decision No.

22/QD-UBND dated 06/1/2011. According to this plan, the total wastewater discharge of the whole province is estimated to be 96,394 $m^3$ (in 2015) and 188,497 $m^3$ (for 2020), of which, wastewater discharge of big cities is 31,398 $m^3$ (in 2015) and 67,462 $m^3$ (for 2020) for Ha Long city and 10,200 $m^3$ (for 2015) and 16,000 $m^3$ (for 2020) for Mong Cai city. In order to carry out treatment for the above volume of wastewater, the Plan proposes to build drainage and wastewater treatment systems in every center of urban areas in the province with the total treatment capacity of all treatment stations at 95,471 $m^3$ in 2015.

91. In terms of investment needs, in line with the Plan, the investment will be carried out in three phases, which are: (a) the period up to 2015; (b) the period up to 2020; and (c) the period up to 2030. In the first period, Quang Ninh will give priority to investment in drainage and wastewater treatment systems at centers of urban areas, especially major areas such as Ha Long city, Mong Cai city, Cam Pha town and Uong Bi with total investment capital of VND 6,202 billion. The expected financing sources include: (a) annually budget allocations; (b) ODA funds; (c) VDB commercial loans; (d) borrowing from socialized sources; and (e) funds raised from BOT, BOO, and BT investment forms (i.e., "land for infrastructure" projects); however, the specific percentages for each financing source are not available.

### 2.2.4. Solid Waste Treatment Sector

#### *a. Brief description of the current state*

92. Solid waste separation:
    - *Municipal solid waste*. Up to now, the separation at source for municipal solid waste in Quang Ninh province has not been executed; collection is mostly implemented in central areas close to main roads. Waste collection in areas far away from the center, and in alleys and small lanes, is mainly handled by the inhabitants themselves. The waste stream consists of biodegradable, non-biodegradable, inert waste (e.g., glass, ceramics) and other contaminants that are not separated among municipal solid waste at households and offices. For business units, factories, enterprises and municipal solid waste, these have commonly been dumped together with other waste;
    - *Industrial waste*. Industrial solid wastes from factories, plants and enterprises have been separated preliminarily by the owners into reusable, recyclable and non-reusable and non-recyclable, from which non-reusable and non-recyclable wastes will be transferred directly to collectors or transported to temporary transfer stations. Waste at temporary transfer stations or dump sites will be re-separated the second time by garbage collectors. Waste products having recyclable value like paper, aluminum and plastics will be sold to refuse shops or recycle units. The remaining will be buried together with solid municipal waste. Meanwhile, some hazardous industrial waste is not being disposed of properly, which creates further problems. In general, separation of industrial solid waste is fairly random, mainly subject to economic benefit and not aimed at environmentally effective protection. In reality, it is a common habit that hazardous solid waste disposal is mixed with normal solid waste. This can cause long-term serious outcomes for the environment and human health, especially the health of workers who directly collect and treat this type of waste.

93. Solid waste collection and transportation:
    - *Municipal solid waste*. The main method of collection and transportation of municipal waste in Quang Ninh province consists of: (a) direct transportation, with small-size vehicles collecting

municipal waste at areas and directly transporting it to final disposal sites; and (b) trans-shipment transportation, with small-size vehicles collecting municipal waste at areas and transporting it to trans-shipment stations. At trans-shipment stations, waste is transferred to large containers by waste compactors, and then containers are transferred to final disposal sites by large trucks. In general, the process from collection to transportation of municipal waste is simple and mainly manual. The daily collection volume of municipal solid waste in Quang Ninh urban areas is 414.8 Cubic Meters-Tons equivalent (MT).

- *Industrial solid waste*. Currently there are two methods of collection and transportation of industrial solid waste: (a) method 1: industrial units are solely responsible for collection, separation and transportation of solid wastes or for outsourcing to private businesses under the governmental solid waste management organization; and (b) method 2: collection, separation and transportation of industrial solid waste (including hazardous industrial waste) is handled by professional companies. Industrial units have to sign contracts with these companies to collect, transport and treat industrial solid waste in line with state regulations on environment protection. Currently, there are three companies specializing in collection and transportation of hazardous waste: Hung Thinh Technology Development and Industrial Equipment Joint Stock Company, Thanh Phuong Trading and Urban Environment Services One Member Limited Company, and Hon Gai Fire Protection Joint Stock Company.

94. Solid waste treatment:

Municipal solid waste and non-hazardous industrial wastes are collected and transferred by service companies to dump sites for treatment. Currently at the province, the two main methods being used are burning and burying.

There are 17 dump sites in Quang Ninh province:

- three landfills that meet sanitation standards (waste is disposed, leveled into layers, mauled, covered with soil and a leached collection system is installed) under Ha Long City Environment Improvement project sponsored by WB, comprising: Ha Khau landfill (area of 3.2ha with capacity of 30 MT/day); Deo Sen landfill (area of 4.8ha with capacity of 200 MT/day); and land fill of Unit 7 Quang Hanh Ward (area of 9ha with capacity of 50 MT/day); and
- 14 landfills below sanitation standards (e.g., inappropriate technical design, manually buried, or technically sub-standard with negative influence on underground water and surrounding environment).

Three out of the 17 landfills are overloaded: Ba Che Town landfill; landfill at Km 7 Hai Yen Ward, Mong Cai City; Voong Xi landfill of Co To district. Furthermore, six out of 17 landfills will be deplete by 2015: landfill at Unit 7, Quang Hanh Ward, Cam Pha City (2014); Voong Xi landfill of Co To District (2015); Ha Khau landfill, Ha Long City (2014); Deo Sen landfill, Ha Long City (2015); landfill at km 7 Hai Yen Ward, Mong Cai City (2012); and Quang Chinh landfill Hai Ha district (2013).

There are two solid waste treatment facilities in the province:

- the Plant of Ha Long Waste Treatment Joint Stock Company, Ha Khanh Ward, Ha Long City, with an area of 5ha, capacity of 145 MT/day, receiving total waste volume of eastern area of Ha Long city. The plant employs microorganism fertilizer manufacture technology from waste (domestic technology). Currently the plant is closed for relocation to a new site far from residential areas; and

- the Solid Waste Treatment Zone located at Bac Son ward, Uong Bi City, covering 13.8ha, with the capacity of 100 MT/day, which serves the Uong Bi Town area.

In terms of solid waste disposal tariffs, currently Quang Ninh charges VND 3,000–VND 20,000/household and VND 70,000–VND 1,500,000/entity for municipal solid waste disposal based on Decision No.3315/2012/QD-UBND dated 17/12/2012 by Quang Ninh PPC on adjusting the solid waste disposal tariffs for Ha Long and Cam Pha cities.

***b. Summarized investment plan***

95. In accordance with the Plan of Solid Waste Management of Quang Ninh province with orientation to 2010 and vision to 2020 issued together with Decision No 4252/QD-UBND, Quang Ninh province has identified the locations for constructing 13 new solid waste treatment zones, comprising: (a) Hai Dong Treatment Zone; (b) Hai Son Treatment Zone; (c) Duong Huy Treatment Zone; (d) The western side of stone road 5 Treatment Zone; (e) Bac Son Treatment Zone; (f) Dong Ngu Treatment; (g) Quang Thanh Treatment Zone; (h) Duong Hoa Treatment Zone; (i) Hoanh Bo Province Treatment Zone; (j) Trung Luong Hamlet, Trang Luong Ward Treatment Zone; (k) Dong Mai Treatment Zone; (l) Dong Tien Treatment Zone; and (m) Thanh Lan Treatment Zone. According to this Plan, during the 2011-2020 period, Quang Ninh will complete building solid waste treatment zones projects at commune-level localities and treatment zones of inter-municipals of the province. However, the Plan has not defined the costs and financing sources for constructing such new solid waste treatment zones.

### 2.2.5. Health Sector

***a. Brief description of the current state***

96. By the end of 2011, Quang Ninh had some 657 healthcare facilities, including: (a) 22 hospitals with 4,385 beds; (b) 10 local clinics with 123 beds; (c) two sanatorium centers and alternative medicine centers with 20 beds; (d) 186 commune medical stations with 474 beds; and (e) 437 private healthcare facilities.
97. By the end of 2010, 100 percent of communes, wards and towns in Quang Ninh achieved the national standard for commune healthcare: bed standard of 42.3 beds *per* one thousand people (national standard is 25 beds *per* one thousand people); the doctors *per* one thousand people standard of 9.4 (national standard being 6.8); and the hospital system has been well invested in infrastructure and equipment. In addition, healthcare entities in Quang Ninh also provide active training on professional skills, employing new technology and following scientific achievement transfers at all levels. Hospitals at the province level are capable of employing the latest technologies (and difficult technologies are applied at the central level); many hospitals at the commune level can manage technologies previously available only at the province level. As a result, healthcare in Quang Ninh has managed to service the number of patients seeking treatment at higher levels within the province, reducing the inconvenience and cost for local patients.

***b. Summarized investment plan***

98. In terms of planning, according to the SEDP 2011-2015, priorities in healthcare in Quang Ninh will be investments in construction and purchasing of equipment for local general hospitals, hospitals at the commune level, and commune medical stations as well as speeding up investment in the Maternity and Children Hospital. The province will mobilize all resources to: develop

hospitals at the province level and commune level, with enough equipment available in line with requirements of the Ministry of Health; invest in preventive healthcare units to improve the effectiveness and quality of epidemic prevention operation; and study what is needed to establish and implement international hospitals in Ha Long and Mong Cai cities.

99. In terms of investment needs, although the targets in healthcare during the period of 2011-2015 are specific, there are neither comprehensive figures on projects or specific categories in place, nor estimated resources available for implementation of the projects in education and training and healthcare, excluding: (a) two projects mobilizing foreign direct investment (FDI) to construct Ha Long International General Hospital (total investment of 30 million USD) and Mong Cai International General Hospital project (total investment of 30 million USD); and (b) projects requiring ODA funds, such as the Vietnam – Sweden – Uong Bi Oncology Center project with total investment of USD 3.5 million.

### 2.2.6. Education & Training Sector

#### *a. Brief description of the current state*

100. In recent years, Quang Ninh province has concentrated on education and training by investment in educational infrastructure to increase the development scale of schools, students and teachers at all educational branches and levels. This has provided suitable education condition for all students in order to introduce primary education at the right age, provide universal secondary education, and promote upper secondary education.

101. During 2007-2011, the number of primary schools has increased from 164 to 177 schools (an increase of 8 percent) and the number of secondary schools has risen from 139 to 146 schools (up 5 percent). At present, there is one university; in addition, there are six colleges, three vocational schools and 35 vocational centers in the province, meeting the education demand of local people.

#### *b. Summarized investment plan*

102. The development orientation of social urban infrastructure sectors such as healthcare, education and training of Quang Ninh is highlighted in the 2011-2015 5-year SEDP. While the objectives for education and training during the period of 2011-2015 are specific, there are neither the figures of each project or specific categories in place, nor the costs and financing resources available for implementation of the projects in education and training and healthcare, except: (a) two projects mobilizing foreign direct investment (FDI) to construct Ha Long International General Hospital (total investment of 30 million USD) and Mong Cai International General Hospital project (total investment of 30 million USD); and (b) projects requiring ODA fund as the Vietnam – Sweden – Uong Bi Oncology Center project with total investment of USD 3.5 million.

### 2.2.7. Social Housing Sector

#### *a. Brief description of the current state*

103. At this stage Quang Ninh has allocated 16.09 ha for social housing development for low income people, including: (a) 0.48 ha for a multi-story-building residential project for low income people at Ha Khanh Ward; (b) 0.17 ha of Lot G1 of Raft Hut urban area Pillar 8, Ha Long city; (c) 0.7 ha of Lot D3 of Cao Xanh – Ha Khanh B urban area; (d) 1.11 ha of Lot

N0 of Doi Thuy villa block at Bai Chay Ward; and (e) 13.65 ha (equal to 30 percent) of the remaining area of some commercial building projects in the province.

104. In order to develop rental houses for students in recent years, the People's Committee of Quang Ninh has submitted to the Ministry of Construction: (a) Document No 3301/UBND-XD2 dated 26/08/2010 registering for capital from Government bonds in 2011 to build nine buildings for students from seven universities; and (b) Document No 4062/UBND-XD2 dated 22/10/2010 registering for capital from Government bonds in 2011 to construct three buildings for students of three universities, with total area of 126,000 $m^2$ floor for nearly 21,000 students. However, no projects for rental house for students have been implemented so far due to the scarce resources.

***b. Summarized investment plan***

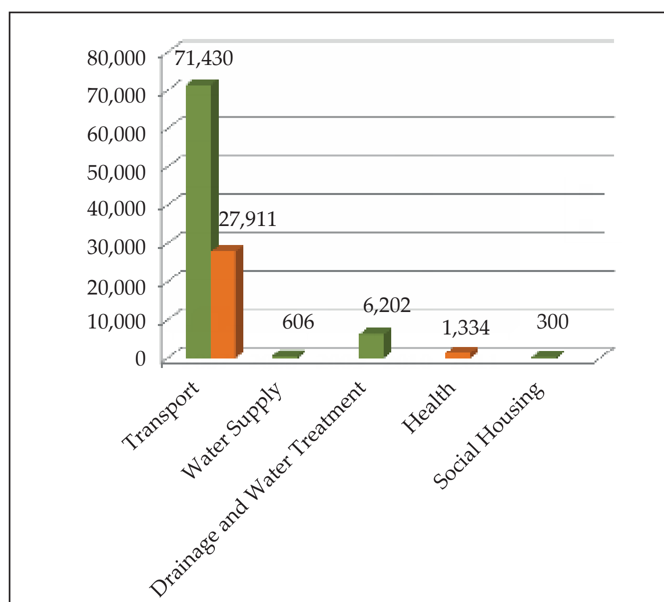
105. In terms of planning, the People's Committee of Quang Ninh has issued Decision No 3476/QD-UBND dated 27/12/2012, approving Plan "Housing development Program in Quang Ninh province with orientation to year 2020, vision to year 2030". However, no progress has been made so far.

106. In terms of investment needs, during the period 2013-2015, investment sources to implement public service houses and houses for students are added to the annual estimation of development expenditures submitted to the People Committee to decide upon the capacity to balance local budget (around VND 100 billion per annum). Housing for other beneficiaries will be mainly financed by private sector combined along with the Government support.

### 2.2.8. Capital Needs, Effective Financing Demand and the Funding Gap

107. Based on the above analysis (sections 2.2.1 to 2.2.7), the capital needs of the Quang Ninh urban infrastructure sectors in the coming period are illustrated in Figure A3.8.

**Figure A3.8. Quang Ninh capital needs by sector for the next period (VND billion)**




*Source:* Consultant estimate based on approved investment plans

108. For the purpose of estimating the Funding Gap, the Consultant Team is in the view that the estimation of the Funding Gap should be based on the "Effective Financing Demand", which would more accurately reflect the real capital needs of the local authorities.

109. The typical public investment management (PIM) cycle involves eight stages. The four initial stages -- strategic guidance and screening, formal project appraisal, appraisal review, and project selection and budgeting -- are often improperly carried out at both the local and central levels due to: (a) the common "application-grant" practices in project approval chain; (b) the limitations in local socio-economic development planning process; and (c) the political reasons driven by the election term mindset. It is reasonable to assume that the effective financing demand for Quang Ninh infrastructure sectors would be less than the projected levels. An accurate effective financing demand for the Quang Ninh municipal infrastructure sectors is not available. The Consultant has, based on the outcomes of the discussions with various experts of local line departments, estimated the "effective rate" -- which is defined as a ratio between the effective financing demand and the capital needs -- for different infrastructure sectors and financing sources, and calculate the funding gaps of Quang Ninh municipal infrastructure sectors over the coming period, as detailed in the Table A3.3 below.

110. It is anticipated that the above effective financing demand would be more realistic if some new approaches and initiatives in infrastructure financing (e.g., MDF, recourse mechanisms, etc.) are introduced.

**Table A3.3. The Quang Ninh province's needs for municipal infrastructure financing, available sources, and funding gaps**

VND billion/USD million

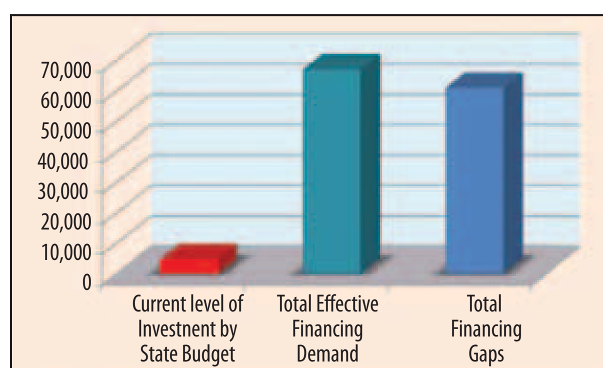
| | Infrastructure Sector | Current Level of Investment | Financing Needs | Effective Rate (%) | Effective Financing Demand | Financing sources arrangeable/ likely available | Funding gaps |
|---|---|---|---|---|---|---|---|
| A | B | C | D | E | F=DxE | G | H = F-G |
| 1. | **Transport, financed by:** | **VND 1,661 bil** | **VND 71,430 bil USD 1,329.1 mil** | 61.4<br>60.0 | **VND 43,873 bil USD 797.5 mil** | **VND3,045 bil** | **VND 40,828 bil USD 797.5** mil |
| | + *State budget (2012-2015)* | | **VND 3,383 bil** | 90 | VND 3,045 bil | Local budget/ support from central budget, Gov. Bonds: VND3,045 bil | Nil |
| | + ODAs (2012-2016) | | VND 8,603.8 bil | 60 | VND 5,162 bill | Being mobilized | VND 5,162 mil |
| | + BT, BOT, PPP | | VND 59,443.6 bil & USD 1,329.1 mil | | VND 35,666 bil & USD 797.5 mil | VND 35,666 bil & USD 797.5 mil | VND 35,666 bil & USD 797.5 mil |
| 2. | Water supply (to 2020) | VND 1,617.3 bil | VND606 bil | 85 | VND 515 bil | Available: VND 515 bil | Nil |

| | Infrastructure Sector | Current Level of Investment | Financing Needs | Effective Rate (%) | Effective Financing Demand | Financing sources arrangeable/ likely available | Funding gaps |
|---|---|---|---|---|---|---|---|
| 3. | Drainage/ waste water treatment | VND 338.3 bil | VND 6,202 bil | 75 | **VND 4,652 bil** | Local budget likely available (at 41.8% of the demand): **VND 1,944.5 bil** | **VND 2,707.5 bil** |
| 4. | Health (2011-2015) | VND946.3 bil | USD 63.5 mil | 70 | USD 44.5 mil | Amount not yet identified | USD44.5 mil |
| 5. | Social housing (2013-2015) | - | VND 300 bill | 85 | VND 255 mil | Local budget: VND 255 bil | Nil |
| | **TOTAL** | **VND 4,563.1 bil** | **VND 78,538.4 bill & USD 1,392.6 mil** | | **VND 49,295 bil & USD 841.9 mil** | **VND 5,759.5 bil** | **VND 43,435.5 bil & USD 841.9 mil** |
| | | | | | **100%** | **11.7% for VND & 0% for USD** | **88.3% for VND & 100% for USD** |

*Source:* Local Government Finance Assessment Report of Quang Ninh province and the Consultant's estimations.

