Provincial Governance and Foreign Direct Investment in Vietnam

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Because of my involvement in the creation of the Provincial Competitiveness Index (PCI, VNCI & VCCI 2005-2007), I am often asked to comment on the relationship between economic governance, the main focus of the PCI, and Foreign Direct Investment (FDI) attraction. Specifically, I am asked why some provinces may have relatively low scores on the PCI, but consistently rank among the most attractive destinations for FDI projects. Names like Hai Duong, Ha Tay, Hai Phong, and this year, Dong Nai, are often mentioned as examples.

My answer to this question over the years has been consistent. The PCI was designed to slay a different set of dragons - namely the economic governance factors impeding the growth of the domestic private sector. At its most basic level, the PCI is the collective voice of 6,700 domestic private firms. Private sector opinions are collected in a large-scale survey; their responses are adjusted with published data to address perception biases; and then these answers are aggregated into provincial-level scores. The final outcome is a composite index ranking Vietnam's 64 provinces according to their relative economic governance. The PCI is a handy tool, but it was not designed with FDI in mind.[1]

That said, the international economics literature indicates that many of the very same indicators used in the PCI are of great concern to foreign investors as well (Knack and Keefer 1995, Henisz 2000, Djankov 2002, Kaufman et al 2007). Foreign investment enterprises (FIEs) also have strong interests in at least nine of the ten PCI sub-indices: 1) lower entry costs; 2) access to land; 3) transparency and equity of business information; 4) low informal charges; 5) less time wasted on bureaucratic compliance; 6) lack of bias toward the state sector; 7) a proactive and creative leadership; 8) well-trained labor; 9) and fair legal protections. The remaining sub-index, private sector development policies (PSD), is specifically about interventions geared at private entrepreneurs, but also includes some indicators which affect FDI prospects as well, such as the number of locally-sponsored trade fairs and business match-making. There is no reason why these ten sub-indices should not also be associated with FDI.

Moreover, because Vietnam's commitments under the World Trade Organization (WTO) and Bilateral Trade Agreement (BTA) with the U.S. require national treatment after phase-in periods, the needs of foreign and domestic investors in regard to regulatory policies should be converging (MPI, CIEM, FIA, and STAR 2007, VNCI 2007: 46-56). The Unified Enterprise Law (2005), Common Investment Law (2005), and the recent equalization of income taxes between foreign and private firms (Vu Long 2007) are just the first stops in enshrining these commitments into national law. Their implementation at the provincial level will affect both private and foreign investors alike.

If private entrepreneurs answered accurately in the PCI survey - and we certainly take every precaution to ensure they do - then the index should be correlated with FDI. In the next few pages, I will demonstrate that there is indeed a strong correlation, but that that there are reasons to be cautious about drawing too much from this finding. Much more interesting is the relationship between governance scores and the decisions of existing investors to implement the full commitments on their investment licenses or expand their original capital outlays. Next, I will break apart the umbrella notion of economic governance into its composite dimensions, answering which specific elements of economic governance are most important

[1] Those interested in further information on methodology and construction of the PCI should consult the three annual reports and datasets available at http://www.pcivietnam.org/.

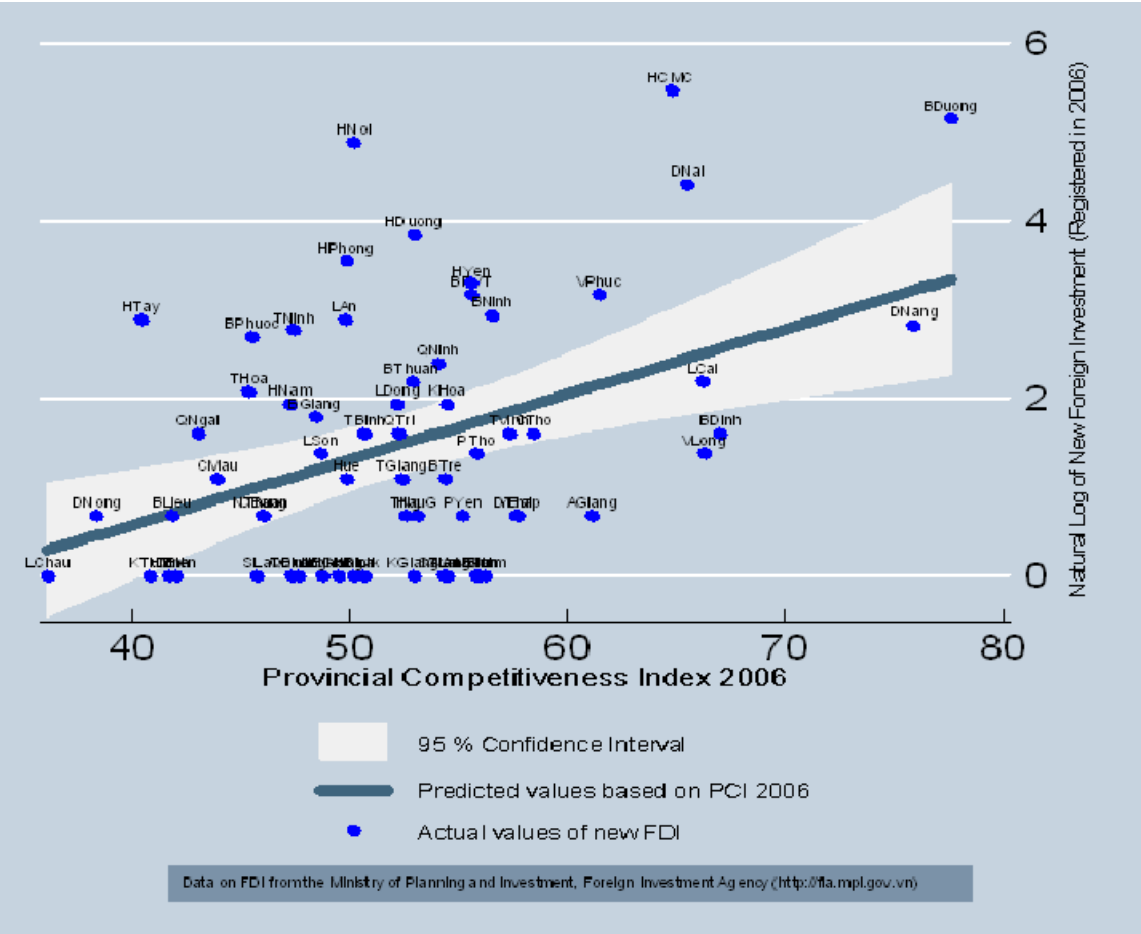
for foreign investment decisions and how they differ from the needs of domestic investors. Finally, I conclude by drawing some distinctions between improvements in economic governance and the modern form of fence-breaking (*xé rào*) through super-incentives presently taking place in some provinces.

