Perfecting Fiscal Decentralization to Increase Economic Growth in Vietnam

SỬ ĐÌNH THÀNH

Associate Professor, Doctor of Philosophy, University of Economics - HCMC

Email: dinhthanh@ueh.edu.vn

MAI ĐÌNH LÂM

Master of Arts, Ho Chi Minh National Academy of Politics and Public Administration

Email: maidinhlam2006@yahoo.com

ABSTRACT

The government intervention in the economy is practical and widely acknowledged. The central government expenditure, like budget incomes, is to regulate the national economy. According to Keynes (1936), the government should aim at demand-side stimuli to facilitate consumption and production. This paper identifies negative impacts of budget expenditure decentralization on Vietnam's economic growth; and positive impacts of central government expenditure, private investments and trade openness on the economic growth as well. Additionally, no relationship between inflation rate along with changes in labor force and economic growth is found.

Keywords: economic growth, budget expenditure, private investment, trade openness, labor force, inflation.

1. INTRODUCTION

In order to promote economic growth, budget expenditures by authorities of any levels must be thoroughly weighed up. Fiscal decentralization and empowerment of lower authorities are part of public section reform that aims at enhancing competitiveness of lower authorities in provision of public services and getting out of the clumsiness of the economy (Bahl & Linn, 1992; Bird, Ebel & Wallich, 1993). In the world there have been plenty of researches on impacts of budget expenditure decentralization on economic growth. In Vietnam, some examples are those by Hoàng Thị Chinh Thon et al. (2010) and Phạm Thế Anh (2008). Yet, their papers just dealt with a specific locality but not the whole national economy. Hence, the present paper is to investigate such impact on Vietnam's national economy as a whole.

2. LITERATURE REVIEW

There have been numerous researches on impacts of budget expenditure decentralization on economic growth such as that of Mankiw, Romer and Weil (1992) which failed to manifest the role of government expenditure in economic growth. Kormedi and Meguire (1985) and Barro (1991) did employ data of many different economies and utilized multiple regressions to explain different growth rates in surveyed countries in the long term; and variables were opted in accordance with growth theories and speculations. But these two papers produced different results. Kormendi and Meguire (1985) contended that government expenditure had no impact on the economic growth while Barro (1991) proved vice versa.

Davoodi, Swaroop and Zou (1996), using data from 43 countries and in more than 20 years of researching, indicated that enhancement of investment expenditure had negative impacts on the economic growth whereas increases in recurrent expenditure had positive impacts. Ghosh and Gregoriou (2008) employed the generalized method of moments (GMM) to analyze the data collated from 15 developing countries in a 28-year period and obtained the same results. As their empirical research indicated, recurrent expenditure but not investment expenditure was significant to economic growth.

Nguyễn Phi Lân (2008) analyzed the data of 34 provinces and cities of Vietnam in the period 2000-2005 by the parametric approach (based on the random production function) and the non-parametric approach (based on DEA). He posited that the ineffectiveness of public expenditure existed in annual public expenditure and

investment. Phạm Thế Anh(2008) employed data of 61 provinces and cities of Vietnam in the period 2001-2005; and analyzed investment expenditure and recurrent expenditure in five different industries. The research indicated more positive impacts of investment expenditure compared with recurrent expenditure in some industries and vice versa in other fields.

Hoàng Thị Chinh Thon et al. (2010) studied how public expenditure at province and district levels influenced the local economic growth by a regression model. Using data collated from 31 localities in Vietnam, she showed that expenditure at district level should be increased and that at province level should be decreased so as to stimulate the local economic growth.

3. RESEARCH MODEL

In this paper, the author employed the data collated in the period 1990-2011 and the neoclassical production function with expansion of endogenous variables. Indeed, if the technical factor (A) is ignored, the comprehensive production function can be simplified as below:

$$Y = f(K, L) \quad (1)$$

Where, Y denotes the production yield; K is the private investment; and L represents the labor force.

Regarding capital formation and stimulation of aggregate demand, Ram (1986), with the time series data of 115 countries, employed the extended production function associated with a variable of government total expenditure (G) to reach the conclusion that central government expenditure (G) was just one of factors affecting the economic growth. Moreover, Yingyi Qian and Meredith Woo-Cumings, when studying the government and public sector reform in South Korea, as quoted by Yusuf and Stiglitz (2002), emphasized the role of public expenditure in promoting private investment and realizing development targets. Like previous researches, this one included the variable of government expenditure (G) as an independent input factor related to formation of capital needed for economic growth.

$$Y = f(K, L, G) \quad (2)$$

Concerning fiscal decentralization, G is divided into central government expenditure (TW) and local authorities expenditure (DF); and thus: $G = TW + DF$

To evaluate impacts of fiscal decentralization on economic growth, local budget expenditures can be divided into investment expenditure (DF^I) and recurrent expenditure (DF^C). We have:

$DF = DF^I + DF^C$.