111. The above figures indicate that while the effective financing demand for key municipal infrastructure sectors of Quang Ninh province in the next period would reach VND 49,295 billion and USD 841.9 million, the total sources arrangeable/likely available are limited to only VND 5,759.5 billion, which accounts for just 11.7 percent of the VND effective financing demand. Therefore, it would be too ambitious for Quang Ninh province to believe it could mobilize a financing gap of around VND 43,435.5 billion plus USD 841.9 million for financing its municipal infrastructure projects.

**Figure A3.9. Quang Ninh's current level of investment, Effective Financing Demand and Financing Gap**




*Source*: Consultant estimate based on approved investment plans

112. The figures in table A3.3 would also provide a relative comparison between the current investment, the total effective financing demand and the total financing gaps of the Quang Ninh municipal infrastructure sector. It is seen that the Quang Ninh total effective financing demand and the total financing gaps over the next period are much higher than its current level of investment by State Budget (Figure A3.9).

113. The in-depth study in Quang Ninh province also reveals that in order to meet the above large financing gap, the Quang Ninh government expects to boost fund mobilization though BT/BTO/PPP in the future. However, the situation seems to be similar to the case of HCMC, where the success factors of such type of investment greatly depend on a sufficient clean "land-fund" in place as well as the availability of substantial capital funds for land clearance, compensation and the resettlement costs. In addition to that, the Quang Ninh real estate market prices lag far behind those in HCMC, which would limit the opportunities to implement the land-for-infrastructure mechanisms as well as for BT/BTO investors in Quang Ninh to commercialize lands received.

## 2.3. Quang Nam province

114. Located in the center of Vietnam with a total land area of 10,438 $km^2$ (of which 41 percent is forest land) and a population of 1.44 million, Quang Nam is a coastal province and belongs to the Central Key Economic Zone.

115. The terrain of Quang Nam province is relatively complicated, lowering from the West to the East and shaped into three ecological regions: the highland region, the midland region and the delta and coastal region.

116. In terms of traffic, Quang Nam province is located in the middle of the country's North-South traffic axis of railway, road, seaway and airway.

117. Detached from the former Quang Nam-Da Nang province in 1997, it resumed its original name and now Quang Nam province has 14 districts and two townships (i.e., Tam Ky and Hoi An cities). The key economic drivers of Quang Nam province include the Chu Lai Open Economic Zone, the Chu Lai Truong Hai Automobile Manufacturing Park, the North Chu Lai Industry Park, and the Dien Nam – Dien Ngoc Industry Park, among others.

118. While Quang Nam has achieved some successes in economic development recently, the province is still amongst the poorest provinces in Vietnam, with the 2011 GDP accounting just for 0.4 percent of the national GDP, and the province is currently a net fiscal recipient.

### 2.3.1. Transport Sector

#### *a. Brief description of the current state*

119. Road System. The roadway system of Quang Nam province is over 6,300km long, and is evenly distributed on the North-South-oriented longitudinal and East-West-oriented horizontal axes, where in combination with the road lines of districts and communes, it makes a convenient traffic network to facilitate exchange among localities in the province. The roadway system of Quang Nam province features important arterial traffic lines which include three components: (a) North-South-oriented longitudinal centers; (b) East-West-oriented horizontal axes; and (c) other important center lines, namely provincial roads (PR).

120. Waterway system. There are 941 km of natural rivers in Quang Nam, 307km of which are under management and exploitation. The waterway network in Quang Nam consists of two

main river systems -- Thu Bon river system and Tam Ky river system -- which flow into the East Sea through the three big estuaries of Han river, Cua Dai and Ky Ha. The Thu Bon river system connects with Tam Ky river through Truong Giang river and with Da Nang port area through Vinh Dien and Han rivers, which make a waterway transportation line of over 100km running along and through from the South to the North of Vietnam. The currently exploited river network has 10 main branches, including: Thu Bon river, Truong Giang river, Vu Gia river, Yen river, Vinh Dien river, Hoi An river, Co Co river, Duy Vinh river, Ba Ren river, Tam Ky river and An Tan river. In general, the major active line in the waterway system of Quang Nam province is the Truong Giang – Thu Bon – Vinh Dien line. They form important routes for waterway transport in the province, which at the same time connect with Tien Sa port complex and Han river of Da Nang city. Currently, the exploitation is made mostly on the natural routes, without suitable investment and main transport vehicles on such routes having limits of 5 – 10 dead weight tons (DWT). Therefore, waterway transportation has a good exploitation potential if there is suitable investment for dredging and clearance in the filled-up sections of the rivers.

121. Port System. Quang Nam province has Ky Ha port, located in Tam Hai commune of Nui Thanh district, being 5km far away from Chu Lai airport and 15km far away from the Dung Quat Oil Refinery. The area of the Ky Ha port is 4 ha, with three wharves (of which one is of specific use for receiving liquefied gas tankers and the two others, with a total length of 410 m, receive vessels of 6,000-6,500 DWT). According to the approved master plan of Vietnam's port system, Ky Ha port is a local general port which serves directly for the Chu Lai Open Economic Zone, and at the same time supports the focal port of Dung Quat area. According to seaway development statistics proposals, wharves of Ky Ha port may receive vessels of 10,000 - 20,000 DWT.

122. Airways. Currently, Chu Lai airport located in Nui Thanh district has been upgraded, and gradually put into civil aviation use. At present, there are flights on the routes of Chu Lai – Ho Chi Minh City and Chu Lai – Hanoi. In general, the existing Chu Lai airport meets the public travelling needs and promotes the development of Chu Lai Open Economic Zone in particular, and of Quang Nam province in general.

123. Railways. The railway crossing Quang Nam province is the Thong Nhat railway line. Road track of the line is 1m. The section crossing Quang Nam is 85km long, with seven rail stations based in the province to facilitate the travel of people and goods transport. Together with the roadway in the province, the railway creates opportunities for exchanges between Quang Nam province and other provinces of the country.

***b. Summarized investment plan***

124. Roadways: (a) being the most important longitudinal center of Quang Nam province, the National Highway 1A is expected to be upgraded to grade I with at least four lanes in the period of 2012-2016; (b) the coastal road line, being under construction financed by government bonds, is expected to become an urban center line with 38m-wide section, in which the total width of lanes for vehicles is to be 20.5m by 2015; (c) the Da Nang – Quang Ngai expressway is in early stage of implementation. It is built under the standard of an expressway of grade 100 with 26m-wide section, in which the total width of lanes for vehicles is 2x10.5m = 21m; (d) the Ho Chi Minh Highway crosses Quang Nam province with 190km of length. Its Truong Son Eastern Highway Section is under construction at the standard of mountainous road of grade V with 6.5-wide section, in which the total width of lanes for vehicles is 5.5m. This project is expected to be completed in 2014; and (e) other roads, such as the East-West-oriented horizontal axis and other important center lines, which continue to be or will be constructed as scheduled.

125. Waterways. According to the detailed plan for waterway development of Quang Nam province for the period of 2002-2020 issued together with Decision No. 100/QD-UB dated 13 January 2003 by the People's Committee of Quang Nam province, 15 river branches would be planned to be upgraded to serve inland waterway transport. However, to gradually completely invest in accordance with the plan, needs and proposals of socio-economic development of the Eastern area of Quang Nam province, in the period of 2011-2015, the transport sector of Quang Nam province proposes to invest in two projects: the project to restore and improve Co Co river and develop technical infrastructure of ecotourism areas along both banks of the river and the project to dredge, improve and restore Truong Giang river.

126. Expected to be financed by state budget, the People's Committee of Quang Nam province issued Decision No. 3343/QD-UBND dated 19 October 2012, together with a list of important investment projects/works (13 projects in total) and respective capital requirements in the period of 2012-2020. These include projects in the municipal transportation sector with total investment capital of VND 13,444 billion (including VND 4,288 billion in the period of 2012-2015 and VND 9,156 billion in the period of 2016-2020). While such a list provides cost estimations and the tentative financing sources including Government bonds, target support from central budget and utilization of land resources for each project, the detailed mix of such resources was not made available. In the Consultant Team's opinion, feasibility of the implementation of all projects above in the period of 2012-2020, especially in the first period of 2012-2015, is rather low and projects will be difficult to complete.

127. The Department of Planning and Investment (DPI) of Quang Nam province has also proposed four municipal transport projects which are expected to be financed in the forms of BOT and BT in the next period, including two BOT projects (costs are not available) and two BT projects (VND 181 billion).

128. The current planning practices in the Quang Nam infrastructure sectors in general and in the transport sector in particular show that fragmentary planning is a key issue causing difficulties in generating revenues for the municipal infrastructure projects in the post-investment phases. Ideally, infrastructure planning should take into consideration both the infrastructure project and the potential benefits drawn from this project at later step. For example, when developing a project for a new road, the road planning should have a broader view as to estimate also the increased values of surrounding land lots which have access to such road as the increased land values are important financing sources for the later road upgrading/expansion phases.

### 2.3.2. Water Supply Sector

#### *a. Brief description of the current state*

129. According to statistics and assessments from 2000 to 31 December 2010 by the Consulting Center of Clean Water and Irrigation of Quang Nam, about 387 centralized water supply works have been built in the province, with a total investment capital of over VND 200 billion and design capacity of 40,679 $m^3$ per day, in which 65 works are capable of sustainable operation, accounting for 16.8 percent of total existing centralized water supply works. The remaining works are considered unsustainable, the main reasons being inappropriate post-investment management, low productivity, absence of collection of water use fee, and high rates of water loss among other reasons. Design capacity only meets about 40 percent of the people's demand.

130. The population using running water from centralized water supply sources as of the end of 2010 was 222,486 out of 1,145,089 people, accounting for 19.4 percent of the total population

using hygienic water in the whole province. The majority of this population is residing in the districts of Tam Ky, Thang Binh, Dien Ban, Nui Thanh, and Hoi An, etc. Fee collection faces many difficulties due to people's low awareness of the need pay fee for running water. Therefore, there is a shortage of funds for O&M each year, which leaves production facilities seriously downgraded. Furthermore, these water supply systems have only been invested at the purification level of depositing and purifying with sand, gravel and grit to meet low standards of hygienic water, but not standards of TCVN:02/2009/BYT.

131. The population using hygienic water from decentralized water supply sources (e.g., driven well, bore well, storm water tank, etc.) as of the end of 2010 was 922,597 out of 1,145,089 people, accounting for 80.57 percent. This is a high rate compared to the number of people using water from centralized water supply sources.

132. In term of water tariffs, based on Decision No.12/2012/QD-UBND dated 20/6/2012 by Quang Nam PPC approving the water tariffs for Quang Nam province, currently Quang Nam applies the tariffs for: (a) households: VND 4,700–VND 5,500/$m^3$; (b) Government offices: VND 8,000/ $m^3$; production activities: VND 7,500–VND8,500/ $m^3$; trading and service sector: VND 8,500–VND 9,500/ $m^3$ (all VAT and environmental protection fees inclusive) which are much lower than those of HCMC and Quang Ninh province. However, as reported by DoF of Quang Nam province, at this stage the Quang nam water sector is just able to cover O&M rather than achieving full cost recovery.

***b. Summarized investment plan***

133. Water supply in rural areas:

In accordance with the Planning for clean water supply and environmental sanitation in Quang Nam's rural areas to 2020 and proposals to 2025 -- issued together with Decision No. 1831/QD-UBND dated 5 June 2012 by People's Committee of Quang Nam province to achieve particular objectives of clean water supply in rural areas -- the estimated total investment capital under this planning is VND 811 billion which is expected to be financed by different sources such as state budget (36 percent), contributed capital (37 percent) and other sources (27 percent), where:

- state budget consists of investment capital from National environmental programs in clean water and environmental sanitation in rural areas (45 percent); Program 134 (20 percent); Program 135 (20 percent); and provincial budget (15 percent);
- contributed capital consists of contribution by the people (70 percent) and loans from the Bank for Social policies (30 percent) in accordance with Decision No. 62/2004/QD-TTg dated 16 April 2004 by the Prime Minister; and
- other resources consist of ODA (50 percent), NGOs' funds (25 percent), and investment capital from enterprises (25 percent).

134. Water supply in urban areas:

According to the Department of Construction of Quang Nam province, some 16 water supply projects of medium and large size totaling VND 2,657 billion are expected to be implemented by 2020, of which: (a) four projects are for upgrading and expanding water plants and pipe system, with the estimated total investment of VND 567 billion; and (b) 12 are new projects with total investment of VND 2,090 billion.

The tentative resources for financing the above projects consist of: State budget (e.g., local budget), enterprises' contribution, trade loans and ODA. Projects expected to be financed by

ODA include: (a) Hoi An Water plant with investment capital of VND 70 billion; (b) Bac Tra Mi Water plant with investment capital of VND 40 billion; and (c) Nam Tra Mi Water plant with investment capital of VND 17 billion.

In the view of the Consultant Team, the feasibility or reality of the implementation of all projects in the period of 2012-2020, as listed above, is rather low and would be difficult to accomplish.

### 2.3.3. Drainage and Waste Water Treatment Sector

#### *a. Brief description of the current state*

135. Drainage:

In general, fully-functioning drainage systems exist only in two cities: Tam Ky and Hoi An, and some residential areas still suffer local inundation. During recent years: (a) some key drainage canals and reservoir system (under the Project for Central Region's Urban Environment Improvement financed by ODA from ADB) have been constructed in Tam Ky city; and (b) the project for drainage (and water waste treatment) of Hoi An city has been implemented with financing from France.

The drainage system in the other urban areas is fragmented. Flooding still occurs in the rainy season, especially in urban areas along the rivers' lower sections.

136. Waste water treatment:

Large-scale wastewater treatment systems have just been implemented in Hoi An city and the Dien Nam – Dien Ngoc Industrial zone. In particular, in recent years, the wastewater treatment station under the project for drainage system for Hoi An city has been implemented with ODA funds granted by France. However in the other urban areas, localities and industrial zones, some small-scale waste treatment systems have been constructed but not as fully-functioning wastewater treatment systems at regulated standards.

In terms of medical facilities, four out of 24 public hospitals (Provincial general hospital, Tuberculosis and Lung disease Hospital, Children's Hospital and General hospital of the Northern mountainous areas), and one out of two private hospitals (Vinh Duc general hospital) already have a qualified wastewater treatment system. In particular, Quang Nam Provincial general hospital has built a wastewater treatment station, with support from the provincial budget. Hoi An hospital has built a waste water treatment system (under the project for drainage system of the city) financed by ODA funds granted by France. In the mountainous areas, medical wastewater, whether treated or not, is absorbed by the land.

#### *b. Summarized investment plan*

137. Quang Nam province is yet to have any planning for local drainage and wastewater treatment to 2020. Instead, there are two projects in this sector that have been approved by provincial People's Committee and relevant agencies, including:

- "Collection and treatment of water waste and drainage in Tam Ky city" Sub-project: This is a sub-project under the "Municipal Water supply and Drainage Project," financed by WB loans and approved by the Prime Minister. Total investment capital of the Sub-project is approximately VND 423.2[35] billion (equivalent to USD 21.7 million), comprising: (a) a

35 Rounded figure.

soft loan from WB of VND 345.3 billion, (equivalent to USD 17.7 million, accounting for 81.6 percent); and counterpart funds of VND 77.8 billion, equivalent to USD 4 million (accounting for 18.4 percent). The sub-project was expected to be implemented during the 2011-2016; however, in line with Decision No. 3343/QD-UBND dated 19 October 2012, this project has been extended to 2020, and will be divided into two phases: the 2012-2015 phase (with estimated total investment capital of VND 300 billion) and the 2016-2020 phase (with total investment capital of VND 123 billion).

- Project of Drainage and Environmental Sanitation of Nui Thanh Urban area: Total investment capital of the project is VND 321 billion (equivalent to EUR 12.8 million), comprising: (a) a loan from Italy (ODA) of VND 238.3 billion (equivalent to EUR 9.5 million); and (b) local counterpart funds of VND 82.8 billion (equivalent to EUR 3.3 million). The project started in 2010.

#### 2.3.4. Solid Waste Treatment Sector

##### *a. Brief description of the current state*

138. Solid waste separation:

- *Municipal solid waste*. Up to now, the separation at source for municipal solid waste has not been executed. The waste stream consists of biodegradable, non-biodegradable, inert waste (e.g., glass, ceramics) and other contaminants that are not separated among municipal solid waste at households and offices. For business units, factories, enterprises, municipal solid wastes have commonly been dumped together with other wastes. There were pilot projects for waste separation at Hoi An City (2008) and at Cu Lao Cham (2009). However, the project at Hoi An has not been successful because the separated wastes were combined jointly for transportation and buried at Cam Ha disposal site; the project at Cu Lao Cham was executed and has been successful on a small scale.
- *Industrial waste*. Industrial solid wastes discharged by factories, plants, and enterprises have been separated preliminarily by the owners into reusable, recyclable and non-reusable and non-recyclable; then, non-reusable and non-recyclable wastes are transferred directly to collectors or transported to temporary transfer stations. Waste at temporary transfer stations or dump sites is re-separated at the second time by garbage collectors. Waste products having recyclable value like paper, aluminum and plastics are sold to refuse shops or recycle units. The remaining is buried together with solid municipal wastes. Meanwhile, hazardous industrial waste has not been disposed of properly, which disturbs the treatment process and creates further problems. In general, separation of industrial solid waste is fairly random, mainly subject to economic benefit, and not aimed at environmentally effective protection.
- *Medical waste*. At provincial hospitals, city and district healthcare centers, separation at sources have been implemented in recent years. Still, separation is limited to distinguishing between hazardous medical wastes and municipal wastes. This task is done by nurse's aides or supposedly specialized officials. At medical stations and in private wards, medical waste has not been separated thoroughly at source.

139. Solid waste collection and transportation:

- *Hazardous solid wastes*. Source generators collect by themselves at source, and then transfer to specific transport units for treatment.

- *Municipal solid wastes and non-hazardous industrial wastes*. Waste from households and offices are stored in specialized plastic bins or temporary transfer stations, to be periodically collected for transport to treatment centers by environment and sanitation service company vehicles. In general, the process from collection to transportation of non-hazardous waste is simple and mainly manual.