1. The Association between FDI and Provincial Economic Governance

Of course, comparing PCI scores to the total stock of FDI in provinces is unreasonable. As many of the articles in this volume certainly make clear, FDI began entering Vietnam in 1987 and actually was booming by 1994, well before major changes in the Vietnamese policy environment like the Unified Enterprise Law 2005 and WTO entry, and long before the first iteration of the PCI in 2005. A number of scholars have shown that the most important factors for this early investment were proximity to large domestic markets and high quality infrastructure for exports (Nguyen Phuoc Hoa 2002, Pham Hoang Mai 2002, Meyer and Nguyen 2005, Nguyen Phi Lan 2006, Phan and Ramstetter 2006, Nguyen Ngoc Anh and Nguyen Thang 2007, Malesky 2008). Meyer and Nguyen (2005) purport to show that governance matters, but proxy for it by using number of industrial zones. Because industrial zones also provide better infrastructure and generally are located in provinces with already burgeoning FDI, it is not clearly that they were able to isolate a separate governance effect.

A more reasonable test is how closely the PCI governance measures are correlated with new investment. Figure 1 displays the logged number of FDI projects registered in 2006 (MPI 2006), the most recent year of fully available data, on the vertical axis and the final 2006 PCI scores on the horizontal axis. It is evident that there is a strong bivariate correlation between the two variables that is statistically significant. This result is robust to adding a range of control variables (see Appendix 1 below) using investment size as opposed to the number of projects, or specifying FDI as a percentage of GDP or *per capita*. In the fully controlled model of FDI attraction, a one point increase in PCI scores is associated with an estimated 3.7% increase in new investment projects. In short, there is empirical evidence that new FDI is associated with the quality of provincial governance and this relationship is too strong to be spurious. The graph demonstrates the dangers of argument by using anecdotes from just a few provinces. Yes, Hai Duong and Ha Tay attract more FDI than would be predicted by governance alone, but the general association holds.

Figure 1: The Association between New FDI and Economic Governance



1.1. The Impact of Structural Conditions

While the correlation is strong, it is also extremely noisy. Most of the actual values are outside of the 95% confidence interval shaded in white. Provinces above the prediction line are provinces that attracted more investment than can be explained by economic governance. Provinces below the prediction line are those that received less investment than they should have if PCI scores were the sole determinant. These distances from the prediction line are known in econometrics as residuals. Analyzing them closely can often be of an enormous benefit. To assist this analysis, I divide provinces into three groups. Provinces with residuals greater than one unit (about the 85th percentile), provinces with residuals between 1 and -1, and provinces with residuals less than -1 (about the 15th percentile). These categories are displayed in Table 1.

A close look at the over-performing provinces reveals an unsurprising pattern. Nearly all of these provinces are major cities themselves or share a border with Ha Noi or Ho Chi Minh City (HCMC). FIEs entering these areas most likely privileged proximity to large markets, other investors, and better infrastructure over governance when making their investment decisions. Though governance played some role in helping investors select between similarly situated provinces. There are two exceptions to the proximity rule. Binh Phuoc, located just to the Northwest of its sister province Binh Duong, benefits

from the spillover investment of its high-flying neighbor. The other exception is Thanh Hoa, which has attracted a lot of investment recently, but these numbers may be inflated slightly by the presence of extremely large investment projects that have yet to be fully implemented. The most well-known of these is the $30 billion Eminence Steel Factory, which on paper is the largest manufacturing FDI project in Vietnam to date (*Tuoi Tre* 2007, *Tien Phong* 2007a, 2007b).