And thus: $Y = f(K, L, TW, DF^I, DF^C)$

The variable of inflation rate (*lp*) can be added to the model to evaluate its impacts on the economic growth, and the trade openness (*xnk*) to evaluate the international integration of Vietnam's economy. Then the gross production function of six macroeconomic variables can be rewritten as follows:

$$Y = f(K, L, TW, DF^I, DF^C, lp, xnk) \quad (3)$$

Taking the derivative the function (3) of Y (excluding the inflation rate - *lp*), we have the equation (4) as follows:

$$dY/Y = (\partial Y/\partial K)dK/Y + (\partial Y/\partial TW)dTW/Y + (\partial Y/\partial DF^I)dDF^I/Y + (\partial Y/\partial DF^C)dDF^C/Y + (\partial Y/\partial xnk)dxnk/Y + (\partial Y/\partial L)dL/L + (\partial Y/\partial lp)dlp/lp \quad (4)$$

where $\partial Y/\partial K$, $\partial Y/\partial lp$, $\partial Y/\partial TW$, $\partial Y/\partial DF^I$ and $\partial Y/\partial DF^C$ are respectively the marginal factor of capital, inflation, central government expenditure, investment expenditure, and recurrent expenditure in comparison with GDP. $\partial Y/\partial xnk$ and $\partial Y/\partial L$ are respectively the marginal factor of trade openness and labor force.

4. RELATIONSHIP BETWEEN FISCAL DECENTRALIZATION AND ECONOMIC GROWTH

Pursuant to the applicable National Budget Law, local authorities mainly assume responsibility for provision of public services within the locality. When assigning expenditure responsibilities, it is expected that local budget expenditures might generate a higher demand side in the local economy and thereby promoting the local and national economic growth.

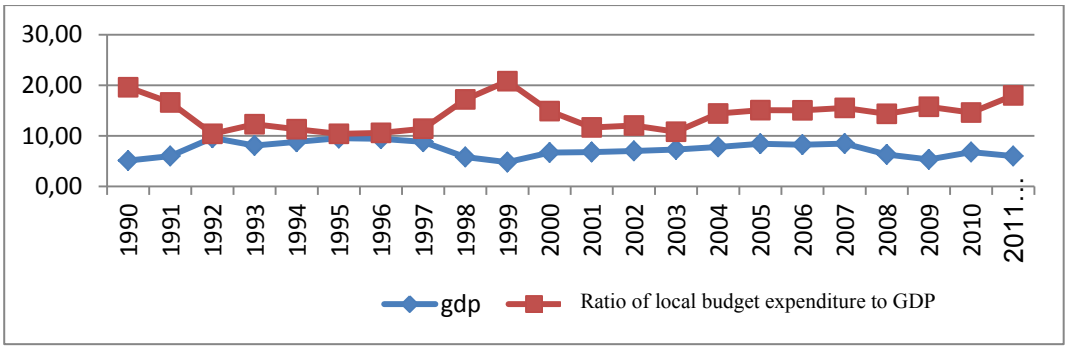

Figure 1: The Relationship between the Ratio of Local Budget Expenditure to GDP and the GDP Growth Rate (as %)

Source: GSO and Ministry of Finance, 1990-2011

It is possible to preliminarily evaluate the relationship between budget expenditure delegation and economic growth as follows:

- For the period 1990 – 1996: delegation of budget expenditure to local authorities reached a high of 19% of GDP in 1990, which then fell in 1992; yet Vietnam's economic growth was quite high, over 8%. In the period 1994 – 1996, GDP was rising steadily while the ratio of local budget expenditure to GDP went down. In short, in this period, the relationship between budget expenditure delegation and economic growth was negative.

- For the period 1997 – 2003: After the 2006 National Budget Law, the ratio of budget expenditure delegated soared swiftly. The economic growth reached 8.8% in 1997 and then gradually fell in the following years. This accounted for inefficiency in budget expenditures, especially recurrent ones. In this period, the Asian economic recession also profoundly influenced Vietnamese economy. The economic growth pace only recovered in 2002 and 2003 to 7% and 7.3% respectively.

- For the period 2004 – 2011: The ratio of local budget expenditure to GDP grew unsteadily. The GDP in this period was quite high, 7.8% in 2004, 8.44% in 2005, 8.23% in 2006 and 8.46% in 2007. Yet in 2008, the growth rate was merely 6.31% due to the recession of the world economy; and then was falling in the following years. This indicated that although local authorities were provided with more expenditure responsibilities, budget incomes were not properly assigned, causing the central government to constantly make up for local budgets. It is a weakness of budget decentralization in Vietnam. In this period, the relationship between assignment of

expenditure responsibilities and economic growth was negative, which will be clarified in following sections of the paper.

The local budget expenditures are also divided into local investment expenditures and local recurrent expenditures. Figure 2 indicates the relationship between the ratio of local investment expenditure to GDP and economic growth rate.