140. Solid waste treatment:

- *Municipal and industrial solid waste*. Municipal solid wastes and non-hazardous industrial wastes are collected and transferred by service companies to dump sites for treatment (i.e., burning and burying). In addition, microorganism fertilizer manufacture technology is being implemented at three municipal waste treatment factories to produce organic fertilizer, consisting of one factory at Tam Ky,[36] one at Cam Ha (Hoi An) commune,[37] and one at Tai Tan Hiep ( Hoi An) island commune.[38] In general, factories are of small scale and mainly treat municipal waste at these localities.
- *Medical solid waste*. Depending on expenses, locations, and hospital level conditions, treatments of medical waste may vary. At plain and midland districts, hospitals, big medical centers and some private hospitals, through the transportation company, Quang Nam Urban Environment Company, solid wastes are treated by Hoval furnace technology (which burns solid waste at heat of 800-1,200$^0$C). In the mountainous area clinics and medical stations/units, etc., treatment of solid hazardous waste (e.g., syringes, needles, lancets, dressings of blood, mound swabs, etc.) is by burying in hollows or burning directly by petrol. In the whole province, 11 out of 27 existing hospitals have no medical waste storehouse. The other 16 others medical waste storing houses; however, these are built inadequately and/or are in rather poor condition.

141. Solid waste treatment areas:

- Today, there are 15 active dump sites in the province, with the total areas of about 55.5 ha, of which only five landfills meet sanitation standard. Waste treatment for the inter-regions is handled by four sites managed by Quang Nam Urban Environment Company (namely: Dai Hiep, Tam Dan, Tam Xuan, and Tam Nghia dump sites) and one landfill built by the People's Committee of Dong Phu town at Dong Phu – Que Son. Meanwhile, most of the remaining dump sites, mainly in the mountainous districts, have not applied standard burying technology or treatment; they only use the burning method to reduce the volume of wastes at the sites. Thus, these dump sites are the planned locations for waste collection.

142. The solid waste disposal tariffs applied by Quang Nam:

- For municipal solid waste (Based on Decision No.4457/QD-UBND dated 30/12/2012 by Quang Nam PPC ):
  - Collection: VND 111,600–VND123,600/MT (rounded figures);
  - Transportation: VND 241,200 – VND 305,600/MT (rounded figures); and
  - Treatment: VND 35,500/MT (rounded figures).
- For medical solid waste (Based on Decision No.4456/QD-UBND dated 30/12/2012 by Quang Nam PPC ):

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36 Quang Nam Urban Environment Company is the investor

37 Invested by French ODA, with design capacity of 55 MTs solid waste/day

38 Invested by funding source from Danish Government

- Collection & transportation: VND 1,037,000–VND 4,411,000/MT (rounded figures); and
- Treatment: VND 14,456,000/MT (rounded figures).

***b. Summarized investment plan***

143. In accordance with the master plan for solid waste management in Quang Nam province in the period 2011 – 2020, issued together with Decision No. 2419/QD-UBND, for achieving the specific objectives in the solid waste management as analyzed in Section B.IV of this Report, the total required investment capital is estimated at VND 1,252.12 billion, of which the investment capital to be needed in the period of 2011-2015 is VND 1,001.39 billion and in the period of 2016-2020 is VND 250.73 billion. The tentative financing sources include: State budget (i.e., grant from central budget and provincial budget) and other resources (State budget, development investment credit, loans and capital from socialization) without clarifying the particular proportion of each resource.

### 2.3.5. Health

***a. Brief description of the current state***

144. By the end of 2011, the Quang Nam province's health network had some 300 healthcare units, including: (a) 26 hospitals with 2,748 beds; (b) nine general clinics with 47 beds; (c) 18 medical centers with 1,023 beds; (d) three maternity houses with nine beds; and (e) 244 commune medical stations, of which:
    - at the province level, there are eight state-owned medical centers/hospitals;
    - at the city and district level there are 18 healthcare centers and 09 local general clinics;
    - at the commune ward and town (in short, the commune level) there are 244 commune medical stations;
    - private-owned facilities consist of two general hospitals; and
    - there are also two general hospitals located in communes.

***b. Summarized investment plan***

145. For implementation of Resolution No. 08-NQ/TU dated 5 April 2012 by the Provincial committee of the Party in the Ninth meeting (Session XX), the People's Committee of Quang Nam province has issued Decision No. 3343/QD-UBND dated 19 October 2012, together with a list of important investment projects/works and respective capital requirement in the period of 2012-2020, including investment projects in health care sector with total investment capital of VND750 billion (including VND 190 billion in the period of 2012-2015, of which VND 100 billion for provincial/district levels and VND 560 billion in the period of 2016-2020). The expected financing sources include government bonds and state budgets.

### 2.3.6. Education & Training Sector

***a. Brief description of the current state***

146. In Quang Nam province, almost all the communes have kindergartens and community education centers. Particularly, each commune has at least one primary school; 100 percent of

communes and wards in plains districts and cities and 85 percent of communes in mountainous districts have secondary schools or classes; and each district or city has at least one high school and most of the communes have a continuing education center. As of the school-year of 2009-2010, only in the block of pre-school, secondary and high school, there were 755 schools, 11,220 classes and nearly 337,000 pupils in the whole province. On average, one person out of four people went to school in this group.

147. The whole province was recognized as meeting the national standardization of primary school at the right age at the end of 2008, and a total of 18 out of 18 districts and cities, and 237 out of 240 communes, wards, and towns have met the standardization of secondary school. Currently, more than 80 percent of schools in the province have access to the Internet.

148. From 2006 up to now, the number of universities, colleges and professional schools in the province has improved quickly, with 10 training schools at the level of university, college and professional school. Of these ten, there are two universities, six colleges and two professional schools with nearly 1000 lecturers and over 20,000 students.

149. In the province there are also 42 vocational schools, of which: three are colleges with vocational training, five are professional schools, and there are 34 centers, enterprises and other entities. During the period of 2006-2010, in the whole province, there were nearly 142,000 people enrolling the vocational schools, which was 1.7 times higher than that of the previous period of 2001-2005.

***b. Summarized investment plan***

150. In accordance with Decision No. 3343/QD-UBND dated 19 October 2012, together with a list of important investment projects/works and capital requirement in the period of 2012-2020, including investment projects in the Education & Training sector, the total investment capital is VND 1,900 billion (including VND 450 billion in the period of 2012-2015 and VND 1,450 billion in the period of 2016-2020). The expected financing sources include: (a) the target support from the central budget; (b) National target programs; and (c) Government bonds.

### 2.3.7. Social Housing Sector

***a. Brief description of the current state***

151. Upon the implementation of Resolution No. 18/NQ-CP dated 20 April 2009 by the Government on a number of policies and mechanism to promote the development of housing for pupils, students, workers in centralized industrial zones, and people with low income in urban area, according to the Quang Nam DPI, the Quang Nam province has implemented projects in social housing financed by state budget, with a total investment capital in the period of 2009-2011 of VND 148,447 million (including VND 39,017 million of centralized budget and VND 109,430 million of targeted transfers from the state budget).

152. Pursuant to Decision No. 65/2009/TTg dated 20 April 2009 by the Prime Minister promulgating some policies on development of social housing for rent by students of the universities, colleges, and training schools, Quang Nam province has already conducted the application procedures for funding from the Government bonds for three (projects in social housing for students (see more details in the following section).

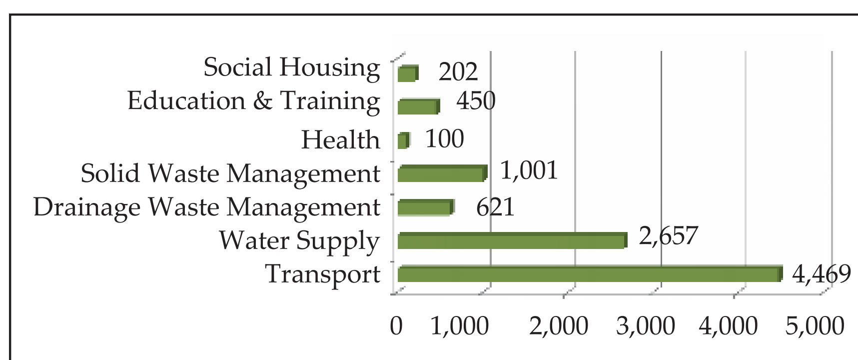
***b. Summarized investment plan***

153. For implementation of Decision No. 65/2009/TTg dated 20 April 2009 of the Prime Minister, Quang Nam province has already carried out the procedures for allocation of the government bonds for three projects of "house for rent" for students, which are: (a) Quang Nam University (VND 24.19 billion); (b) Technical and Economic College of Quang Nam (VND 49.2 billion) and (c) Medical College of Quang Nam (VND 28.46 billion).

154. Moreover, according to the investment plan in the period of 2013-2015 by Quang Nam Development and Investment Fund (QNIF), pursuant to Decision No. 123/QD-UBND dated 17 April 2012 by People's Committee of Quang Nam province approving of list of investment projects, loans and financial plans in 2012 of Quang Nam Development and Investment Fund, QNIF intends to lend money to two projects of social housing in Dien Nam – Dien Ngoc urban area and the Chu Lai Open Economic Zone in the period of 2013-2015, with a total credit fund of VND 100 billion.

### 2.3.8. Capital Needs, Effective Financing Demand and the Funding Gap

**Figure A3.10. Quang Nam capital needs by sector for the next period (VND billion)**




*Source*: Consultant estimate based on approved investment plans

155. Based on the above analysis (sections 2.3.1 to 2.3.7), the capital needs of the Quang Nam urban infrastructure sectors in the coming period are illustrated in Figure A3.10. It is seen that the capital needs of the transport and water supply sectors are much higher than those of other sectors

156. For the purpose of estimating the funding gap, the Consultant Team is of the view that the estimation of the funding gap should be based on the "effective financing demand," which would more accurately reflect the real capital needs of the local authorities.

157. The typical public investment management (PIM) cycle is involves eight stages. The four initial stages –namely: strategic guidance and screening, formal project appraisal, appraisal review, and project selection and budgeting -- are often improperly carried out at both the local and central levels due to: (a) the common "application-grant" practices in project approval chain; (b) the limitations in local socio-economic development planning process; and (c) the political reasons driven by the election term mindset. It is reasonable to assume that the effective financing demand for Quang Nam infrastructure sectors would be less than the projected levels. While the accurate effective financing demand of the Quang Nam municipal infrastructure sectors is not available, the Consultant has, based on the outcomes of the discussions with various experts

of local line departments, estimated the "effective rate" (which is defined as a ratio between the effective financing demand and the capital needs) for different infrastructure sectors and financing sources, and calculated the funding gaps of Quang Nam municipal infrastructure sectors over the coming period, as detailed in the Table A3.4.

158. It is anticipated that the above effective financing demand would be more realistic if some new approaches and initiatives in infrastructure financing (e.g., MDF, recourse mechanisms, etc.) are introduced.

**Table A3.4. The Quang Nam province's needs for municipal infrastructure financing, available sources and funding gaps**

VND billion

| No. | Infrastructure Sector | Current Level of Investment | Financing Needs | Effective Rate (%) | Effective Financing Demand | Financing sources arrangeable/ likely available | Funding gaps |
|---|---|---|---|---|---|---|---|
| A | B | C | D | E | F=DxE | G | H = F-G |
| 1. | Transport (2012-2015), financed by: | 3,274.4 | 4,469 | | 3.093 | 3,002 | 91 |
| | *+ State budget* | | *4,288*[1] | *70* | 3,002 | *Local budget + Gov. Bonds: 3,002* | *Nil* |
| | *+ BT* | | *181* | *50* | 91 | *Nil* | *91* |
| 2. | Water supply (2012-2020) | 63.4 | 2.657 | 80 | 2,126 | Local budget: 364.6 | 1,761 |
| 3. | Drainage/ waste water treatment (2011-2015) | 27.5 | 621 | 70 | 435 | ODAs and local contributions: 435 | Nil |
| 4. | Solid waste treatment (2011-2015) | | 1,001.4[2] | 70 | 701 | Local budget:193.4 | 508 |
| 5. | Health (2012-2015) | 411.5 | 100 | 90 | 90 | State Budget + Gov. Bonds: 90 | Nil |
| 6. | Education & training (2012-2015) | 656.7 | 450 | 90 | 405 | Central Budget + Gov. Bonds: 405 | Nil |
| 7. | Social housing (2013-2015) | 148.4 | 201.9 | 60 | 121 | Borrowings & Gov. Bonds: 121 | Nil |
| | **TOTAL** | **4,582** | **9,500** | | **6,970**<br>**100%** | **4,610**<br>**66.2%** | **2,359**<br>**33.8%** |

*Source:* Local Government Finance Assessment Report of Quang Nam province and the Consultant's estimations.

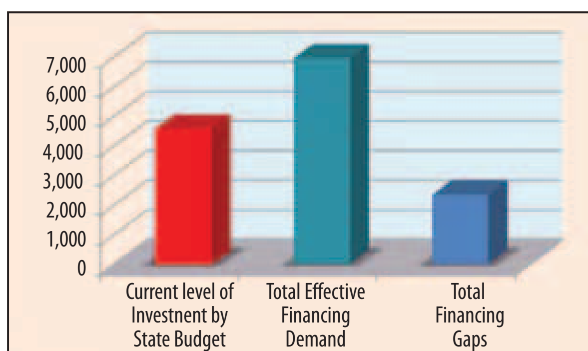
*Notes*:

1. For comparison purpose, the total spending by State Budget for the transport sector in the period of 2007-2011 was VND 3,274 billion representing an annual spending of VND655 billion.

2. For comparison purpose, the total spending for this sector in the period of 2007-2010 was VND 110.5 billion representing an annual spending of VND27.6 billion

159. The figures in Table A3.4 would provide a relative comparison between the current investment, the total effective financing demand, and the total financing gaps of the Quang Nam municipal infrastructure sector. It is seen that the Quang Nam total effective financing demand over the next period is fairly higher than its current level of investment and the total funding gaps are at a reasonable level (Figure A3.11). However, as mentioned above, as Quang Nam is still among the poorest provinces in Vietnam, such funding gaps are also challenges for Quang Nam province.

**Figure A3.11. Quang Nam current level of investment, effective financing demand and financing gap**




*Source*: Consultant estimate based on approved investment plans

160. While the effective financing demand for key municipal infrastructure sectors of Quang Nam province in the next period would reach VND 6,970 billion, the total sources likely available/arrangeable are limited to only VND 4,610 billion, which accounts for just 66.2 percent of the effective financing demand. Therefore Quang Nam province would face a financing gap of around VND 2,359 billion (accounting for 33.8 percent of the effective financing needs) for financing its municipal infrastructure projects in the coming period.

161. Being among the poorest provinces, it is a challenge for Quang Nam province to fund the above financing gaps. In addition to that, the situation is Quang Nam province is quite different from that of HCMC and Quang Ninh province. In Quang Nam province, the same market factors are not available to drive the socializing infrastructure development policy. The land-for-infrastructure mechanisms and investment projects in the form of BOT/BT/PPP would encounter many difficulties due to the low urban development level which makes such projects less attractive to investors. In addition, the disadvantaged socio-economic conditions of the locality, the poorly developed real estate market, and the limited number of investors with strong technical and financial capacity would limit opportunities for land resources mobilization.

162. In overall, the above analysis shows that while the needs for municipal infrastructure finance are high for provinces, the resources in provinces are limited resulting in an imbalance between the projections and the available resources. The reasons could be a lack of coordination and linkages between the line agencies in the planning process where the local municipal infrastructure development planning used to be made in a way to reflect the expectations of line agencies rather than based on the actual resources available. Given the budget constraints at central level, it is therefore essential to pave a way for provinces to increase local resources in general and the above funding gaps for municipal infrastructure in particular.

## 3. Recommendations for the improvement of the current framework for municipal infrastructure finance and investment planning and appraisal

### 3.1. General observation

163. Having carried out the review of the legal framework for the three designated areas within existing law, it is apparent that the overall basic framework of the State budget law and the legislation governing the law is adequate under present circumstances but requires adjustments in various areas. Most of these seem directed at the need to keep up with the decentralization policies that are evolving over time.
164. The studies of the three selected provinces by the Consultant Team also showed disparity between the levels of development and that despite best intentions of government, as would be expected, the poorer part of the population remain relatively disadvantaged in infrastructure services. There remain, however, two sides to this equation given that high density cities suffer from traffic congestion not suffered by the rural poor who, on the other hand, suffer from a lesser degree of water supply service.
165. There also appears to be considerable fragmentation -- as between ministries and between different levels of government. MPI is responsible for the socio-economic planning master plans while line ministries develop sector plans, so there will always be horizontal and vertical linkages. The plans themselves appear to be formulated by government-backed think tanks and it is not clear how much liaison there is between all agencies with little public participation. While it is possible to put rules into place with regard to coordination and liaison, the rules themselves often delay the process on their own. It is noted that in Vietnam nothing can be done unless there is a law which states it can be done -- while in many other countries anything can be done unless a law says it cannot.
166. With its overall planning apparatus supported by poverty reduction plans and specific development plans focusing on water supply, wastewater treatment, drainage, transport etc., government plans/proposals often lack specifics and economic/financial justifications. It would appear that costing of these proposals is secondary, so with rough estimates made on total amounts required, as a planning activity, one then has to work backwards and see what can realistically be achieved from budget sources and what the identified gap would be. It can be seen where a shortfall can be identified but with this there is no certainty as to exactly how or if the shortfall can be funded. The result is that you move into a plan that is not fully funded and it then becomes a matter of trade off on what can be started and what has to be deferred. The delays are then passed on into the next planning period.
167. Having identified specifics, it is also apparent that the ability to cost out projects and then finance them in a timely manner is a major issue. From an international context, this is not only a problem for Vietnam.[39] The reasons for the ill-conceived and poorly operating PPP projects such as toll roads and tunnels seem, from international experience, to come to a large extent from pressure exerted by commercial banks keen to fund these projects given that most have some degree of government guarantee and overruns are not seen as a major issue. If this can be a problem in developed economies, it has high possibility that such issues could be encountered elsewhere.

39 Australia has had many tunnels and toll roads collapse financially due to poor planning and costing.

168. The operational issues within the designated areas of Quang Ninh, Quang Nam and Ho Chi Minh City have been dealt with separately and in depth in the respective Provincial Assessment Reports. This Diagnostic and Action Plan moves on from this analysis to extract the salient features identified where gaps may occur and attempts to establish an action plan which could be followed in order to streamline procedures to close the gap in necessary finance for required infrastructure.

## 3.2. The current revenue sources for municipal infrastructure development in the three selected provinces

### 3.2.1. HCMC

169. The current State Budget reporting system does not require provinces and the budget levels to break down resources for the infrastructure sector in general and the municipal infrastructure sub-sector in particular. Thus, basically the revenue sources for socio-economic development in general and municipal infrastructure development in particular of HCMC are combined together as general revenue sources of local the budget including transfers from the central budget (inclusive of government bonds), local revenue sources, commercial loans and short-term borrowings from the State Treasury, ODA sources/non-governmental aid from international NGOs, and private investments (BOT/BT).