Table 1: Residual Analysis of Provincial Economic Governance and FDI

1.) Provinces with higher investment than predicted by economic governance scores.	**2.) Provinces where governance is a reasonably accurate predictor of investment.**		**3.) Provinces with lower investment than predicted by economic governance scores.**
Residuals > 1	*Above Prediction Line*	*Below Prediction Line*	*Residuals < 1*
Ha Noi	Ha Nam	Bac Lieu	Quang Binh
HCMC	Quang Ngai	TT-Hue	Vinh Long
Hai Duong	Quang Ninh	Tra Vinh	Tuyen Quang
Ha Tay	Binh Thuan	Lai Chau	Yen Bai
Hai Phong	Bac Giang	Lao Cai	Dong Thap
Dong Nai	Lam Dong	Can Tho	Nam Dinh
Binh Duong	Khanh Hoa	Ninh Thuan	Ha Giang
Binh Phuoc	Thai Binh	Cao Bang	Hoa Binh
Tay Ninh	Dak Nong	Phu Tho	Dak Lak
Long An	Ca Mau	Da Nang	An Giang
Hung Yen	Lang Son	Tien Giang	Kien Giang
BRVT	Quang Tri	Ben Tre	Gia Lai
Bac Ninh		Kon Tum	Soc Trang
Thanh Hoa		Ha Tinh	Nghe An
Vinh Phuc		Dien Bien	Ninh Binh
		Thai Nguyen	Bac Kan
		Hau Giang	Quang Nam
		Binh Dinh	
		Son La	
		Phu Yen	

The provinces that under-perform their government trajectory are predominantly rural provinces in the Central Coast, Northern Uplands, or Mekong Delta. They are far from large urban markets and burdened by poor infrastructure. Economic growth in these provinces has been driven predominantly by domestic investment. The presence of Quang Nam at the bottom of the list results from the lumpiness of investment figures. Quang Nam has an extensive foreign investment portfolio, consisting of over 36 active projects (MPI 2007), but simply did not register any new ones in 2007.

This short analysis illustrates that while economic governance matters, it is far from fully determinate. Investors must balance a range of different factor in their decisions. Governance is only one of these. In the fully specified models of 2006 investment attraction, infrastructure and distance from Hanoi are both highly significant. For each 100 kilometers a province is from Hanoi or HCMC, FDI decreases by about 1%. Percentage of high school graduates is close to, but does meet traditional levels of significance. Indeed, recent work based on surveys of current foreign investors indicates that structural, not governance

factors may even become more important. A recent high level policy memorandum cites education and infrastructure as the two primary impediments to investors following on the "dragons' flight path," (Vu, Dapice, and Wilkinson 2007).

1.2. Perceived Bias toward FIEs

Outside of structural conditions, economic governance (as perceived by the private sector) and FDI attraction may diverge if private investors believe there are institutional biases favoring foreign investors over domestic entrepreneurs. In one-on-one interviews, private investors often complain that tax holidays and breaks on land transfer fees are often unfairly bestowed on large foreign investors. Even if tax incentives are available to all, provincial officials in some provinces may be more likely to inform FIEs of provincial munificence. More generally, the rush to build industrial zones and concentrations in many localities did not take into consideration the locations of existing private investors. Some complain that expanding their operations into industrial zones is more inconvenient than simply accessing land adjacent to their existing operations (Malesky and Dau 2006).

To gauge the extent of this perceived bias toward foreigners, the PCI survey asks domestic investors whether they agree with the statement, "Favoritism toward foreign investors is an obstacle to my business." In general, perceived bias toward foreign investors is low. Only 25% of respondents agreed with the statement, as opposed to 29% for equitized firms, and 43% for existing state owned enterprises (SOEs). Nevertheless, variance across provinces was quite substantial. Over 40% of firms in Hanoi cited overt biases toward FIEs, compared to only 9% of firms in Bac Kan. Among the provinces with foreign investment exceeding governance predictions, all but four (Vinh Phuc, BRVT, Thanh Hoa, and Binh Phuoc) have perceived bias above the median score of 25.5%. As Table 2 shows there does appear to be a relationship between residual investment and perceived favoritism toward FIEs. Average favoritism is highest among provinces (29.5%) with higher FDI than governance would predict and declines remarkably when looking at provinces where FDI was less than expected (22.5%).

Table 2: Perceived Favoritism toward FIEs by Residual Group

FDI Prediction based on Economic Governance	Size of Residuals	Private Firms Citing Favoritism toward FIEs as an Obstacle to their Business.	Standard Deviation
FDI higher than expected	1. Residuals >1	29.49%	5.43%
FDI prediction is accurate	2a. Residuals between 1 and 0	24.91%	5.97%
	2b. Residuls between 0 and -1	24.36%	5.42%
FDI lower than expected	3. Residuals < -1	22.54%	6.29%

2. **Caution Ahead – Limitations to Focusing on Newly Licensed Investment**

While the relationship between new investment projects in 2006 and governance above seems pretty robust. There are very strong reasons to be cautious. First, the presence of previous investors swamps all other factors in explaining the amount of new investment received by a province. Second, licensed investment can be misleading as an indicator of investment attraction. And third, there is reason to believe that the causal arrow runs in both directions. Foreign investors do not simply slide their money across the table like amateurs at a poker table, they actively work to alter and improve the business environment in which they operate.

2.1. Economies of agglomeration…. or why it helps to locate near investors like yourself

Models 2 and 3 of Appendix 1 are astonishing. Once we include the stock of implemented investment from 2005 in the regression models, everything else drops out. That is, lagged stock of investment explains the vast majority of the variance (about 79%) in the determination of new investment and appears far more important in investor decisions than any other factor.

There is a large economics literature called Economies of Agglomeration (see Krugman 1993) that helps explicate this result. Investors like to be near their peers. It is helpful to locate close to potential suppliers of raw material and intermediate goods. And, of course, it makes sense to locate near consumers of your products. By locating near others like themselves, investors can also share information, form together in business associations and chambers, and take advantage of softer infrastructure, such as the international hospitals and schools that usually pop-up when there is a critical mass for their services. Finally, the presence of other foreign investors is a useful signal of potential success. Investors can save themselves headaches and a lot of research by choosing to locate in a province where other investors are functioning profitably. Presumably, the presence of other successful investors encapsulates in an easily digestible manner the investment environment of that province. There are strong reasons to suspect that the perception of economic governance comprises a large portion of this signal, but we really do not know how much.

2.2. Irrational Exuberance – the limitations of licensed investment as an indicator of attraction.

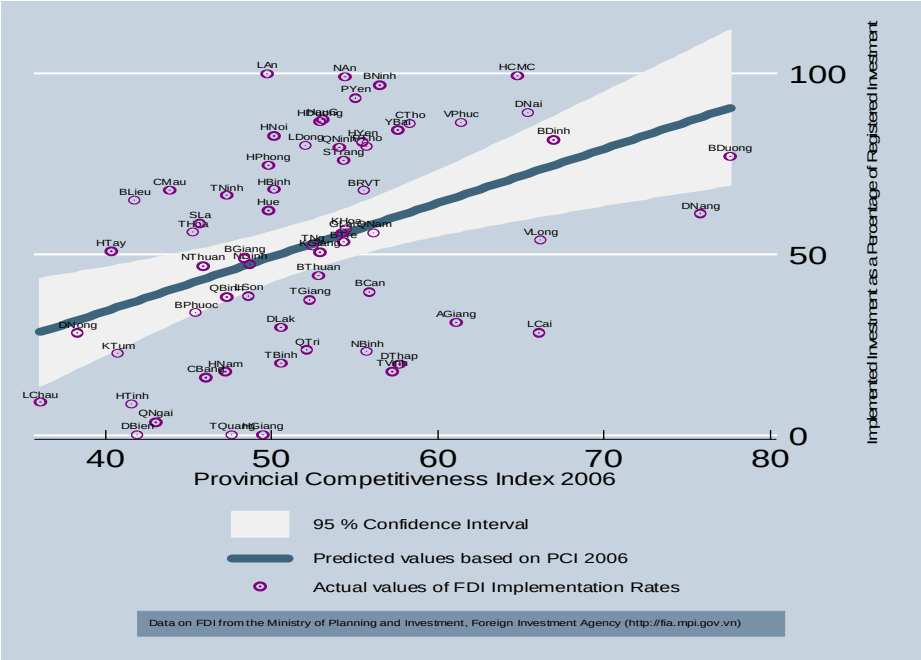
A second issue is that the analysis above relies on registered and not implemented investment. As the Eminence Steel Factory example illustrates, it is fairly easy to register a large investment. At the end of the day, this is only a number written on a piece of paper. What really matters for provincial welfare, employment, and revenue, is how much of that investment was actually implemented. Often registered and implemented investment can be millions of dollars apart (Freeman and Nestor 2004). While the magnitude of this problem has narrowed recently from its peak in the years before the Asian Financial Crisis, it remains an important dilemma. Investors are unlikely to fulfill their registered capital levels when they have irrational expectations about the success of the project from the onset, when business prospects soured due to changes in international or domestic markets, or when problems with the regulatory environment or informal charges raise the costs of businesses above their original business plans. This latter set of problems is related to governance and we should see evidence for it in the data.

Indeed, percentage of registered FDI that is implemented by investors (the implementation rate) is strongly correlated with PCI scores. Once again, I use a scatter plot to demonstrate the statistically

significant correlation. As before, this relationship is robust to a range of different structural controls. In fact, in fully specified models (Appendix 1, Models 5-8), only two factors are statistically significant - the average profitability of foreign ventures in the province and economic governance. Infrastructure, proximity to markets, and even the presence of previous investors all prove less important factors. It appears that investors may choose locations for a variety of different reasons, but the quality of the provincial institutions regulating the economy is most important for keeping them there.