170. According to the SEDP 2011-2015 of HCMC, total development investment in social programs for the period of 2006 – 2010 reached VND 604,128 billion (i.e., it tripled in the period of 2001-2005, representing an average annual growth of about 24.8 percent and accounted for 41.5 percent of the HCMC GDP, higher than the 35 percent for the period between 2001-2005).

171. Regarding the "Gross" State Budget revenue in the period 2006-2010, HCMC did achieve very promising results with the total State Budget Revenues of VND 583,466 billion, which is 2.66 times higher than that in its previous period 2001-2005, and is broken down by revenue sources in the Table A3.5 below.

**Table A3.5: Total Budget Revenue Sources in HCMC in the period of 2008-2011**

Unit: VND Billion

| No | Items | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| | **Total State Budget Revenues (A+B)** | **125,457** | **137,362** | **167,427** | **198,176** |
| **A.** | **Local State Budget Revenues (1+2+3+4)** | **125,457** | **135,362** | **165,427** | **198,176** |
| 1. | Domestic Revenues | 68,450 | 68,912 | 87,446 | 102,581 |
| 2. | Export, Import Taxes | 47,114 | 53,022 | 60,476 | 68,011 |
| 3. | Crude oil revenues | 9,748 | 13,428 | 17,317 | 27,351 |
| 4. | Grant | 146 | - | 187 | 234 |
| **B.** | **Borrowings** | **-** | **2,000** | **2,000** | **-** |

*Source:* Statistical Yearbook of HCMC, 2011.

172. It is noted that the budget revenue sources, as mentioned in Table A3.5 above, do include: (a) some revenues being 100 percent under the central budget (e.g., export, import taxes);

and (b) some revenues, under the item of "Domestic Revenue," which are either under 100 percent central budget or are revenues to be shared between the local and central budget. By taking out all the revenues belonging to and/or shared with the central budget, there remains the "Net Budget Revenue Sources" of HCMC, which are as calculated[40] and provided in the Local Government Assessment Report of HCMC by the Consultant Team, presented in the Table A3.6 below:

**Table A3.6: Net budget revenues sources of HCMC in 2005 and in the period of 2008-2011**

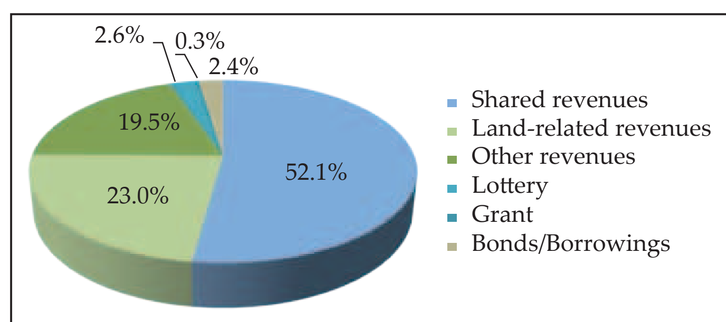
Unit: Billion VND

| No | Item | 2005 | 2008 | 2009 | 2010 | 2011 (Est.) | Total (2008-2011) | As a % of the total | CAGR (%) |
|---|---|---|---|---|---|---|---|---|---|
| | **TOTAL (A+B+C)** | **20,400** | **34,200** | **42,088** | **45,446** | **45,851** | **167,584** | **100** | **14.5** |
| **A.** | **Domestic revenues for local budget (1+…+4)** | **16,645** | **34,054** | **40,088** | **43,258** | **45,617** | **163,017** | **97.3** | **18.3** |
| 1. | Shared revenues entitled to HCMC | 7,578 | 14,866 | 22,203 | 25,933 | 24,289 | **87,292** | 52.1 | 21.4 |
| 2. | Land revenues | 3,440 | 9,603 | 7,069 | 9,296 | 12,643 | 38,611 | *23.0* | *24.2* |
| 3. | Lottery | 520 | 832 | 894 | 1,252 | 1,379 | 4,357 | 2.6 | 17.7 |
| 4. | Other revenues | 5,108 | 8,753 | 9,922 | 6,776 | 7,306 | 32,757 | *19.5%* | *6.1%* |
| **B.** | **Grant** | **57** | **146** | **-** | **187** | **234** | **567** | **0.3%** | **26.5%** |
| **C.** | **Borrowings (e.g. bond issuance)** | **3,698** | **-** | **2,000** | **2,000** | **-** | **4,000** | **2.4%** | **-** |

*Source:* Consultant's calculation in line with the Law on State Budget.

173. The above data show that, for 2008-2011, the net revenues/funds available to HCMC account for only 26.8 percent of the gross revenues earned by HCMC, reflecting the fact that HCMC has been the biggest contributor to the national budget, as some 73.2 percent of the gross revenues earned by HCMC have been transferred to the Central Budget.

**Figure A3.12: The composition of net budget revenue sources in HCM in period 2008-2**




*Source:* Consultant estimate based on approved investment plans

40 The domestic revenue for local budget could be calculated based on the principle stipulated in the State Budget Law that the total local budget revenue is equal to the total local budget Expenditure (i.e., no budget deficit at local level).

174. In terms of revenue composition, in the 2008-2011 period, the domestic revenues for local budget (consisting of the share revenue entitled to HCMC, the land-related revenue, lottery and others) account for 97.3 percent, and the grant and borrowings just account for 11.4 percent of the HCMC's net revenues, as illustrated in Figure A3.12.

175. In terms of sustainability, HCMC is among the few provinces which are able to balance the annual budget revenues/expenditures itself without relying on Central Budget's additional transfers. In terms of growth, during the period of 2005-2011, the province's net budget revenues and domestic revenues experienced a good compound average growth rate (CAGR) of 14.56 percent pa and 18.3 percent pa, respectively. In particular, the shared revenues and the land-related revenues achieved a fairly solid CAGR of 21.4 percent pa and 24.2 percent pa, respectively, reflecting the high efforts paid by the local government for revenue collection in general and the success of local government in mobilizing land resources for increased provincial budget revenues.

176. HCMC is considered the leading and most successful province in diversifying capital mobilization for development investment in general and for infrastructure development in particular. The proportion of the State Budget expenditure in the total expenditures of social development has been decreasing (average level of 12.3 percent over five years during the period 2006-2010), while the total expenditure of the society is increasing. The sources from other investors utilizing BOT, BT, BTO and BOO have made significant contributions to the technical and social infrastructure sectors in HCMC.

177. In recent years, despite that the HCMC budget revenues experienced a high growth, the HCMC net revenues/funds available are insufficient to meet the increasing demand for infrastructure development due to the fact that the revenue share percentage eligible to HCMC has been in a decreasing trend (i.e., down from 29 percent in 2006 to 26 percent for the period of 2007-2010 and to 23 percent for the period 2011-2015). Thus, the city has had to switch capital mobilization for municipal infrastructure to other sources -- by way of land use right auctions, issuing municipal bonds, short-term borrowings from the State Treasury, piloting diversified investment models, etc., -- in order to meet the increasing demand for repair, maintenance, upgrading and construction of urban infrastructure facilities in HCMC.

### 3.2.2. Quang Ninh province

178. As noted in Section 3.2.1 above, the current State Budget reporting system does not require provinces and the budget levels to break down resources for the infrastructure sector in general and the municipal infrastructure sub-sector in particular. Thus, like the case of HCMC, the revenue sources for socio-economic development in general and municipal infrastructure development in particular of Quang Ninh province are combined together as to constitute the general revenue sources of the local budget, including transfers from the central budget (inclusive of government bonds), local revenue sources, short-term borrowings from the State Treasury, private investments, ODA sources and the non-governmental aids from international NGOs.

179. During the period 2007-2011, the total gross state budget revenue of Quang Ninh has grown strongly, reaching VND 119,171 billion, which is broken down for each year by revenue sources in the Table A3.7 below. It is recorded that the local State Budget revenue in 2011 had

reached VND 33,079 billion, 2.8 times higher than for the 2007 figure, and the ratio of the State Budget Revenue over the provincial GDP for the period 2007-2011 attaining nearly 61.0% proved that Quang Ninh province was one of leading provinces in mobilizing State Budget Revenue in the whole country.

**Table A3.7. Gross Total State Budget Revenue Sources in Quang Ninh during the period of 2007-2011**

Unit: Billion VND

| No | Item | 2007 | 2008 | 2009 | 2010 | 2011 (Est.) | CAGR |
|---|---|---|---|---|---|---|---|
| | **TOTAL (1+2)** | **13,176** | **18,269** | **22,929** | **27,399** | **37,398** | **30%** |
| 1. | Local State Budget Revenues (1.1+1.2) | **11,835** | **16,614** | **20,906** | **24,814** | **33,079** | *29%* |
| 1.1 | Local State Budget Balancing Revenues: | 11,519 | 15,812 | 19,940 | 24,127 | 32,223 | |
| | + Domestic revenues | 3,817 | 4,028 | 5,443 | 9,785 | 13,770 | *38%* |
| | + Export, import taxes | 6,286 | 10,491 | 12,802 | 12,300 | 15,218 | *25%* |
| | + Balance of the last budget year | 138 | 329 | 201 | 295 | 323 | |
| | + Budget brought forward from the previous fiscal year | 1,268 | 964 | 1,153 | 1,227 | 2,592 | |
| | + Borrowings for irrigation canal reinforcement program | 10 | - | - | - | | |
| | + Borrowing for infrastructure development | - | - | 340 | 520 | 320 | |
| 1.2. | + Other revenues left for the spending unit to manage | 316 | 802 | 966 | 687 | 856 | |
| 2. | Other revenues (2.1+2.2+2.3) | 1,341 | 1,654 | 2,023 | 2,856 | 4,318 | |
| 2.1 | Additional transfers from Center Budget | 1,341 | 1,642 | 2,023 | 2,586 | 4,315 | *34%* |
| 2.2 | Transfers from lower-level budget | - | 2 | - | - | 3 | |
| 2.3 | Bills – Bonds provided by Central Budget | - | 10 | - | - | - | |

*Source:* Statistical Yearbook of Quang Ninh Province 1955-2011.

180. By taking out all the revenues belonging to and/or shared with the central budget from the Table A3.7 above, there remains the net budget revenue sources of Quang Ninh province, which are as calculated[41] by the Consultant Team, in Table A3.8 below.

41 The domestic revenue for local budget could be calculated based on the principle stipulated in the State Budget Law that the total local budget revenue is equal to the total local budget Expenditure (i.e., no budget deficit at local level).

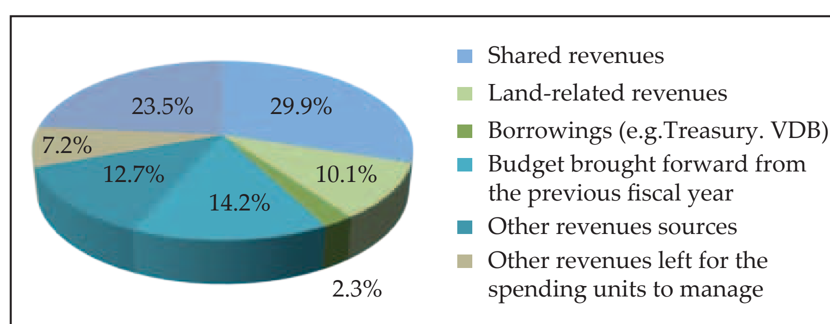
### TableA3.8. Net budget revenue sources of Quang Ninh during the period of 2007-2011

Unit: Billion VND

| No | Item | 2007 | 2008 | 2009 | 2010 | 2011 (Est.) | Total | As a % of the total | CAGR (%) |
|---|---|---|---|---|---|---|---|---|---|
| | TOTAL (A+B+C+D) | 5,914 | 6,814 | 8,951 | 13,256 | 15,729 | 50,665 | 100 | 27.7 |
| **A.** | **Balancing Local State Budget Revenues (1+2+...+5)** | **4,257** | **4,367** | **5,962** | **9,984** | **10,554** | **35,125** | **69.3** | **25.5** |
| 1. | Domestic revenues for local budget | 2,842 | 3,074 | 4,268 | 7,941 | 7,320 | 25,444 | *50.2* | |
| 2. | Balance of the last budget year | 138 | 329 | 201 | 295 | 323 | 1,286 | *2.5* | |
| 3. | Budget brought forward from the previous fiscal year | 1,268 | 964 | 1,153 | 1,227 | 2,592 | 7,204 | *14.2* | |
| 4. | Borrowings for irrigation canal reinforcement program | 10 | | | | | 10 | - | |
| 5. | Mobilisation under Article 8.3 of Law on State Budget | | | 340 | 520 | 320 | 1,180 | *2.3* | |
| **B.** | **Other revenues left for the spending unit to manage** | **316** | **802** | **966** | **687** | **856** | **3,627** | **7.2** | **28.3** |
| **C.** | **Additional transfers from Central Budget** | **1,341** | **1,642** | **2,023** | **2,586** | **4,315** | **11,907** | **23.5** | **33.9** |
| **D.** | **Transfers from lower-level budget** | | **2** | | | **3** | **5** | - | |

*Source:* The Consultant Team's calculation.

### Figure A3.13. The composition of net budget revenue sources in Quang Ninh in period 2007-2011




*Source:* The Consultant Team's calculation.

181. The above data show that while the net revenues/funds available to the Quang Ninh province experienced a high CAGR of 27.7 percent during the period 2007-2011 they just account for 42.5 percent of the total gross revenues in Quang Ninh province for the same period.

182. In terms of revenue composition, in the period 2007-2011, the domestic revenues for local budget account for 50.2 percent, of which two key items of the domestic revenues are the shared revenue and the land-related revenues, account for 29.9 percent and 10.1 percent, respectively, of the province's net revenues. The additional transfers from the Central Budget and the budget brought forward from the previous fiscal year account for 23.5 percent and 14.2 percent, respectively, of the province's net revenues. Figure A3.13 presents the composition of net budget revenue sources in Quang Ninh province in the period 2007-2011.

### 3.2.3. Quang Nam province

183. As mentioned above, the current State Budget reporting system does not require provinces and the budget levels to break down resources for the infrastructure sector in general and the municipal infrastructure sub-sector in particular. Thus, like the case of HCMC and Quang Ninh province, the revenue sources for socio-economic development in general and municipal infrastructure development in particular of Quang Nam province are combined together as to constitute the general revenue sources of the local budget.

184. During the period 2007-2011, the gross state budget revenues of Quang Nam province increased strongly from VND 4,906 billion to VND 14,103 billion representing CAGR of 30.2 percent *per annum*. Table A3.9 shows the province's detailed revenues for each year from 2007 to 2011 and the revenues items with the highest growth were import/export tax (54.8 percent pa), domestic revenues (37.2 percent pa) and budget brought forward from the previous fiscal year (38.4 percent pa).

**Table A3.9. Gross State Budget Revenues of Quang Nam during the period of 2007-2011**

Unit: Billion VND

| No | Items | 2007 | 2008 | 2009 | 2010 | 2011 (est.) | Total | CAGR |
|---|---|---|---|---|---|---|---|---|
| | **Total State Budget Revenues** | **4,906** | **6,133** | **7,936** | **11,135** | **14,103** | **44,213** | **30.2%** |
| 1. | Local State Budget Revenues | 1,571 | 2,084 | 2,816 | 5,055 | 6,300 | 17,826 | 41.5% |
| 1.1 | Domestic revenues | 1,240 | 1,633 | 2,261 | 3,270 | 4,400 | 12,804 | 37.2% |
| 1.2 | Export, import taxes | 331 | 451 | 555 | 1,784 | 1,900 | 5,021 | 54.8% |
| 2. | Borrowings for infrastructure construction | 25 | 30 | 80 | 40 | 40 | 215 | 12.5% |
| 3. | Additional transfer from higher-level budget | 2,348 | 2,715 | 3,210 | 3,565 | 4,530 | 16,368 | 17.9% |
| 4. | Balance of the last budget year | 81 | 108 | 78 | 147 | - | 414 | |
| 5. | Budget brought forward from the previous fiscal year | 881 | 1,197 | 1,751 | 2,329 | 3,233 | 6,391 | 38.4% |

*Source:* Statistics Year Book of Quang Nam Province 2011, Quang Nam Statistical Office.

185. It would be noted that the above gross revenues also include some revenues entitled to/to be shared with the central budget. Thus, by netting all the revenues entitled to the central budget from Table A3.9 above, one arrives at the net budget revenues which would actually be received by Quang Nam province. By the Consultant Team's calculation, such net budget revenues of Quang Nam province during the period 2007-2011 are shown in Table A3.10.

**Table A3.10. Net budget revenues of Quang Nam during the period of 2007-2011**

Unit: Billion VND

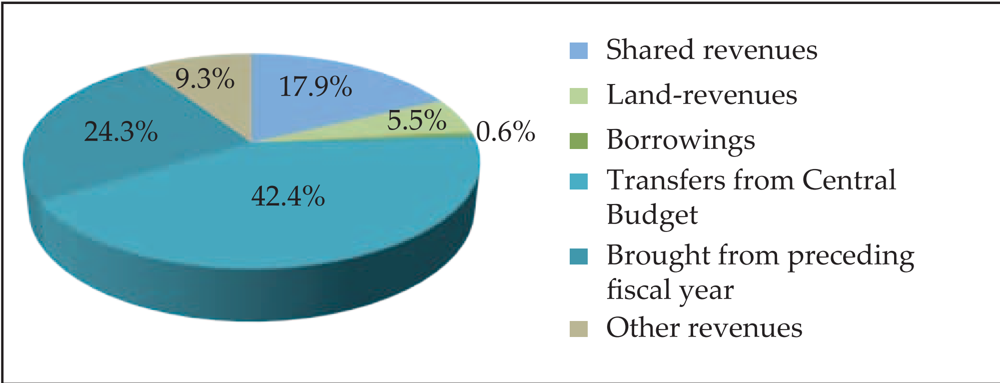
| No | Item | 2007 | 2008 | 2009 | 2010 | 2011 (Est.) | Total | As a % of the total | CAGR (%) |
|---|---|---|---|---|---|---|---|---|---|
| | TOTAL (A+B+C+D+E) | 4,460 | 5,596 | 7,199 | 9,148 | 12,195 | 38,598 | 100 | 28.6 |
| **A.** | **Domestic revenues for local budget (1+…+4)** | **1,125** | **1,547** | **2,079** | **3,067** | **4,392** | **12,210** | **31.6** | **40.6** |
| 1. | Shared revenues entitled to province | 391 | 643 | 1,059 | 1,773 | 3,060 | 6,925 | *17.9* | 67.3 |
| 2. | Land revenues | 265 | 342 | 344 | 511 | 661 | 2,123 | *5.5* | *25.7* |
| 3. | Revenues left for the spending unit to manage | 268 | 326 | 380 | 500 | 400 | 1,874 | *4.9* | *10.5* |
| 4. | Other revenues | 202 | 236 | 296 | 283 | 271 | 1,288 | *3.3* | *7.6* |
| **B.** | **Borrowings for infrastructure development** | **25** | **30** | **80** | **40** | **40** | **215** | **0.6** | **12.5** |
| **C.** | **Additional transfers from Central Budget** | **2,348** | **2,715** | **3,210** | **3,565** | **4,530** | **16,368** | **42.4** | **17.9** |
| **D.** | **Balance of the last budget year** | **81** | **108** | **78** | **147** | **-** | **414** | **1.1** | **-** |
| **E.** | **Budget brought forward from the previous fiscal year** | **881** | **1,197** | **1,751** | **2,329** | **3,233** | **9,390** | **24.3** | **38.4** |

*Source:* Consultant's calculation in line with the Law on State Budget.