The third set of models in Appendix 1 (Models 6-12) probes this analysis even further, asking what factors cause investors to add capital to existing projects. When an investor decides to *'re-up'* on an existing project, it is a strong indication that they are more than just satisfied with their present situation. Once again, profitability and the presence of other FIEs matter, but the impact of governance remains robust. All else equal, a one point improvement on PCI scores yields an expected 4.3% improvement in additional investment from existing projects in 2006. Governance is a dominant factor in the decision

Figure 2: The Association between FDI Implementation Rates and Economic Governance



2.3. Foreign Investors as Agents of Change

The present paradigm of thinking of FDI as simply rushing in to reward governance improvements is overly simplistic. As the strong presence of International Chambers of Commerce, law firms, newsletters, and conferences with policymakers demonstrates, foreign investors do not believe the sole extent of their business options are limited to deciding whether to shell-out their money or not. At the national level in Vietnam, foreign investors have played critical roles in advocating for changes in the Competition Law, 2005 Investment Law, and the ban on motorcycle imports, among other activities.

Around the world, investors actively try to engage local officials and improve the environment in which they operate. Hewko (2002, 2003) and (Lewis 2004) have provided a range of different examples of investors impacting the policy environment in Eastern Europe and the Former Soviet Union. Similarly, Malesky (2008) demonstrates empirically that most early investors in Vietnam entered provinces due to infrastructure and market proximity. Once there, however, they pushed for small improvements in the business environment that would improve their prospects. In locations, where foreign investment was the dominant source of local revenue, they were more successful. In this sense, governance improvements followed foreign investment. In fact, many of key provisions of Public Administration Reform, the 2003 Land Law, and the 2000 Enterprise Law, which bolstered economic performance on a national level, began as individual provincial experiments in the early nineties. Song Be province (now Binh Duong and Binh Phuoc), Dong Nai, Ba Ria-Vung Tau, HCMC, and later Vinh Phuc and Long An were at the forefront of these policy experiments (Malesky 2004).

In understanding the present association between economic governance and investment attraction, these early fence-breaking experiments (*phá bỏ rào*) create a bit of a 'chicken and egg' quandary. What is most important for present FDI attraction, the provincial governance experiments of the early nineties or the large presence of foreign investors that may have spawned them? This is a very difficult question that is complicated to settle empirically. The bottom-line is that both factors led to first-mover advantages for a handful of provinces that continues to this day. With very few exceptions, the largest recipients of foreign investment in 1994 are the largest recipients today.

3. Types of Policies

The concept of economic governance can be all-encompassing and rather vague. For both foreign investors and provincial officials trying to improve policies, it is far more useful to dissect the impact of economic governance by individual sub-indices. In Table 3 below, this analysis is performed. The table provides the regression coefficients from a series of regression equation using the sub-indices as independent variables. Coefficients that were transformed into natural logs for the analysis are converted into percentage changes in the table to ease interpretation. Stars denote whether or not a particular sub-index has a statistically significant relationship with the dependent variable in the fully specified model. It is immediately obvious that different aspects of governance are associated with particular dependent variables.

3.1. FDI Attraction

Two policy arenas have significant associations with investment attraction – the transparency and equity of business information and private sector development policies. Transparency is a measure of whether firms have access to the proper planning and legal documents necessary to run their business, whether those documents are equitably available, whether new policies and laws are communicated to firms and predictably implemented, and the business utility of the provincial web page. Foreign firms clearly benefit from access to these provincial materials. In fact, a one-point (10%) improvement in transparency is associated with a 36% increase in newly-registered investment projects. One critical source of this information for foreign investors is provincial web pages. Many Vietnamese provinces have highly sophisticated web pages, detailing provincial regulations, the location of industrial zones, and charting

investment incentives (See VNCI 2006: 30 for more detail). They often also provide application forms for registration, licenses, and land use right certificates (LURCs). Considering just the impact of a one-point improvement on the twenty-point PCI diagnosis of provincial web-pages, we find that this would yield an expected 5% increase in new provincial FDI projects.

Private Sector Development Policies (PSD) measures the provincial services for private sector trade promotion, provision of regulatory information to firms, business partner matchmaking, provision of industrial zones or industrial clusters, and technological services for firms. The index was designed specifically with the private sector in mind, but also has very strong implications for the foreign sector as well. Further analysis reveals that foreign firms are particularly attracted to locations where provincial governments assist private entrepreneurs in the acquisition and use of new technologies. This likely improves the quality of the intermediate goods that FIEs can acquire form local producers.

3.2. Implementation

A different set of factors impacts implementation of investment. Transparency and PSD remain important, but Column 2 catalogues new variables with statistically significant relationships. Key among these are Land Access and Security of Tenure and Confidence Legal Institutions.

Land Access combines two dimensions of the land problems confronting private entrepreneurs: how easy it is to access land and the security of tenure once land is acquired. The first dimension comprises whether firms possess their official land use rights certificate, whether they have enough land for their business expansion requirements, whether they are renting from SOEs and an assessment of land conversion efforts. The second dimension includes perceptions of various tenure security risks (such as expropriation, unfair compensation values, or changes in the lease contract) as well as the duration of tenure. At its essence, Land Access is about the ability to acquire and maintain property rights.

Interestingly, neither aspect of Land Access was robustly correlated with domestic, private sector outcome variables. As a result of this, it received the lowest possible weight in the weighted PCI score. The sub-index, however, is strongly correlated with implementation of foreign investment projects. All else equal a one-point improvement on Land Access & Security of Tenure leads to an estimated 15% increase in implementation rates. This result makes a great deal of sense, foreign investors want to feel confident in the security of their investment before committing greater resources. They may be attracted to a location of other reasons, but will hold off committing the full amount until they feel secure about their property rights.

A similar logic is evident behind the result of Confidence in Legal Institutions, which consists of whether firms regard provincial legal institutions as an effective vehicle for dispute resolution, or as an avenue for lodging appeals against corrupt official behavior. As with Land Access, this variable does not appear to be associated with initial investment decisions, but has a strong influence on implementation rates. Once again, it appears FIEs are willing to test the waters by signing large investment licenses, but are more likely to implement their projects when they can enforce their contracts in a court of law.

3.3. Additional Investment

What governance factors are influential in firm decision to expand an existing project? We have already determined that previous profitability is the strongest general indicator, but governance plays an important role here as well. The sub-indices with the two largest substantive effects are Land Access (a 1-point shift yields a 48% increase in additional investment relative to other provinces!) and PSD.

Two other factors also have quite large substantive effects – 1) Proactivity, which captures the creativity and cleverness of provinces in both implementing central policy, designing their own initiatives for private sector development, and working within sometimes unclear national regulatory frameworks to assist and interpret in favor of local private firms, and 2) Labor Policies, which measures the efforts of provincial authorities to promote vocational training and skills development for local industries and to assist in the placement of local labor.

These results are important. The Proactivity finding indicates that FIEs most likely to expand their projects when their experience has taught them that local officials have a positive attitude toward the business sector and are willing to work with investors in clearing regulatory obstacles. The Labor Policy result echoes a consistent refrain from foreign investors over the years. They feel constrained by the limited skill sets of the existing labor supply. Expansion is contingent on whether they can find the appropriate managerial and technical talent. Firm-level training is always a possibility, but can be self-defeating if competitors simply poach the newly trained labor. As a result, provinces with relatively high-level vocational training for the existing labor pool have a major competitive advantage.

Table 3: Relationship between FDI and Individual Sub-Indices

2006 Sub-Index Score	New FDI Projects Licensed in 2006 (% Change)†	Implementation Rate (Implemented FDI /Registered FDI, (%))	Additional Capital for Existing Projects in 2006 (% Change)†
1 Entry Costs	-11.49 (0.18)	1.436 (3.82)	10.16 (0.21)
2 Land Access & Security of Tenure	3.76 (0.13)	15.03 (3.26)***	43.48 (0.19)*
3 Transparency	36.21 (0.11)***	5.82 (2.60)**	19.84 -0.12
4 Time Costs of Regulatory Compliance	10.19 (0.25)	-3.175 (5.21)	-2.01 (0.29)
5 Informal Charges	-9.13 (0.18)	3.848 (5.05)	-22.59 (0.25)
6 Bias toward State Owned Enterprises	19.72 (0.23)	5.808 (5.36)	28.27 (0.25)
7 Proactivity	13.43 (0.095)	4.978 (1.75)***	20.68 (0.089)**
8 Private Sector Development Policies	25.61 (0.099)**	5.096 (2.46)**	35.53 (0.10)***
9 Labor Policies	17.23 (0.11)	4.749 (2.24)**	21.17 (0.11)*
10 Legal Institutions	7.87 (0.16)	10.03 (3.85)**	41.20 (0.21)

OLS Regression; Robust standard errors in parentheses. All dependent variables are from MPI 2006, Sub-Indices are from VNCI 2006
*** p<0.01, ** p<0.05, * p<0.1; ln indicates natural log taken.; Dummy denotes dichotomous dependent variables.
All are results of multiple regression countrolling for National City Dummy, Distance from Hanoi and HCMC (km), Telephones per Capita (1995), and Percentage of Secondary School Graduates, GDP per capita (2005), Population (2005), lagged FDI (2005)
† Regrression coefficients (β) with natural logs are converted to percentages using the following formula (e^{β}-1)*100.

4. The Impact of the New Provincial Fence-Breaking

As mentioned above, in the early and mid-nineties a handful of provinces led the country in experimenting with regulatory reforms beneficial to the performance of foreign investors and the private sector. These experiments, known at the time as fence-breaking (*phá bỏ rào*), had long-lasting implications for the economic growth and welfare in those provinces, but played an important role in the development of major national-level economic reform initiatives.

In recent years, a different type of fence-breaking has begun to emerge. This new fence-breaking , which is often translated as *xé rào* by Vietnamese journalists, is fundamentally different from its predecessors.[2] Rather than experimenting with general and long-term reforms in economic governance and business regulation, these provinces have chosen an alternative short-cut. They have simply begun to offer tax and land incentives in excess of national regulations. Such incentives include tax holidays as long as twenty years, free land rental for foreign invested projects, and lower profits taxes (Thai Press Reports 2006). These policies are on-off gifts to new investors. As an official from Binh Duong's Department of Planning and Investment (DPI) noted, "Incentives are merely cosmetic and are thus unsustainable," - a bit like putting lipstick on a pig (MPDF 2004). Contrasting the new fence-breaking with Binh Duong's own

[2] It is interesting that Vietnamese journalists have begun to substitute the lighter *xé rào*, which means tear, in their descriptions of fence-breaking. *Phá bỏ rào*, the term commonly used to describe the earlier activities (popularized by Fforde and de Vylder 1996) has a much stronger connotation of breaking-down the fences.

experience, “What's most important is to create a transparent and enabling business environment,” (MPDF 2004).