186. The above figures show that the net revenues/funds available to the Quang Nam province account for 87.3 percent of the gross budget revenues in Quang Nam province for the same period, reflecting the fact that Quang Nam is among the provinces which have a limited contribution to the country budget. The domestic revenues for local budget account for 31.6 percent and the additional transfers from Central Budget account for 42.4 percent of the province's net revenues for the period of 2007-2011. These imply that the domestic revenues are insufficient to meet all the province's spending requirements and Quang Nam province has been substantially relying upon the fund transfer from the central budget (though such fund transfer decreased from 52.3 percent of the province's net revenues in 2007 to 37.1 percent in 2011). It is also seen that the budget brought forward from the previous fiscal year accounts for 24.3 percent of the province's net revenues in the period 2007-2011, reflecting the fact that the province has not been able to absorb/disburse all available funds in the intended fiscal year. In terms of growth, during the period of 2007-2011, the province's net budget revenues in general and the domestic revenues in particular experienced high compound average growth rates (CAGR) of 28.6 percent pa and 40.6 percent pa, respectively; the shared revenues in particular achieved an impressive CAGR of 67.3 percent, reflecting the revenue collection success of the local government during that period.

187. In terms of revenue composition, in the 2007-2011 period, the major revenue sources included: (a) the additional transfers from the Central Budget, accounting for 42.4 percent of the net revenues; (b) the domestic revenues for the local budget, accounting for 31.6 percent of the net revenues; and (c) the budget brought forward from the previous fiscal year, accounting for 24.3 percent of the net revenues. Such a high level of additional transfers from the central budget indicates that the Quang Nam budget still relies on the support of the central budget. In the domestic revenues, the shared revenues and the land-related revenues account for 17.9 percent and 5.5 percent, respectively, of the province's net revenues. The low percentage of land-related revenues reflects the underdeveloped nature of the Quang Nam land market. Figure A3.14 presents the composition of net budget revenue sources in Quang Nam province in the period 2007-2011.

**Figure A3.14. The composition of net budget revenues in Quang Nam during the period of 2007-2011**




*Source*: Consultant estimate based on approved investment plans

## 3.3. The financing instruments for municipal infrastructure development in three selected provinces

188. Table A3.11 presents the current status of the financing instruments for municipal infrastructure development in each of three provinces.

**Table A3.11. Summarized financing instruments for municipal infrastructure development in three selected provinces**

| No. | Financing instruments | HCMC | Quang Ninh province | Quang Nam province |
|---|---|---|---|---|
| 1. | Bank loans/borrowings<br>(i.e. bank debt market) | HCMC has not had bank borrowings so far; expect some short-term borrowings from State Treasury. This notwithstanding, HIFU/HFIC (an arms-length entity of the HCMC local government) has borrowed some through commercial loans, guaranteed by the Government, from foreign banks such as Credit Agricole Corporate & Investment Bank Vietnam and Societé Generale Bank for financing municipal infrastructure in HCMC. | Quang Ninh has not had bank borrowings so far; expect some short-term borrowings from State Treasury. | Quang Nam has not had bank borrowings so far; expect some short-term borrowings from State Treasury. |
| 2. | Debt capital market (i.e. local government bonds) | Being the first local government that issued municipal bonds in the country, during the 2003-2007 period HCMC had successfully completed its municipal bond issuance plan totaling VND 10,000 billion (VND 2,000 billion each year). The outstanding balance of HCMC's local government bonds (LGB) as of 31 December 2012 was approx. VND 7,069 billion. As an arms-length body of HCMC, HIFU used to be an authorized entity which issues such LGB on behalf of HCMC. | N/A. However, as reported, Quang Ninh is now in the preparation process aiming to LGB by late 2013. | N/A |

| No. | Financing instruments | HCMC | Quang Ninh province | Quang Nam province |
|---|---|---|---|---|
| 3. | ‘Land for infrastructure” | HCMC has sound experience in developing and implementing BOT/BT projects, with tens of projects already implemented or in the pipeline. BOT/BT structure is considered an effective tool for raising money for financing local municipal infrastructure projects while the budget sources are limited. | Quang Ninh province has not been involved in any BTO/BT project. However, during the period of 1998 – 2002, Quang Ninh had approved nine projects using land resources with a total value of VND 656.2 billion, of which, eights projects were in Ha Long City area and one project was in Van Don district. | Quang Nam province has implemented only one BT project so far, in which the local government pays investors in cash.<br>Also, in the previous years, Quang Nam province had attempted to implement some projects under “land-for-infrastructure” mechanisms. However, most of the projects failed to meet the implementation schedule and some projects even had to return the allocated land (for example the Cua Dai bridge). |
| 4. | Local Development Investment Funds (LDIFs) | HCMC is the first local government in Vietnam to set up an LDIF (i.e., HIFU, established in1996, which is a typical success story for this type of instrument). HIFU was known as a sound LDIF model in terms of internal process, sub-project appraisal, protection of social security and the environment, and cooperation with the private sector. With a strategic focus on municipal infrastructure finance and aiming to be a more effective financing vehicle, HIFU has been recently restructured into HFIC. | N/A. This instrument is still absent. | Established in 2009, QNIF has invested in 24 projects in various sectors such as transport, water supply and drainage, health care, education, infrastructure of residential and urban areas, industrial parks and clusters, etc., with total investment capital over VND383.5 billion. |

| No. | Financing instruments | HCMC | Quang Ninh province | Quang Nam province |
|---|---|---|---|---|
| 5. | Other financing instruments (e.g., collateral/ recourse mechanisms, guarantees, pooled financing, etc.) | HFIC/HIFU has had commercial loans backed by Government guarantee, as mentioned above. | N/A | N/A |
| 5.1 | VDB | According to a report of VDB, in the period of 2005-2012, VDB has provided 18 credit facilities totaling VND 3,362 billion for financing some municipal infrastructure projects in HCMC and now the outstanding loan balance is VND 1,336 billion. | As reported by VDB, in the 1999-2012 period VDB granted credit facilities totaling VND 620.4 billion to five municipal infrastructure projects in the Quang Ninh area. | As reported by VDB, in the period 1998-2010, VDB granted credit facilities of VND 68 billion and USD 3.78 million to three municipal infrastructure projects in Quang Nam province. |
| 5.2 | PPPs | There is one pilot PPP project in the transport sector, implemented in the HCMC area i.e the Dau Giay – Phan Thiet Expressway. For management and implementation of this pilot project in the form of PPP, the Prime Minister has issued a specific mechanism in favour of this project where some incentives such as costs for ground clearance, resettlement, and removal of utility facilities from project premise, bomb and mine disarming are funded by state budget. | N/A | N/A |
| 5.3 | Municipal Development Fund at the central level | N/A | N/A | N/A |

189. Observations:

- The level of using financing instruments for municipal infrastructure development varies substantially from province to province, where HCMC has been the most successful local government in using such financing instruments.. Most importantly, some financial instruments such as the recourse mechanisms and the municipal development fund do not exist in the Vietnam context.
- User charges: Although the user tariffs (e.g., water tariffs, environmental protection charges for wastewater, solid waste disposal charges) have been applied elsewhere in municipalities in Vietnam, in many cases such charges just cover O&M rather than achieving full cost recovery.
- Property taxes/charges: According to the public information of MOF, the land-based revenues of the state budget in 2010 are around VND 52,870 billion, accounting for around 10 percent of the total state budget revenue (or 2.4 percent of 2010 GDP), and they include: VND 1,360 billion of land tax, VND 48,522 billion of land use right fee, and VND 2,988 billion of land rental.[42] Although some property-related charges exist in Vietnam, a comprehensive law on property tax is still absent; MOF has recently started some initiatives for its design. This type of charge is an important instrument for municipal development.
- In practice, the "land-for-infrastructure" mechanism does not always work well in Vietnam. While some success stories could be found in some geographic locations, many bad experiences are also apparent especially when there is a downturn in the real estate market resulting in fallen land prices.

**Box A3.1. The Nam Cuong Group returned the infrastructure project**

Building a north-south arterial road in former Ha Tay province, now merged to Hanoi, was one of the projects do be done by Nam Cuong Group as an infrastructure developer.

Nam Cuong stepped into the project in 2007 when the property market was vibrant. The project involves building a 63.3 km long, 42-metre wide road at an estimated cost of VND7,694 billion ($370 million). In exchange, Nam Cuong was given 10,000 hectares along the road by the former Ha Tay provincial People's Committee to develop four urban areas.

Nam Cuong reportedly has pumped over VND1 trillion ($48 million) into site clearance, compensation and building an overpass crossing Thang Long Avenue. The project then incurred delays as it had to wait for results from authorities' reviewing planned construction projects in Hanoi areas and for the approval of Hanoi's expanded master planning.

In mid-2012, Nam Cuong Group returned the above project to Hanoi authorities, while how the road will be built further remains unclear.

However, other developers believe that, one of the key reasons causing the return of project by Nam Cuong Group is the recent downturn in real estate market.

Source: www.vietnamnet.vn

42 Evaluation of current local government infrastructure financing practice and In-depth studies in Ho Chi Minh City, Quang Nam and Quang Ninh provinces under AAA P130039 (TF012686), Inception Report, November 2012.

### 3.4. Specific recommendations

190. The overall specific recommendation following the Consultant Team review is that the legal framework should be modified in order to further support the government's direction towards decentralization.

191. The recent in-depth analysis in the three selected provincial areas and the review of the overall framework for infrastructure financing in Vietnam indicate that in order to enable provinces to be able to increase local resources for municipal infrastructure finance there is a need to arrange a number of interventions/changes for improving the current framework for infrastructure finance and investment planning and appraisal as detailed in Table A3.12 below.

**Table A3.12. Recommended interventions at the national and local levels**

| No. | Areas of intervention | At national level | At local level |
|---|---|---|---|
| 1. | Incentives for increasing local revenues and extending financial autonomy | • To increase the budget share proportion in favor of the provincial areas (such as HCMC and Quang Ninh province) having substantial budget contributions in the next budget stabilization period commencing from 2015.<br>• To improve capital mobilization by the local governments (e.g., based on the repayment capability of the local governments)<br>• To allow some large provinces/cities such as HCMC to apply extended public finance autonomy with less control from the central government.<br>• To regulate a reward mechanism for revenue increase of the provinces/cities (e.g., HCMC) in case there is an increase in the revenue from central budget in comparison with budget estimates assigned by the Prime Minister. | • Making incentives for mitigating water supply losses and collecting user charges on waste water.<br>• Developing a roadmap for full cost recovery of the key municipal public services (water supply, waste water treatment, solid waste disposal etc) |
| 2. | Improving "land for infrastructure" schemes for increasing land resources utilization | • There is a need to amend the Land Law, to allow the recovery of the land in the surrounding areas of infrastructure works to be built.<br>• In addition, there is a need to have a decree promulgating the regulations on management, utilization and mobilization of assets of road transportation infrastructure to provide legal foundation for localities to mobilize revenue from land for local transport infrastructure development | • To review and arrange available land resources to create a "clean" land fund to support resettlement and ground clearance to attract more investment in infrastructure in the form of BT.<br>• For widening road and improving urban areas, despite different opinions, it is worthwhile to consider land recovery of both sides of roads to generate financial resources for road construction. |

| No. | Areas of intervention | At national level | At local level |
|---|---|---|---|
| | | | • For provinces having more opportunities for BT/BOT/BTO projects, but having limited experiences, there is a need for their local line agencies to develop more capacity for implementing and managing BT/BOT/BTO projects. |
| 3. | Improving credit worthiness and forming hedging instrument | • To study the application of credit rating for infrastructure financing institutions across the country to better support capital mobilization.<br>• To study the regulations and application of derivative products to hedge exchange risks | |
| 4. | Improving regulations for local government bond as a financial instrument for infrastructure development | • To get localities more active in issuing local government bonds, it is necessary to adjust current regulations (i.e., The Law on Public Debt Management and Decree No.01/2011/ND-CP, dated 05 November 2011, of the Government, on the issuance of Government bonds, bonds guaranteed by the Government and local Government bonds ("**Decree No.01**")) towards simplification of procedures and improvement in awareness of localities regarding issuing these bonds. In particular, the requirement that MOF appraisal and approval in writing is required for any proposal for issuing local government bonds is contrary to the decentralization trend in favor of local governments, and would limit the autonomy and accountability of provinces as the sources for bond principal and interest repayment come from the provincial budget. Therefore, this requirement is unnecessary and needs to be removed.<br>• It would be more cost effective for small provinces to have local government bond issuance jointly with other provinces. Such a joint bond issuance option would require a new legal framework, as the current regulations have no stipulations for such option. | For provinces with less experience, there is a need for them to improve the bond issuance capacity at the relevant agencies. |

| No. | Areas of intervention | At national level | At local level |
|---|---|---|---|
| 5. | Improving local revenues sustainability | • Improving the national policies on investment and the business environment.<br>• Strengthening the administrative reform, | Improving investment and the business environment, strengthening competitiveness of enterprises, promoting administrative reform, enhancing mobilization of investment capital from all economic sectors for the stable and sustainable growth of revenues of local budget |
| 6. | Improving efficiency for budget resources usage | • Improving budget preparation and allocation procedures.<br>• Improving the public investment appraisal and approval procedures as to achieve "high value for money" for public investment. | • Strengthening budget management capacity, amending, supplementing, disclosing and making transparent criteria for annual state budget allocation and using public expenditure norms and a medium-term expenditure framework (MTEF) approach.<br>• To further review and restructure the state budget use plan for improving the public investment quality to avoid scattered investment problems; to stop or adjust projects that are not urgent so as to fit better with available resources and to enhance the use, management and control of state budget investment sources to avoid their loss and waste. |
| 7. | Improving provincial investment/planning capacity | To allow some provinces having specific conditions (e.g., HCMC) to apply increased investment/planning discretions. | • To improve the investment project appraisal skills and the transparency of public procurement procedures so as to screen and select well qualified contractors for project implementation. At the same time, to improve guidance, inspection, monitoring activities on capital investment, especially implementing policies, regulations, master planning and investment planning and inspection. |

| No. | Areas of intervention | At national level | At local level |
|---|---|---|---|
| | | | • To improve the coordination and linkages between the line agencies in the planning process to ensure that the local municipal infrastructure development planning is based on the actual resources rather than reflecting expectations of the local line agencies. In reality, sector development plans must be based on the available resources and fit into the master plan of the whole province for periods of 10-15 years. |
| 8. | Removing barriers for private investment | Improving/developing the country framework to better support private participation in municipal infrastructure. | To study and set up mechanisms and policies to allow private sector to invest in public services such as: public infrastructure operation leasing, term transfer of transport infrastructure, allowing private organizations/ individuals to operate services along project roads (petrol stations, bus-stops/ restaurants, advertisements etc.) |
| 9. | PPP framework improvement | Necessary steps should be taken to issue a specialized PPP Law to create a full legal framework as a legal basis for the private sector to engage in PPP projects | For promoting PPP projects, local government needs to have an incentive policy in favor of investors such as to share their burden of costs for land clearance and compensation and/or to provide a part of the initial investment costs. |
| 10. | Improvement of ODA management and utilization efficiency | To improve regulations promulgating ODA management and utilization to: (a) form the national comprehensive framework on public investment and (b) streamline the procedures of Vietnam and the sponsors. | • To develop capacity of officers in ODA management and utilization at all levels, especially at the basic level;<br>• To enhance monitoring and assessment of ODA programs and projects; and<br>• To involve beneficiaries in the process of receiving and using ODA to improve ODA efficiency. |

| No. | Areas of intervention | At national level | At local level |
|---|---|---|---|
| 11. | Strengthening the role of LDIFs and improving legal framework for LDIFs | To facilitate LDIFs to widen activities, it is necessary to review and adjust Decree No. 138/2007/ND-CP dated 23/08/2007 on establishment and organization of local development investment funds - LDIFs ("**Decree No. 138"**) to improve and simplify organizational structure, operational procedures and supplement the list of infrastructure sectors. | Practices in other provinces especially in HCMC show that the infrastructure financing vehicle is a very effective instrument for project screening, appraisal and selection as well as for raising money and for making financial arrangement for development of infrastructure projects. This vehicle is also a channel for mobilizing ODAs for infrastructure and especially helps to improve the province capacity in infrastructure financing. Therefore for provinces that have yet to set up LDIF (e.g., Quang Ninh province) it is worthwhile for them to consider the establishment of such vehicle so as to better support the infrastructure sector development. |
| 12. | Introducing the new financing instruments for municipal infrastructure development:<br>• Municipal Development Fund (MDF);<br>• Recourse mechanisms | There is a need of amendment of the State Budget Law and the Decree 60/2003/ND-CP which allows to apply the recourse mechanisms.<br><br>There is a need to set up the Municipal Development Funds as a channel providing long-term loans to local government for financing municipal infrastructure projects. | The recourse mechanisms are to be piloted at selected local governments, then it could be applied by other local governments.<br><br>The same concept could be applied for local governments to obtain long-term loans from MDF for financing infrastructure development projects. |

## 4. Assessment of the regulatory changes needed in order to implement the financing mechanisms identified by the joint MOF-WB team

192. In line with the ToR, this section aims to provide the assessment of the Consultant Team on the necessary changes of the Vietnam's prevailing legislations so that the financing mechanism identified by the joint MOF-WB Team in their previous studies (i.e., Synthesis Report ("SR") and International Experiences Assessment Report ("IEAR")) could be implemented either at the national level or local level in Vietnam.

### 4.1. Municipal Development Fund (MDF)

193. It is seen that municipal development funds (MDF) are the first international model of the financing mechanisms, which are as identified in the IEAR either the public funding intermediaries in Tunisia or the market-oriented financial intermediaries in Colombia and the Czech Republic.
194. The Table A3.13 presents the main features of those municipal development funds, as described in the IEAR, the assessment of the Consultant Team on their possible application in Vietnam's context, and the necessary regulatory changes required for such application at both the national and local level.