In July 2005, the Ministry of Finance cited 33 provinces which had provided tax incentives beyond those permitted under central law (Burke and Nguyen 2005, Vu Long 2005). These incentives were declared invalid by the General Department of Taxation and consequently the Vietnamese government moved to terminate them.

Confirming the Binh Duong official’s claim that the new fence-breaking is fundamentally different from the general regulatory improvements that took place in early years, Table 4 documents that these new super incentives are negatively correlated with the older cases of Fence-Breaking and with Economic Governance today. This finding implies that different sets of provinces are engaged in super incentives than those that engaged in early fence-breaking. By contrast, the early fence-breaking experiments paved the way for the performance of provinces on the overall PCI scores and on the specific PCI pro-activity index.

Table 4: Bivariate Correlations between New Fence-breaking, Old Fence-Breaking, and Economic Governance

Variables	***1***	***2***	***3***	***4***
1 Super Incentives (New Fence-Breaking)	1			
2 Cases of Early Fence-Breaking (1990-2000)	-0.1267	1		
3 PCI Proactivity Sub-Index 2006	0.0163	0.2938*	1	
4 Final PCI Score 2006	0.0723	0.3923*	0.7945*	1

* Indicates Statistical Significance at the 5% level
Super Incentives derived from Ministry of Finance 2005 (See VIR 2005a for list of provinces).
Early Fence-Breaking is from Malesky 2004
PCI scores are from VNCI 2006

Less developed provinces, however, argued that these super-incentives were necessary to make up for the deficiencies in endowments. They were catching up for lost time. Detailed survey analysis, however, has shown that incentives tend to be more wasteful than effective. Investment incentives play only a limited role in investors’ location decisions. As a result, they tend to be duplicative, granting to investors bonuses for decisions they would have made anyway (VNCI 2004, FIAS 2003).

To test this hypothesis in Appendix 1 (Models 4, 8, and 12), I include a dummy variable measuring whether a province provided super incentives in excess of national regulation in 2005 and 2006. This variable is uncorrelated with investment attraction, implementation, and additional incentives in the fully specified models. In short, the new form of fence-breaking is distinguished from its predecessor, not only in its time-frame but also in its utility. Investors do not appear to consider super incentives in their long-term decisions.

More surprisingly, super incentives do not even appear to lead to higher FIE profitability. Despite the significant discounts on taxes and land fees registered to investors over the time period, according to data from the GDO enterprise census, the average foreign investors is over four times more profitable in provinces without super-incentives (23.8 Billion VND per year) than with them (5.5 Billion VND per year).

Worse yet, provincial officials contemplating super incentives should keep in mind that they are notoriously hard to rescind. Investors are wont to surrender tax breaks to which they have become

accustomed. In fact, one of the key reasons FIEs have resisted re-registering their operations under the 2005 Investment Law is because they fear their existing investment incentives will not be grandfathered into the future (VIR 2007).

5. Conclusion

In this analysis, I have endeavored to show that recent FDI attraction is correlated with economic governance, even if the governance measure itself is derived from domestic private sector perceptions. Because of fundamental problems with the way FDI is measured and because most analyses of FDI are mere snapshots of a long term and dynamic process, it makes more sense to focus on other outcome variables related to FDI. Here, the impact of governance is even more striking. Better governance is strongly associated with FDI implementation rates and the decisions of FIEs to add capital to existing projects.

Different dimensions of economic governance have varying effects on these three outcome variables. Transparency of regulatory information and private sector development services, such as trade fairs and technology training, are strongly associated with investment attraction. Implementation rates, however, are most strongly influenced by the access to and security of property rights as well as the ability to defend those rights in provincial courts. It appears that FIEs are willing to sign large investment projects for a range of different factors, but this initial decision is merely an opportunity to test the waters. Whether they decide to fulfill their investment commitments is strongly influenced by whether they believe their business premises, materials, and contracts will be securely defended into the future. This is a critical finding for Vietnamese policy makers. Systematic legal reform is of utmost importance is ensuring sustained commitments of FIEs in Vietnam. When it comes to the decision to expand existing projects, property rights remain influential, but investors are also appear to pay careful attention to the demonstrated pro-activity of the local leadership and the availability labor training facilities, which can meet their expansion needs.

Finally, I have shown that the new form of fence-breaking through excess incentives is not only illegal and fundamentally different from the fence-breaking of the early nineties, but inefficient and damaging as well. Provinces offering these incentives have seen limited gains in terms of FDI attraction, implementation, and profitability.