**Table A3.13: Assessment of Municipal Development Funds identified in the IEAR**

| Type of MDF | Main features[1] | Assessment of the Consultant Team | |
|---|---|---|---|
| | | At national level | At local level |
| The Tunisian MDF - Caisse de Prest et aux Collectivities Locales or "CPSCL") | • It is a wholly public institution which is to provide financing only to the local authority through loans and government subsidiaries as part of the Tunisian state's five-year development plan.<br>• To provide financing at below-market rates, often combining subsidized loans with grants.<br>• CPSCL is not a bank, thus it is not subject to Tunisian banking regulations.<br>CPSCL has been considering changing its status to a wholly state-owned limited liability company in order to have greater autonomy in its daily operation and have broader client base. | • It is seen that the Vietnam Development Bank (VDB)[2] does provide development investment credits (i.e., soft loans) to the local governments (i.e., PPCs) pursuant to a decision of the Prime Minister.[3] In this regard, it is noted that according to Decree No.75/2011/ND-CP dated 30/08/2011 of the Government on the development investment credit and export credit of the state ("**Decree No.75**"), the borrowers are investors having the investment projects belonging to the list of eligible projects promulgated in attachment to Decree No.75 and the investors are as defined in Point (a) of Article 1.2 including the enterprises; the economic entities and the state entities having income/revenue. In the view of the Consultant Team, the local governments (i.e., PPCs) are not eligible borrowers even in the case it is covered by a decision of the Prime Minister.<br>• Thus, to make the model of CPSCL somehow workable in Vietnam, it is necessary to have the regulatory changes in either one or two following alternatives: *(a) amend Decree No.75 so that the local governments (i.e., PPCs) are also defined as one of the eligible investors. However, under this alternative, there is a difference in comparison to CPSCL, as VDB is a bank (though operating on a non-profitable basis); and (b) have new legislation, which could be in the form of a decree or decision of the Prime Minister, creating a legal base for establishment of a municipal development fund at* | |

| Type of MDF | Main features[1] | Assessment of the Consultant Team | |
|---|---|---|---|
| | | At national level | At local level |
| | | *the national level, which has a function to provide loans/credits to the local authorities.* In this regard, in the view of the Consultant Team, the first alternative seems to be more easily implemented within Vietnam's current context. However, the second alternative could better meet the capital need for the municipal infrastructure development in urban areas of Vietnam. | At present, there is no similar public fund in Vietnam that provides subsidized loans to the local authorities. |
| The Colombia Municipal Development Fund – FINDETER (*Financiera de Desarrollo Territorial)* | • It is a local government development finance company, which is 90 percent owned by the Republic of Colombia and 10 percent by Colombia's local governments.<br>• FINDETER gets the funding from the government as well as from donor support (e.g., loans).<br>• FINDETER acts as a second-tier lender, encouraging first tier lenders (commercial banks) to enter into direct relationship with local entities being local government or corporatized entities under a control of a local government.<br>• FINDETER lends to a commercial bank all or part of the loan provided to sub-national entities at a discounted rate. The commercial bank is responsible for servicing the loan and fully absorbs the credit risks. | • It is noted by the Consultant Team that the State Bank of Vietnam (SBV) has a similar role in re-financing credit institutions. However, there are several differences, such as: (a) SBV has a role of a central bank while FINDETER is a financial company; (b) once being refinanced or given on-lending loans[4] by the SBV, the credit institutions do often lend money to enterprises, including those belonging to the ownership of the local government (i.e., PPCs).<br>• In addition, there is also a need to have a by-law (e.g., in the form a decree or decision of the Prime Minister)[5] which can either regulate or create a legal base for the establishment and operation of a municipal development fund at the national level in a model similar to FINDETER.<br>• In the view of the Consultant Team, the MDF which is in the form like FINDETER, seems to be a good model of financing instrument for Vietnam to follow. | • According to the Law on Public Debt Management (*i.e., Article 38.1*), for domestic borrowings, local governments are allowed to borrow money from the legitimate financing sources (e.g., commercial banks) for social-economic development in accordance with the Law on State Budget (*i.e., Article 8.3*).<br>• However, practically there is not any local government in Vietnam in general and in the three selected provinces in particular, which have managed to get borrowing so far from commercial banks due to |

| Type of MDF | Main features[1] | Assessment of the Consultant Team | |
|---|---|---|---|
| | | At national level | At local level |
| | • The commercial bank conducts the loan appraisal based on FINDETER's credit evaluation guidelines.<br>• The commercial banks' loan to local government is mostly secured by constitutionally mandated transfers from the central government.<br>• FINDETER has succeeded in establishing itself as a viable financial institution. | The expected operations of this MDF type:<br>• A municipality applies for a loan to a commercial bank;<br>The commercial bank conducts the loan appraisal based on MDF's credit evaluation guidelines and if this assessment is satisfactory, it lends directly to the municipality. Such loan is secured by a recourse mechanism. The commercial bank is responsible for servicing the loan and fully absorbs the credit risk;<br>• MDF lends all or part of the loan provided to the sub-national entity at a discounted rate.<br>Local governments would welcome this type of MDF as it provides an additional channel for local governments to finance its infrastructure. However there are still some concerns for the recourse mechanism as: (a) the local debt management capacity is still limited; and (b) such a mechanism seems to not work under the existing Law on State Budget --a revised Law on State Budget/other regulations would be needed for this mechanism to be workable. | a lack of a clear recourse mechanism[6] in the laws (e.g. the Law on State Budget and/or the by-laws[7]), which allows the commercial bank to secure their loan given to local governments through a mechanism where the local government has to set up a special account opened at a commercial bank for receiving the budget revenue (e.g. budget transfers from the central government) and the lending commercial bank has a senior right to intercept revenues if loan payments are due (See more details in Annex 1 – Recourse Mechanism as proposed by the Consultant Team). |

| Type of MDF | Main features[1] | Assessment of the Consultant Team | |
|---|---|---|---|
| | | At national level | At local level |
| Municipal Infrastructure Financing Company (MUFIS) – Czech Republic | • MUFIS is owned 49 percent by the MOF, 49 percent by the Czech and Moravian Guarantee and Development Bank and 2 percent by the Union of towns and cities.<br>• MUFIS provides commercial banks with long-term funding at market rates for on-lending to local governments. As the Czech municipal credit market matured, commercial banks began lending from their own resources rather than accessing credit line at MUFIS, Thus, MUFIS stopped making new loans to commercial banks in 2003, 10 years after its creation. | • It is seen that the mode of operation MUFIS is quite similar to FINDETER. There is however, a big difference in that Findeter provide commercial banks with discounted loan while MUFIS provided loans at market rates.<br>• This explains why MUFIS lost the interest of commercial banks and was dissolved after 10 years of operation. Thus, this type of municipal development fund would not be, in a view of the Consultant Team, a good model for Vietnam to follow. | |

*Notes*:

1. More details are provided in the IEAR.
2. Which was established under Decision No.108/2006/QD-TTg of the Prime Minister by reorganizing the previous Development Assistance Fund (DAF)
3. For instance, VDB provides development investment credits to the local authorities for the implementation of the irrigation system reinforcement programs in the period 2009-2015 pursuant to Decision No.13/2009/QD-TTg dated 21 January 2009.
4. SBV does often get some soft loans from some international donors (i.e. JICA) under a signed loan agreement, which will then provide on-lending loans to commercial banks for their lending sub-loans to eligible borrowers (e.g. small & medium enterprises etc..).
5. In this regard, it is noted that there is a new Decree No. 11/2013/ND-CP dated 14/01/2013 on management of urban development investment, which is however silent on establishment and operation of municipal development fund (“Decree No.11”).
6. Currently, the banks are reluctant to finance infrastructure projects because in their view, the recourse mechanism by intercepting the revenues generated from the project seems to be too risky.
7. Decree No.79/2010/ND-CP dated 14 July 2010 of the Government on the management of the public debts (“Decree No.79”) and Decree No.60/2003/ND-CP dated 6 June 2003 of the Government, guiding the Law on State Budget (‘Decree No.60”).

195. Observations: From the above three types of MDF, as a second-tier lender mobilizing funds from the government and donors and lending to commercial banks, FINDIETER appears to be a most relevant for the Vietnam context which could be highly possible to apply in Vietnam.

## 4.2. Pooled financing for small municipalities

196. Pooled financing is the second financing mechanism introduced in the IEAR, where the financing requirements of several municipalities are pooled together in a single debt issuance in order to reduce transactions and borrowing costs. Pooled financing is suitable for smaller municipalities with lower debt requirements and lower creditworthiness.
197. It is noted that while pool financing would be an effective financing instrument for small municipalities, there are still many obstacles for this instrument to be workable in Vietnam, such as: (a) the cooperation of small municipalities has not been tested in Vietnam; (b) there are differences for demand and capacity of the municipalities; and (c) this instrument would require a revised legal framework for implementation.
198. The Table A3.14 below presents the main features of an example of pooled financing in India as described in the IEAR and the assessment of the Consultant Team on their possible application in Vietnam's context and the necessary regulatory changes required for such application.

## 4.3. Credit Enhancement Entities (CEE)

199. Credit enhancement is the third financing mechanism introduced in the IEAR, the objective of which is to mitigate the credit and liquidity risks that are common to local government borrowers. Two models as highlighted in the IEAR are the Philippines' Local Government Unit Guarantee Corporation (LGUGC) and the Indonesia's Infrastructure Guarantee Fund (IIGF), the main features of which are presented in the Table 15 below, together with the assessment of the Consultant Team on their possible application in Vietnam's context and the necessary regulatory changes required for such application.

**Table A3.14. Assessment of Pooled Financing identified in the IEAR**

| Example of pooled financing | Main features[1] | Assessment of the Consultant Team | |
|---|---|---|---|
| | | At the national level | At the local level |
| Tamil Nadu Urban Development Fund (TNUDF) in India | • TNUFD is a public-private partnership, providing long-term finance for infrastructure on a non-guarantee mode. The fund provides loans for revenue generating projects such as toll roads and a mix of loan and grants for basic environment infrastructure. The eligible borrowers are urban local authorities, public undertakings and private investors.<br>• TNUDF mobilizes private capital by facilitating innovative financing schemes, which includes, among others, credit pooling.<br>• TNUDF has received support from various donors, including WB, JICA, USAID and KfW | • The Consultant Team shares the same view as cited in the Synthesis Report that pooled financing provides wider market access for smaller municipalities. Many of Vietnam's provinces, which are small, financially and institutionally weak and having relatively small capacity of repayment, have little prospect of issuing bonds in their own name in the medium and long term. Bond issuance entails high upfront fixed costs and therefore it seems to be not cost effective to issue bonds unless the size of the issue is sufficiently large to make the upfront cost a small portion of the total value of the issued bonds. With bond pooling, the resulting economies of scale reduce the average cost for bond issuance.<br>• However, as there is a lack of legal foundation where the Law on Public Debt Management and the relevant legal documents (e.g., **Decree No. 01**) have no particular provisions for such pooling (i.e., common local government's bond issuance), it is necessary to have a regulatory change by reviewing and amending such legal documents (i.e., Law on Public Debt Management and/ or Decree No.01) so as to create a legal corridor for localities to cooperate in capital mobilization through issuance of common bonds for the purpose investment in municipal infrastructure development in accordance with socio-economic development plan of relevant localities. | • Among three selected provinces: (a) only HCMC has been capable of capital mobilization through issuance of local government bonds[2]; (b) Quang Ninh has not issued any local government bond yet[3]. However, Quang Ninh planned to complete the bond issuance procedures in the fourth quarter of 2013; and (c) Quang Nam seems to have no financial capacity to issue bonds by themselves.<br>• In the view of the Consultant Team, even with the regulatory change as proposed in the left column hereof, the pooled financing could hardly be applied in small provinces (e.g., Quang Nam) without great efforts and constructive cooperation of the related local governments. |

*Notes*:

1. More details are provided in the IEAR.
2. HCMC has issued local government bonds to mobilize capital for budget of the city, with VND 10,000 billion in the period of 2003-2007, and VND 1,540 billion in 2009.
3. The reason as explained by the Quang Ninh authority is that Quang Ninh started to have sound financial resources only since 2009 and the maximum limitation of capital mobilization of 30 percentas stipulated in the Law on the State Budget is fairly small

**Table A3.28. Assessment of Credit Enhancement Entities identified in the IEAR**

| Type of CEE | Main features[1] | Assessment of the Consultant Team | |
|---|---|---|---|
| | | At the national level | At the local level |
| Local Government Unit Guarantee Corporation (LGUGC) in Philippines | • LGUGC was formed as a private financial service corporation, functioned to develop the municipal bond market in Philippines.<br>• LGUGC guarantees the indebtedness of local government units (LGU) and others.<br>• LGUGC guarantee is a straight insurance of the periodic debt service payment.<br>• All LGUGC guarantee policy has involved the assignment of the project revenue, project assets and internal revenue allotments (IRA).<br>• There is a recourse mechanism where the debt service of bond issued by LGU is implemented through government financial institution (GFI) bond trustee which has a right to intercept LGU's revenues and IRA and pay to the LGUGC if the LGU fails to pay debt service. | • It is seen that though such type of Guarantee Corporation has not been existing in Vietnam yet, they could be established under the prevailing laws of Vietnam. For instance, according to the Law on Credit Institutions of 2010, credit institutions (including banks and financial companies[2]) are allowed to provide guarantees to bond issuers, which include local government units (e.g., PPCs or LDIF) and state-owned or private enterprises.<br>• It means that the model of LGUGC is possible in Vietnam from the legal perspective. However, as there is a lack of clear recourse mechanism in the prevailing laws, which allows the guarantor to secure the guarantee payment from the bond issuers being the local governments, to make this model workable in Vietnam, the Consultant Team is of the view that there is a need for having regulatory changes facilitating the recourse mechanism in the laws (e.g. the Law on State Budget) as noted in relation with the model of FINDETER above. | • Out of three selected provinces, there are HCMC and Quang Ninh provinces having established financial institutions being HFIC and QNIF respectively. However neither of them has licensed function to provide guarantee service like LGUGC.<br>• Thus, to enable the LDIFs and HFIC to provide guarantee to its customers, which are corporate entities (but not local government), it is necessary to have appropriate changes to: (a) Decree No. 138 and Decision No.4952/QD-UBND[3]; and (b) Decision No.1700/QD-UBND[4], respectively. |

| Type of CEE | Main features[1] | Assessment of the Consultant Team | |
|---|---|---|---|
| | | At the national level | At the local level |
| Indonesia Infrastructure Guarantee Fund (IIGF) | • IIGF was established by the Indonesian Government with support from WB.<br>• IIGF serves as the government's single window for appraisal and processing/structuring of risk guarantee for PPP projects.<br>• IIGF enters into: (a) guarantee agreement with PPP investor(s) and (b) recourse agreement with CA - Contracting Agency which is the government's representative or partner in the PPP (e.g., ministry or local government). | • It is seen that though such type of guarantee funds have not been existing in Vietnam yet; they could be established under the prevailing laws of Vietnam without a need for having regulatory changes.<br>• However, to make this model of IIGF workable in Vietnam, it is necessary: (a) to have a complete PPP framework (i.e., PPP Law as further assessed by the Consultant Team in Section 4.5 below); and (b) to have a clear recourse mechanism in the related laws as noted above. | • It is the same assessment of the Consultant Team as to the model of LGUGC above. |

*Notes*:

1. More details are provided in the IEAR.

2. According to the Law on Credit Institutions, financial companies can provide banking services, including guarantee service if they are permitted by the SBV.

3. Decision No.4952/QD-UBND dated 05/11/2010 of the PC of HCMC approving the charter on establishment and operation of HFIC.

4. Decision No.1700/QD-UNF dated 26 May 2009 of the People's Committee of Quang Nam province on the establishment and operation of QNIF.

### 4.4. Land-based financing of infrastructure (LBF)

200. Land-based financing of infrastructure is another mode of financing mechanism introduced in the IEAR. There are three models as exampled in the IEAR, which include: (a) Land Leasing in China; (b) sales of land development rights in Brazil; and (c) betterment levies in Colombia. The Table A3.16 below presents the main features of those models as well as the assessment of the Consultant Team on their possible application in Vietnam's context and the necessary regulatory changes required for such application.

**Table A3.29. Assessment of Land-based financing identified in the IEAR**

| Type of LBF | Main features[1] | Assessment of the Consultant Team | |
|---|---|---|---|
| | | At the national level | At the local level |
| Land Leasing in China | • In China, all land is owned by the municipal government.<br>• The purchaser of a land leasing acquires land rights for a period of 40-70 years.<br>• Many cities have financed half or more of their very high urban infrastructure investment levels directly from land leasing.<br>• According to the Chinese laws, from 2002, all land leasing must be conducted through bidding at auction.<br>• An illustration of this model is the construction of the outer ring road encircling the region around Changsha, the capital of Hunan province in Central China where to finance the project, the municipality transferred to a public-private agency, the Ring-Road Investment Corporation leasing rights for strips of land 200-meters wide on the both sides of the highway that was to be built. | • Land based financing has already been used in Vietnam. In this regard as noted in the Assessment Report on three provinces: (a) previously in the period 1999-2004, prior to the effectiveness of the Land Law of 2003, the land-based financing in the form of the 'land for infrastructure' mechanism, was allowed but subject to the approval of the Prime Minister for each project; and (b) from the date of effectiveness of the Land Law of 2003 (i.e., 1st July 2004), the land based financing in the form of a BT project is also allowed under the laws of Vietnam[2], where the use of land funds for creation of investment capital for construction of infrastructure could be implemented in either of the two following forms: (a) Auction of the land use rights to create capital sources in money for direct use for investment in infrastructure construction; and (b) Bidding for construction of works and auction of land use rights for creation of capital for construction of such works in the same bidding packages. | • With regard to HCMC, the application of the land-based financing did provide a large contribution to the infrastructure development where the total land-related revenue in the period 2008-2011 account for 23 percent of the total net budget.[5]<br>• With regard to Quang Ninh province, the total land-related revenue in the period 2007-2011 accounts for a smaller portion with 6.97 percent of the total net revenue sources.[6].<br>• While with regard to Quang Nam province, the total land-related revenue in the period 2007-2011 accounts for a smallest portion (i.e., among three selected provinces) with 5.5 percent of the total net revenue sources.[7] |

| Type of LBF | Main features[1] | Assessment of the Consultant Team | |
|---|---|---|---|
| | | At the national level | At the local level |
| | | • However, as the Land Law of 2003 and its by-laws are silent on the possibilities for the government to withdraw the land strips on the both sides of the roads/highways that is to be built, for the purpose to make the Chinese model workable in Vietnam, it is necessary to have a regulatory change in the current Land Law of 2003 as noted above. In this regard, it is seen that the current draft of the amended land law[3] dated 28/01/2013 which was published to get the comments from Vietnamese people, does already contain a provision (i.e., in Article 60.3), allowing the withdrawal of the land parcels in the surrounding areas of the infrastructure works[4] to be built. | |
| Development Rights in Brazil | • It is an alternative to the sale of land to capture incremental land value generated by public infrastructure projects where public authorities sell development rights, which can be either: (a) the right to convert rural land to urban use and (b) the right to build at greater densities that would be allowed by zoning rules or highest restrictions. | • Though this model seems not to be contrary to the prevailing laws of Vietnam, for making it workable in Vietnam, the Consultant Team is in view that: (a) there is a need of change in the current Land Law of 2003 where the land in the surrounding areas of the infrastructure works could be withdrawn; and (b) detailed guidance in the sub-laws would be required for smooth application. | • This model has not been applied yet in any provinces in Vietnam. |

| Type of LBF | Main features[1] | Assessment of the Consultant Team | |
|---|---|---|---|
| | | At the national level | At the local level |
| Betterment Levies – In Colombia | • Betterment levies are charged directly on the increments in land values created by public works, which could be made at one time and on an upfront basis.<br>• Under this Colombian model, the land parcel within a special planning district for the conversion into urban use authorized by the municipal government could be subject to a betterment levy of 30-50 percent at the municipal discretion. Payment of the betterment levy was due on the realization of the land value gain at the time of sale or development. | • It is noted that the betterment levies are not yet applicable under the prevailing laws of Vietnam (on taxes, fees and levies). | • This model of the Colombia's Betterment Levies, seems to be difficult to apply in a near coming time as the related regulatory changes could hardly be made without a proper justification on the rationale and necessity of its application. |

*Notes*:

1. More details are provided in the IEAR.
2. Decree No.108/2009/ND-CP dated 27/11/2009 on investment in the form of BOT, BTO and BT ("**Decree No.108**") and Decree No.24/2011/ND-CP dated 05/04/2011 on amendment of Decree No.108/2009/ND-CP ("**Decree No.24**").
3. The current draft of the amended land law seemed to be made in line with Resolution No.19/NQ-TW of the Sixth Conference of the Central Committee of the Communist Party of 11th Session on renovation of land policy.
4. According to this draft, the infrastructure works include the transportation, power, irrigation, water supply, drainage, waste collection and treatment, communications, oil & gas pipe lines and storages and other works in accordance with the laws on investment and construction.
5. The total net budget revenue sources of HCMC in period 2008-2011 is VND167,584 billion as provided in the Local Government Finance Assessment Report of HCMC.
6. Which is VND50,665 billion as provided in the Local Government Finance Assessment Report of Quang Ninh province.
7. Which is VND38,598 billion as provided in the Local Government Finance Assessment Report of Quang Nam province.

## 4.5. Sub-national PPP

201. The PPP (Public Private Partnership) is the cooperation between the State and private sector in an infrastructure development project to provide public service on a Project contract basis. The PPP model has been strongly developed in many countries for decades. There is a sub-national PPP in Brazil introduced in the IEAR, reviewed by the Consultant Team on it's their possible application within Vietnam's context and the necessary regulatory changes are as follows:

**Table A3.30. Assessment of Sub-national PPP identified in the IEAR**

| Type of PPP | Brief description[1] | Assessment of the Consultant Team | |
|---|---|---|---|
| | | At the national level | At the local level |
| Sub-national PPP in Brazil | • In 2004, the Brazilian Government adopted a PPP Law that applies to all levels of government.<br>• The Law includes a safeguard for public finance, limiting total public finance commitments to PPP projects to a maximum of 1 percent of the local government's net revenue. If a local government exceeds this limit, the Federal Government is authorized to withhold fiscal transfers.<br>• The Law also provides for the creation of a guarantee fund to which public assets are contributed to backstop government obligations under PPPs. | • Under Vietnam's prevailing legal framework, there is Decision No. 71/2010/QD-TTg[43] of the Prime Minister, promulgating the regulation on pilot investment in the public-private form ("Decision 71"). As this decision has not guaranteed a complete legal framework for the implementation of a PPP model, it is necessary, in the view of the Consultant Team, to have a special law on PPP so as to create a legal corridor as foundation for private sector engagement (investment in the form of PPP) in infrastructure development.<br>• The sub-national PPP model in Brazil could be of good reference when making the draft PPP Law in Vietnam. | • There has not been so far any PPP project in the three selected provinces.<br>• There is only one pilot PPP project in the transport sector, implemented in the surrounding area of HCMC (i.e., the Dau Giay – Phan Thiet Expressway), which could give good opportunities to local authorities to get experienced with PPP implementation. |

*Notes*:

1. More details are provided in the IEAR.

43 The MPI is now in charge of drafting a decision of PM for replacing this Decision No.71, which will likely be issued in year 2013.

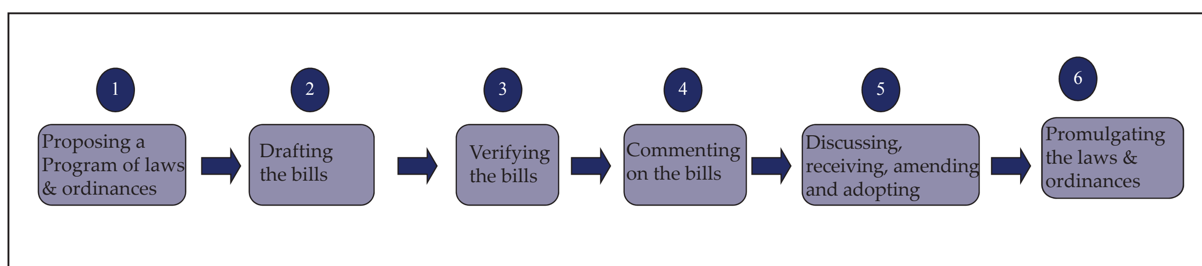
## 5. Sequencing of regulatory changes and other procedural considerations for the implementation of the suggested recommendations

202. It is noted that the adoption of any changes to the existing legal documents or a new bill is currently governed by the Law No. 17/2008/QH12 dated 3/6/2008 on promulgation of legal documents (**'The Law No.17'**), according to which, the legal documents include, among others, the followings: (a) Laws and Ordinances which are to be promulgated by the National Assembly and Standing Committee of National Assembly respectively; (b) Decrees which are to be promulgated by the Government; and (c) Decision of the Prime Minister.

203. According to this Law No.17, the procedures for drafting and adopting the bills are summarized as follows:

**Regarding the laws and ordinances**

**Figure A3.15. Procedures for developing laws/ordinances**

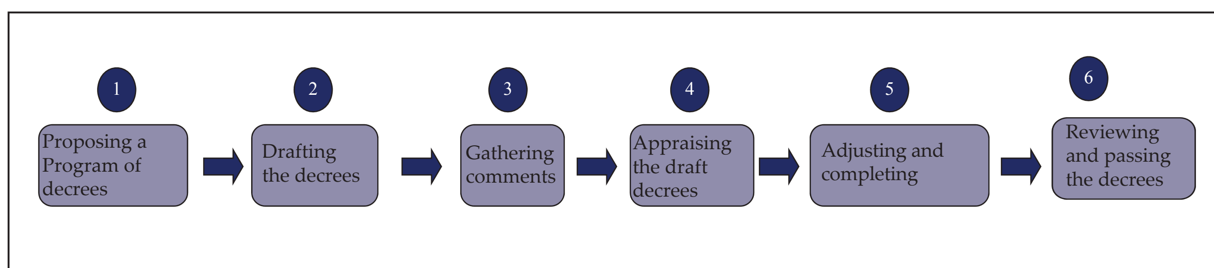



204. As illustrated in Figure A3.15 above, the process of developing and adopting law/ordinances and their amendments is a rather long one, with the involvement of many bodies and agencies (both legislative and administrative agencies). It consists of six steps, starting with Step 1 where a proposal is made by the relevant agency (e.g., the Government) for the program of the laws to be put forth and ends with Step 6 which is the promulgation of the laws/ordinances by the National Assembly/Standing Committee. A detailed procedure for each step is provided in Chapter III of the Law No.17. Practically, once a law project is already in the approved program, it may take a year or more for the National Assembly to adopt it.

**Regarding the decrees**

205. As illustrated in Figure A3.16 below, the (six-step) process for adopting decrees and their amendments is somewhat similar to the law-making process as described above; however, it is much less time consuming in comparison with the former because for decree preparation and adoption, only the administrative agencies (i.e., government agencies) are involved. A detailed procedure is provided in Chapter V of the Law No.17.

**Figure A3.16. Procedures for developing decrees**




**Regarding decisions of the Prime Minister**

206. According to the Law No.17 (i.e., Article 67), a lead drafting agency shall be responsible for preparing draft decisions of the Prime Minister as assigned by the Prime Minister. Depending on the nature and the contents of the draft decision in question, the lead drafting agency shall send the draft decision to Ministries, Ministry-equivalent agencies, and Government-affiliated agencies concerned to collect their comments and suggestions. The Ministry of Justice shall be responsible for assessing and verifying the draft decision of the Prime Minister. Comparing the two procedures above, the procedure for passing a decree or its amendment is less time-consuming and any intervention for proposed regulatory changes in the form of a new decision would be regarded as short-term ones ("**Short-term Intervention**").

207. Thus, taking into account the different complexity and time consumption for adopting the bills (e.g., laws or decrees or decisions of the Prime Minister), it is necessary to sequence the regulatory changes for the implementation of the recommendations as described in Section 3 and Section 4 above so that those proposed regulatory changes could be adopted in the appropriate sequence and in a timely manner, which will improve access to municipal infrastructure financing. Table A3.18 below presents the sequencing of the suggested regulatory changes where: (a) the *Short-term Interventions* are defined as those which could be implemented in a short period (i.e., up to two years); and (b) the *Long-term Interventions* are those which will take more than two years.

**Table A3.31. The sequencing of the suggested regulatory changes**

| No. | Proposed regulatory change | Related model in the IEAR | Related legal documents | Sequencing |
|---|---|---|---|---|
| 01 | To improve the capital mobilization by the local governments. | Not related | The Law on State Budget should be amended.<br><br>For HCMC and Hanoi, Decree No.124/ND-CP dated 18/05/2004 on some special financial and budgetary regime for HCMC ('**Decree No.124'**) and Decree No.123/ND-CP dated 18/05/2004 on some special financial and budgetary regime for Hanoi Capital ("**Decree No.123**") should be amended respectively. | • The proposed change of the Law on State Budget could be made in the period 2013-2014 as it is of the "Preparation Program" as provided in Resolution No.20/2011/QH13 dated 26/11/2011 of the National Assembly, adopting the list of laws/ordinances to be promulgated and prepared during the office of the National Assembly of Session XIII (i.e. 2011-2016) ("**Resolution No.20**") and as adjusted in Resolution No.23/2012/ QH13 dated 12/06/2012 ("**Resolution No.23**"), (**Short-term Intervention**).<br>• Subject to the amendment of the Law on State Budget, the amendment of Decree No.124 and Decree No.123 could be made in period 2013-2014 as the procedures for adopting decrees could be implemented in short period as noted above (**Short-term Intervention**). |
| 02 | Need a legal provision allowing the PPC to provide a guarantee. | Not related | The Law on Public Debt Management (LPDM) should be amended. | As the amendment of this LPDB has not been in the Program of drafting the laws/ ordinances of the National Assembly of XIII Session as provided in Resolution No.20, the proposed change could not be adopted in the period 2011-2016 unless there is an additional adjustment of the Program in Resolution No.20 as said above (**Long-term Intervention**). |

| No. | Proposed regulatory change | Related model in the IEAR | Related legal documents | Sequencing |
|---|---|---|---|---|
| 03 | Need a clear recourse mechanism which allows the commercial banks to secure their loans given to local authorities. | FINDETER model in Colombia | The Law on State Budget should be amended.<br>Subject to the amendment of the Law on State Budget, either Decree No.60 or Decree No.79 should be amended accordingly. | • The amendment of the State Budget Law could be of the Short-term Intervention for the same reason as noted above.<br>• The amendment of Decree No.60 or Decree No.79 could be of the Long-Term Intervention. |
| 04 | A specialized facility (e.g., municipal development fund or guarantee entity) is needed at the national level for credit enhancement, guarantee services and funding of municipal infrastructure. | Models of Tunisian CPSCL; MUFIS | Either Decree No.11/2011/ND-CP dated 14/01/2011 on management of urban development ("**Decree No.11**") should be amended or a decision of the PM is needed on establishment and operation of the municipal development fund. | • The issuance of a new decision of the Prime Minister will be a Short-term Intervention for the same reason as noted above.<br>• The amendment of Decree No.11 will likely be a Long-Term Intervention. |
| | | LGUGC, IIGF | The State Budget Law should be amended in the manner to facilitate in the recourse mechanism like the case of Findeter model above | This could be a Short-term Intervention for the same reason as noted above. |
| 05 | A clear legal provision is needed to allow the PPCs to be eligible to receive investment development credit to be provided by VDB. | Model of Tunisian CPSCL | Decree No.75 should be amended in the manner where PPC are clearly defined as the investors eligible to development investment credits. | It could be a Short-term Intervention for the same reason as noted above. |
| 06 | A legal provision for pooled financing is needed. | Model of Tamil Nadu Urban Development Fund in India | Decree No.01 should be amended accordingly. | It could be a Short-term Intervention for the same reason as noted above. |

| No. | Proposed regulatory change | Related model in the IEAR | Related legal documents | Sequencing |
|---|---|---|---|---|
| 07 | Legal provisions are needed to facilitate increasing land resource utilizations. | Model of Land Leasing in China | The Land Law of 2003 should be amended in a manner that allows for land recovery in the surrounding areas of public works. | It could be a Short-term Intervention, as the Amended Land Law is expected to be issued in year 2013. |
| | | Development rights in Brazil | There should be a new decree on land-based resources exploitation for infrastructure development. | It could be a Short-term Intervention, as the MOF is now the lead in the drafting process. |
| 08 | There is a need to have a complete legal framework for the implementation of PPP models | Sub-national PPP in Brazil | There should be a new PPP Law. | It could be a Long-term Intervention, although the MPI was already assigned by the Government to study the necessity of issuance of the Law on Encouragement of investments in the form of PPP pursuant to Decision No.1229/QD-TTg dated 07/09/2012 of the Prime Minister on assignment to the state agencies to preside over the drafting of the laws and ordinances as assigned by the National Assembly to the Government pursuant to Resolution No.23/2012/QH13 (“**Decision No.1229**”). |
| 09 | There is a need for giving the PPC more authority in issuance local government bond. | Not related | The Law on Public Debt Management should be amended in such a manner that the issuance of local government bonds is no longer subject to approval of the MOF. | It could be a Long-Term Intervention for the same reason as noted above. |

## 6. Capacity building/training required to implement the suggested recommendations

208. Based on the results of previous work of the MOF-WB team and the Consultant Team's in-depth analysis in three selected provinces, the Consultant Team has identified some specific gaps in the municipal system as well as the appropriate recommendations at both the national and local levels. In order to successfully implement these recommendations, there is a need to arrange capacity building/training for relevant parties. The Table A3.19 provides a suggested capacity building /training scheme for both the national and local levels:

**Table A3.32. Suggested Capacity Building/Training Scheme**

| No. | Capacity Building/ Training Areas | Objectives | Key topics | |
|---|---|---|---|---|
| | | | Central level | Local level |
| 1. | PPP | • To raise PPP awareness and promote coordination at the central level<br>• To improve PPP management capacity at the local level | • International PPP standards.<br>• PPP incentive schemes.<br>• PPP strategy and policy development<br>• | • International PPP success and unsuccessful stories.<br>• PPP project identification, preparation, screening, selection and appraisal skills.<br>• PPP contract design. |
| 2. | BT/BOT/BT | To improve the capacity to develop, implement and manage of BT/BOT/BTO projects | | • BT/BOT/BTO project identification, preparation, screening, selection and appraisal skills. |
| 3. | Debt management | To improve overall public debt management capacity | • International public debt standards and practical models.<br>• Public debt strategy development | Improving public debt management capacity |
| 4. | Infrastructure Financing Risk | Improving credit worthiness of infrastructure financing institutions | | Infrastructure financing/credit risks and improvement of LDIF's risk management capacity |
| 5. | Local Government Bond | To improve bond issuance capacity for relevant agencies at local levels | | Practices on bond issuance plan development and implementation |

| No. | Capacity Building/ Training Areas | Objectives | Key topics | |
|---|---|---|---|---|
| | | | Central level | Local level |
| 6. | Investment Planning | Improving provincial investment/planning capacity | | International infrastructure planning practices and lessons learnt for Vietnam |
| 7. | ODA | Improving ODA utilization and strategy | • Streamlining the local ODA procedures and the sponsor practices.<br>• ODA sources and potential alternatives | Streamlining the local ODA procedures and the sponsor practices |
| 8. | Transparency in public finance | Improving the awareness of public finance transparency | International public finance transparency practices and lessons learnt for Vietnam | International public finance transparency practices and lessons learnt for Vietnam |

## 7. Action Plan

209. Based on the above analysis and recommendations for framework and regulatory changes, as well as the proposed sequencing of such changes, from the perspectives of practical implementation the Consultant Team would recommend the below the Action Plan for both the Central Government and local governments to improve access to local financing for municipal infrastructure development, with the considerations for timing as well as task allocation.