These findings offer important insights for the present decentralization and PAR campaigns taking place. Good governance has enormous benefits for economic growth and welfare. As more responsibilities are delegated to local leaders, efficient local regulations and creative new policies will assume even greater importance. Every effort should be made to communicate the best practices of well-governed provinces to all local leaders. Without such an effort, Vietnam risks a division of its provinces into two groups: 1) Well-governed and well-endowed localities capable of investment attraction, efficiency, and growth; and 2) Poorly governed provinces increasingly dependent on state investment and transfers.

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Appendix 1: Multiple Regression Analysis of Foreign Direct Investment and Economic Governance

Dependent Variables /Coefficient	New FDI Projects Licensed in 2006 (ln)				Implementation Rate (Implemented FDI /Registered FDI, (%))				Additional Capital for Existing Projects in 2006 (ln)			
Model	*(1)*	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*	*(8)*	*(9)*	*(10)*	*(11)*	*(12)*
Weighted 2006 PCI Score	0.0375**	0.000365		0.0365**	1.128***	1.159***	1.005**	0.988**	0.0624**	0.0464**	0.0419**	0.0422*
	(0.017)	(0.012)		(0.017)	(0.41)	(0.42)	(0.39)	(0.40)	(0.024)	(0.021)	(0.021)	(0.021)
GDP per Capita 2005	3.36E-09	5.51E-09		3.72E-09	5.18E-08	6.14E-08	-1.60E-08	-1.41E-08	3.83E-10	-1.09E-10	-3.35E-11	-3.39E-11
	(2.8e-09)	(1.9e-09)		(2.8e-09)	(7.1e-08)	(7.4e-08)	(7.2e-08)	(7.8e-08)	(4e-09)	(3.7e-09)	(3.8e-09)	(3.9e-09)
Population in 1000s of Citizens	0.000105	-0.0000426		0.0000918	0.00580	0.00683	0.00414	0.00382	0.000159	-0.000372	-0.000451*	-0.000444*
	(0.00017)	(0.00012)		(0.00018)	(0.0043)	(0.0050)	(0.0047)	(0.0049)	(0.00025)	(0.00025)	(0.00025)	(0.00026)
Distance from Metropolises	-0.00177***	-0.000858*		-0.00190***	-0.0223	-0.0237	-0.0322**	-0.0336**	-0.00140	-0.000675	-0.000923	-0.000893
	(0.00065)	(0.00045)		(0.00071)	(0.016)	(0.017)	(0.015)	(0.016)	(0.00092)	(0.00083)	(0.00082)	(0.00087)
Telephones per Capita 1995	6.178***	0.816		6.286***	20.43	35.18	27.05	25.92	9.473***	1.891	1.653	1.677
	(2.30)	(1.69)		(2.32)	(57.2)	(67.7)	(62.1)	(62.7)	(3.28)	(3.37)	(3.30)	(3.34)
Secondary School Graduates	0.0323	-0.00918		0.0302	0.157	0.136	-0.344	-0.356	0.0306	0.0415	0.0274	0.0277
	(0.022)	(0.016)		(0.023)	(0.55)	(0.55)	(0.53)	(0.53)	(0.031)	(0.028)	(0.028)	(0.028)
City Dummy	0.101	0.225		0.114	4.170	3.878	6.334	6.509	-0.561	-0.411	-0.339	-0.343
	(0.67)	(0.45)		(0.68)	(16.7)	(16.8)	(15.4)	(15.6)	(0.96)	(0.84)	(0.82)	(0.83)
Natural Log of Projects in 2005		0.734***	0.807***									
		(0.090)	(0.053)									
Super Incentives Dummy				0.131				1.996				-0.0415
				(0.28)				(7.42)				(0.39)
Total Investment Stock in 2005						-1.02e-09	-8.99e-10	-6.93e-10		5.25e-10***	5.29e-10***	5.25e-10***
						(2.47e-09)	(2.26e-09)	(2.40e-09)		(1.23e-10)	(1.20e-10)	(1.28e-10)
Natural Log of Profit per Enterprise							2.849***	2.753***			0.0833*	0.0852*
							(0.84)	(0.91)			(0.044)	(0.049)
Ba Ria - Vung Tau Dummy												
Constant	-3.802*	0.264	-0.941***	-3.579	-27.08	-28.46	19.95	22.01	-5.424*	-4.716*	-3.301	-3.344
	(2.15)	(1.54)	(0.18)	(2.22)	(53.6)	(54.1)	(51.5)	(52.5)	(3.07)	(2.69)	(2.74)	(2.79)
Observations	64	64	64	64	64	64	64	64	64	64	64	64
R-squared	0.56	0.80	0.79	0.57	0.32	0.32	0.44	0.44	0.48	0.61	0.64	0.64
Root Mean Squared Errpr	1.003	0.680	0.667	1.010	24.98	25.17	23.05	23.25	1.434	1.253	1.225	1.237

All models use OLS analysis on province-level data; Standard errors in parentheses; *** p<0.01, ** p<0.05, * p<0.1
ln denotes natural log; dummy denotes dichotomous dependent variable.
Data on FDI derived from Ministry of Planning and Investment, Foreign Investment Agency data.
Weighted PCI from VNCI & VCCI 2006
Control Variables from GSO *Statistical Handbook* 2006