### 7.1. Action Plan for the Central Level

| No. | Name of legal documents | Proposed changes/Content | Related model | Related clause | Time period | Lead agency | Notes |
|---|---|---|---|---|---|---|---|
| **A.** | **Action for regulatory change of the laws** | | | | | | |
| 1. | State Budget Law dated 16/12/2002 | To improve the capital mobilization by the local governments. | | Article 8.3 | 2013-2014 | MOF | The amended Law is expected to be issued in 2014. |
| 2. | | To have a recourse mechanism which will facilitate improved capital mobilization at the local government level | FINDETER model in Colombia | | | | MOF is assigned by the PM[1] to be the lead drafting agency. |
| 3. | Law on Public Debt Management dated 17/06/2009. | Changes in legal framework to lessen barriers for local government bond issuance by removing the requirement that the local bond issuance plans need to be approved by the central level. | | Point b of Article 39.1 | 2015-2016[2] | MOF | At the request of local governments |
| 4. | | Changes in legal framework to allow PPCs to provide guarantees. | | Chapter V. | | | It is suggested by the Consultant Team. |
| 5. | Land Law dated 26/11/2003 | Changes in legal framework for improved land resources utilization | Land leasing in China | | 2013 | MONRE | The amended Land Law is expected to be issued in 2013.<br>It is not priority. |

| No. | Name of legal documents | Proposed changes/Content | Related model | Related clause | Time period | Lead agency | Notes |
|---|---|---|---|---|---|---|---|
| **B.** | **Action for regulatory changes of decrees and decisions of Prime Minister** | | | | | | |
| 1.a | New decision of Prime Minister OR 1.b below. | The regulation on the establishment and operation of a Municipal Development Fund (MDF). | FINDETER in Colombia | | 2014 | MOF | It is for the pilot MDF |
| 1.b | **Decree No.11**/2011/ND-CP dated 14/01/2011 on management of urban development. | Changes in Decree No.11 to allow the establishment of the MDF (with full scale) by MOF. | MUFIS in Czech Republic | | 2016-2017 | MOF or MOC | It is an alternative – as a substitute for the new decision of PM above; however, its realization needs to be discussed with MOF. |
| 2. | **Decree No.124**/ND-CP dated 18/05/2004 on some special financial and budgetary regime for HCMC | To improve the capital mobilization by the local government of HCMC | | Article 5.3 | 2014 | MOF | It is subject to the amendment of the State Budget Law as proposed above |
| 3. | **Decree No.123**/ND-CP dated 18/05/2004 on some special financial and budgetary regime for Hanoi Capital | To improve the capital mobilization by the local government of Hanoi capital | | Article 5.3 | 2014 | | |
| 5. | **Decree No.60**/2003/ND-CP dated 06/6/2003 of the Government, guiding the Law on State Budget | Changes in legal framework to have a recourse mechanism which would allow the lending entities and guarantee providing entities to secure the debt repayments through a special account opened at the lending bank. | FINDETER; LGUGC in Philippines; IIGF in Indonesia | Article 52.2 and 52.4 | 2015-2016 | | To make the recourse mechanism workable, it is necessary to have the amendment of not only the State Budget Law as proposed above, but |

| No. | Name of legal documents | Proposed changes/Content | Related model | Related clause | Time period | Lead agency | Notes |
|---|---|---|---|---|---|---|---|
| 6. | **Decree No.79**/2010/ND-CP dated 14/07/2010 on debt management operation. | | | Article 21 | | | also its guiding by-laws, which includes Decree No.60 and related circulars.[3] |
| 7. | A new decree | Containing the legal provisions on land-based resource exploitation and infrastructure development | Development right in Brazil | | 2013 | | • MOF is now drafting this decree.[4]<br>• It is not priority. |
| 8. | Decree No. 138/2007/ND-CP dated 23/08/2007 on establishment and organization of local development investment funds - LDIFs | To facilitate LDIFs to widen activities, it is necessary to review and adjust this Decree No. 138 to improve and simplify organizational structure, operational procedures and supplement the list of infrastructure sectors eligible for financing. | | | 2013-2014 | | • MOF is now drafting this decree.<br>• It is not priority. |

*Notes*: Pursuant to Decision No.1229/QD-TTg dated 07/09/2012 of the Prime Minister.

1. As the amendment of this LPDB has not been in the Program of drafting the laws/ordinances of the National Assembly of XIII Session as provided in Resolution No.20, the proposed change could not be adopted in period 2011-2016 unless there is an additional adjustment of the Program in Resolution No.20 as said above.
2. Pursuant to Decision No.1229/QD-TTg dated 07/09/2012 of the Prime Minister.
3. As the amendment of this LPDB has not been in the Program of drafting the laws/ordinances of the National Assembly of XIII Session as provided in Resolution No.20, the proposed change could not be adopted in period 2011-2016 unless there is an additional adjustment of the Program in Resolution No.20 as said above.

## 7.2. Action Plan for the Local Level

### 7.2.1. HCMC

| No. | Proposed Activities | Output/Monitoring Indicators | Implementation Timing | Lead Agency |
|---|---|---|---|---|
| 1. | Revising/issuing regulations for improving the local investment and business environment. | • The local investment and business environment is approved. | 2013-2014 | DPI |
| 2. | Promoting administrative reform; enhancing mobilization of investment capital from all economic sectors. | • Improved local revenue sustainability | | |
| 3. | Amending, supplementing, disclosing and making transparent criteria for annual state budget allocation and using public expenditure norms and medium-term expenditure framework (MTEF) approach. | •<br>•<br>• Improved efficiency for budget resource usage. | | DoF |
| 4. | Reviewing and restructuring the state budget use plan for improving the public investment quality as to avoid scattered investment problems; | • Improved the Incremental Capital Output Rate (ICOR). | From 2014 | DPI |
| 5. | Stopping or adjusting projects which are not urgent so as to fit better with local available resources. | | | DPI |
| 6. | Proposing a pilot PPP in municipal infrastructure. | A new PPP project in municipal infrastructure is approved | 2014 | DPI |
| 7. | Reviewing all the ODA projects by the related local line departments and delivering ODA training courses to local officers at different related departments. | ODA mobilization is enhanced and the ODA management and utilization effectiveness is improved. | 2013-2014 | DPI |
| 8. | Reviewing and arranging available land resources to create a clean land fund to support resettlement and ground clearance to attract more investment in infrastructure in the form of BT. | • Unused land is recovered and number of land based financing projects is increased.<br>• Land management and usage is enhanced. | From 2013 | DONRE |
| 9. | Applying land recovery of both sides of roads[1] to generate financial resources for road construction. | • Land revenues are increased;<br>• Land-based financing projects in general and BT projects in particular are leveraged. | From 2014 | DoT |

| No. | Proposed Activities | Output/Monitoring Indicators | Implementation Timing | Lead Agency |
|---|---|---|---|---|
| 10. | Borrowing money (by PPC) from commercial banks under the recourse mechanisms (RM)[2]. | Improved access to local financing of the commercial banks. | From 2015 | DoF |
| 11. | A new function/task of public debt management (e.g., monitoring bond issuance/repayment and the performance of recourse mechanisms) is assigned to an existing unit within the PPC (e.g., Division of Finance, Trade and Service). | The local debt management capacity is improved. | 2015 | PPC |

*Notes:*

1. Assuming that it is allowed in the Amended Land Law, which will be adopted by the National Assembly in 2013.

2. Assuming that the RM will be allowed in the Amended Law on the State Budget, which will likely be adopted by the National Assembly in 2014.

### 7.2.2. Quang Ninh province

| No. | Proposed Activities | Output/Monitoring Indicators | Implementation Timing | Lead Agency |
|---|---|---|---|---|
| 1. | Revising/issuing regulations for improving the local investment and business environment. | • The local investment and business environment is approved. | 2013-2014 | DPI |
| 2. | Promoting administrative reform; enhancing mobilization of investment capital from all economic sectors. | • Improved local revenue sustainability | | |
| 3. | Amending, supplementing, disclosing and making transparent criteria for annual state budget allocation and using public expenditure norms and medium-term expenditure framework (MTEF) approach. | •<br>•<br>• Improved efficiency for budget resource usage. | | DoF |
| 4. | Reviewing, and restructuring the state budget use plan for improving the public investment quality as to avoid scattered investment problems; | • Improved the Incremental Capital Output Rate (ICOR). | From 2014 | DPI |
| 5. | Stopping or adjusting projects which are not urgent so as to fit better with local available resources. | | | DPI |
| 6. | Issuing local government bonds | Increased revenue sources for financing municipal infrastructure projects | 2013-2014 | DoF |
| 7. | Setting up a local development investment fund (i.e., LDIF) | A new financing vehicle for infrastructure development is set up. | 2014 | DoF |
| 8. | Proposing a pilot PPP in municipal infrastructure. | A new PPP project in municipal infrastructure is approved | 2015 | DPI |
| 9. | Delivering ODA training courses to local officers. | The ODA management and utilization effectiveness is improved. | 2013-2014 | DPI |

| No. | Proposed Activities | Output/Monitoring Indicators | Implementation Timing | Lead Agency |
|---|---|---|---|---|
| 10. | Reviewing and arranging available land resources to create a clean land fund to support resettlement and ground clearance to attract more investment in infrastructure in the form of BT. | • Unused land is recovered and number of land based financing projects is increased.<br>• Land management and usage is enhanced. | From 2013 | DONRE |
| 11. | Applying land recovery of both sides of roads to generate financial resources for road construction. | • Land revenues are increased;<br>• Land-based financing projects in general and BT projects in particular are leveraged. | From 2014 | DoT |
| 12. | Borrowing money (by PPC) from commercial banks under the recourse mechanisms (RM) | Improved access to local financing by the commercial banks. | From 2015 | DoF |
| 13. | A new function/task of public debt management (e.g., monitoring bond issuance/repayment and the performance of recourse mechanisms) is assigned to an existing unit within the PPC (e.g., Division of Finance and Trade). | The local debt management capacity is improved. | 2015 | PPC |

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### 7.2.3. Quang Nam province

| No. | Proposed Activities | Output/Monitoring Indicators | Implementation Timing | Lead Agency |
|---|---|---|---|---|
| 1. | Revising/issuing regulations for improving the local investment and business environment. | • The local investment and business environment is approved. | 2013-2014 | DPI |
| 2. | Promoting administrative reform; enhancing mobilization of investment capital from all economic sectors. | • Improved local revenue sustainability | | |
| 3. | Amending, supplementing, disclosing and making transparent criteria for annual state budget allocation and using public expenditure norms and medium-term expenditure framework (MTEF) approach. | •<br>•<br>• Improved efficiency for budget resource usage. | | DoF |
| 4. | Reviewing, and restructuring the state budget use plan for improving the public investment quality as to avoid scattered investment problems; | • Improved the Incremental Capital Output Rate (ICOR). | From 2014 | DPI |
| 5. | Stopping or adjusting projects which are not urgent so as to fit better with local available resources. | | | DPI |
| 6. | Issuing local government bonds | Increased revenue sources for financing municipal infrastructure projects | 2015 | DoF |
| 7. | Proposing a pilot PPP in municipal infrastructure. | A new PPP project in municipal infrastructure is approved | 2016. | DPI |
| 8. | Delivering ODA training courses to local officers. | The ODA management and utilization effectiveness is improved. | 2013-2014 | DPI |
| 9. | Applying land recovery of both sides of roads to generate financial resources for road construction. | • Land revenues are increased;<br>• Land-based financing projects in general and BT projects in particular are leveraged. | From 2015 | DoT |
| 10. | Borrowing money (by PPC) from commercial banks under the recourse mechanisms (RM). | Improved access to local financing by the commercial banks. | From 2015 | DoF |
| 11. | Setting up a new unit within the office of the PPC, which has function/task of public debt management (e.g., monitoring bond issuance/repayment and the performance of recourse mechanisms). | The local debt management capacity is improved. | 2015 | PPC |

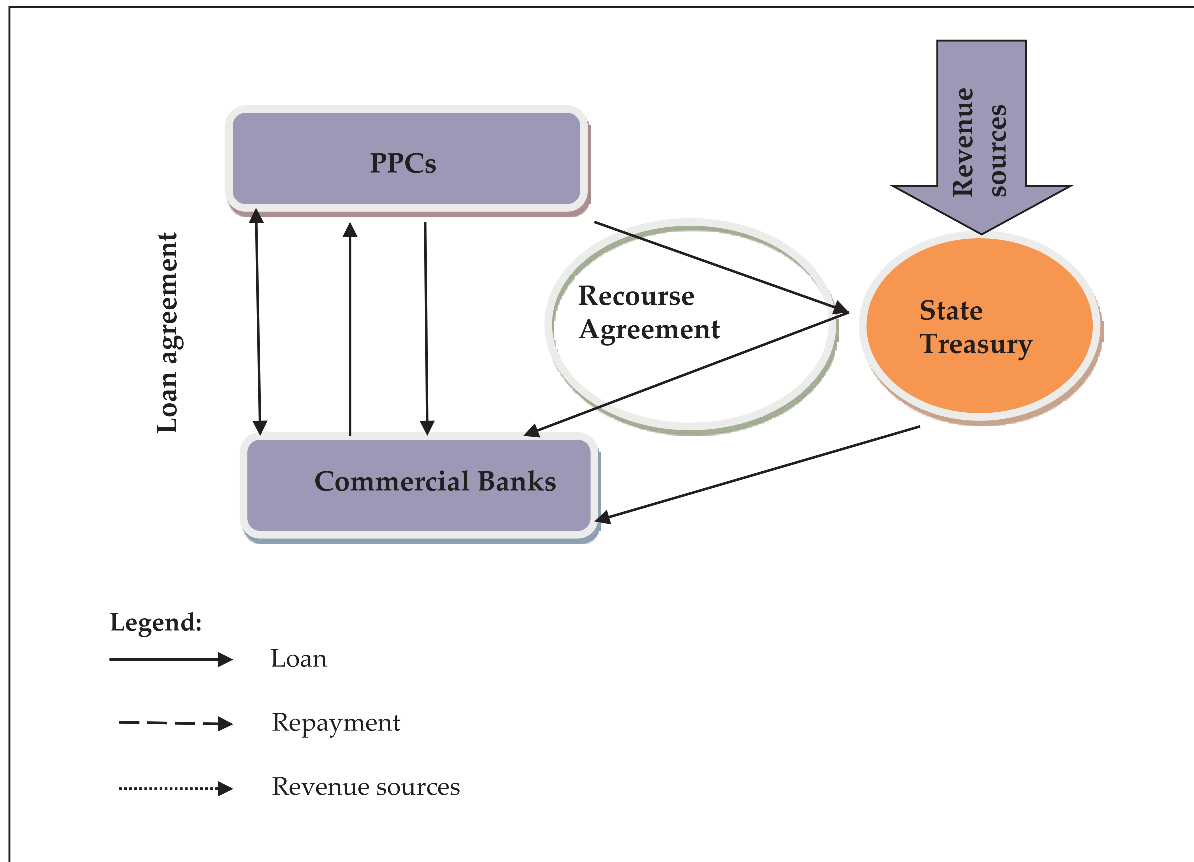
# Attachment 1 RECOURSE MECHANISM

**Purpose of Recourse Mechanism**

The purpose of the Recourse Mechanism is to encourage the commercial banks to provide loans to the PPCs; the mechanism would allow the commercial banks to secure their loans given to the PPCs: the PPC has to set up a special account, opened at a commercial bank, for receiving a part the annual revenue of the PPC (e.g., net local budget revenue sources), and the lending commercial bank has a senior right to intercept revenue if the debt service defaults.

**Proposed Recourse Arrangement**

Subject to the necessary regulatory changes of the laws, as the outcome of the work of the related parties (i.e., MOF) as further described below, the proposed Recourse Arrangement could be illustrated as shown in the graphic below:




*Loan Agreement*: to be signed by and between PPC and a Bank

*Recourse Agreement*: it is a tripartite agreement among PPC, Bank and State Treasury

**Main contents/provisions of the Recourse Agreement**

As suggested by the Consultant Team, for the benefit of both the lending commercial bank and the PPC, the Recourse Agreement should contain the following main provisions:

The recourse account is under the name of the PPC as account-holder and opened at the lending commercial bank.

The recourse account is an interest-bearing account where the earned interest is of the PPC.

The money balance in the recourse account should be maintained at least at a level equal to the outstanding liability/debt (i.e., loan interest and partial principal) of the PPC to be paid/repaid in the payment period (e.g., quarterly or semi-annual or annual basis) to the lending commercial bank.

The lending commercial bank has an irrevocable right to deduct any interest and/or principal from the recourse account if the PPC fails to pay/repay on the date when they are due. After such deduction and receipt of a written request of the lending commercial bank, the state treasury will transfer a partial revenue of the PPC to the recourse account so as to ensure that the required/desierd money balance (as noted in Point 3 above) is met.

**Works to be carried out for the regulatory changes**

As mentioned in the Diagnostic and Action Plan Report, in the view of the Consultant Team, the prevailing body of legislation in Vietnam is not so clear on the Recourse Mechanism. Therefore, to facilitate the application of the Recourse Mechanism by the related parties (e.g., PPC, commercial banks and the State Treasury), it is suggested to have specific legal provisions on the recourse mechanism in the Law on the State Budget, which might be guided further in the amendment of Decree No.60/2003/ND-CP guiding the implementation of the State Budget Law and the related circular (i.e., Circular No.161/2012/TT-BTC dated 02/10/2012 on the regime for control and settlement of the state budget expenditure through the State Treasury).

Pursuant to the Law No.17/2008/QH12 dated 03/06/2008 on Promulgation of Legal Documents ("**The Law No.17**"), and assuming that the Law on the State Budget will be amended in the schedule pursuant to Resolution No.20/2011/QH13 dated 26/11/2011 of the National Assembly, adopting the list of laws/ordinances to be promulgated and prepared during the office of the National Assembly of Session XIII (i.e. 2011-2016), the five (5) following or steps will be carried out as follows:

***Step 1: Drafting the amendment of the State Budget Law***

The drafting process is described in details in Item 2 of Chapter III of the Law No.17 according to which, the drafting board, which is to be set up and chaired by the MOF, will be responsible for drafting the bill and collecting comments from the related agencies on the bill. The MoJ will be responsible for appraising the bill before submission to the Prime Minister for his/her approval.

***Step 2: Verifying the bill***

The verifying process is described in details in Item 3 of Chapter III of the Law No.17 according to which the ethnic committee and other related committees (e.g., the legislation committee; the committee of social affairs) of the national assembly will be responsible for verifying the bill dossier submitted by the Government and for making the verification report.

***Step 3: Making comments on the bill***

The procedures under Step 3 are described in details in Item 4 of the Chapter III of the Law No.17 according to which the Standing Committee will be responsible for making their comments on the bill dossier and the verification report.

***Step 4: Discussing, receiving, amending and adopting the bill***

The procedures under Step 4 are described in details in Item 5 of the Chapter III of the Law No.17 according to which the national assembly will discuss the bill, receive the comments, make appropriate amendment and adopt the bill in one or two sessions.

***Step 5: Promulgating the new law/Amendment of the laws***

The procedures under Step 5 are described in details in Item 6 of the Chapter III of the Law No.17 according to which the State President will promulgate the new law/Amendment of the law (e.g. State Budget Law) within 15 days from the date the bill has been adopted by the National Assembly.

**Possible impacts to central and sub-national level**

It is expected that when it the recourse mechanism is introduced, the possible positive impacts to both the central and sub-national levels include:

Central level

There will be the fundamental changes in project appraisal and approval procedures which would improve the current practices for project granting by the central level.

As a new local financing channel for municipal infrastructure will be available, there will be less pressure on central funding for local municipal infrastructure development.

Sub-national level

It would help to move the current "low value for money" public investment preparation/approval practices towards a more effective approach. As a result, the public investment efficiency will be improved.

As the sub-national government is responsible for full debt servicing, the debt management capacity and accountability of the sub-national governments will be improved.

**Assessment of the financing framework for municipal infrastructure in Vietnam**

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