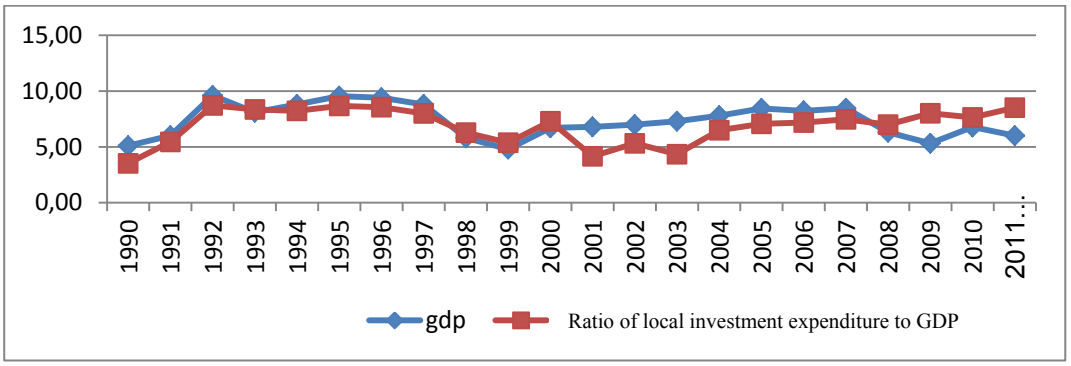

Figure 2: The Relationship between the Ratio of Local Investment Expenditure to GDP and the Economic Growth Rate (as %)

Source: GSO and Ministry of Finance, 1990-2011

As Figure 2 shows, the local investment expenditure in the period 1990 – 2000 was financed by local budget incomes and balanced revenues, or by targeted transfers from central government determined by the GDP growth rate. This indicates that public expenditures by local authorities are still a fundamental factor to promote the economic growth in the years 1990-2000. In the next decade (2001 – 2011), however, the trend of local investment expenditure and GDP growth rate was opposite, which might be explained by the ineffectiveness of local investment expenditures and high ICOR; and thus it could not stimulate the economic development.

It is questioned whether or not it is necessary to change the scale of local expenditures with a view to improving the economic growth. In fact, Vietnam's economic growth, as from 1997, cannot be merely explained by the fiscal decentralization. It is generally admitted that Vietnam, after the 1997 financial crisis, has adopted many dynamic policies to stimulate the economic growth such as: encouraging private business, attracting foreign investments, promoting foreign trade and liberating the financial system, etc.

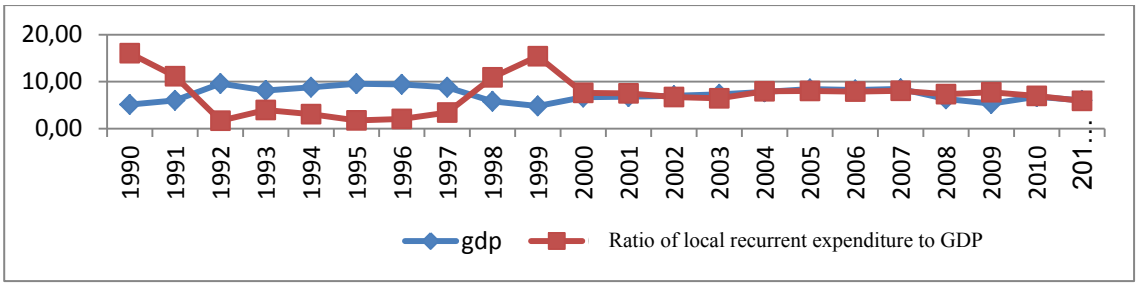

Figure 3: The Relationship Between the Ratio of Local Recurrent Expenditure to GDP and the Economic Growth Rate (as %)

Source: GSO and Ministry of Finance, 1990-2011

Additionally, private investment, trade openness and inflation are also able to promote or hinder the economic growth.

5. RESEARCH MODEL AND RESULTS

a. Research Model:

Before estimation, the equation (4) is rewritten as:

$$dY/Y = (\partial Y/\partial K)dK/Y + (\partial Y/\partial TW)dTW/Y + (\partial Y/\partial DF^{I})dDF^{I}/Y + (\partial Y/\partial DF^{C})dDF^{C}/Y + (\partial Y/\partial xnk)dxnk/Y + (\partial Y/\partial L)dL/L + (\partial Y/\partial lp)dlp/lp \quad (5)$$

where, *dY/Y* is the annual GDP growth rate; *dK/Y, I/Y* or *PI* is the ratio of private investment to GDP; *dL/L* or *PGR* is the labor force fluctuation ratio; *dlp/lp* or *inf* is the inflation rate; *dTW/Y* or *CG* is the ratio of central government expenditure to GDP; *dDF/Y* or *LG* is the ratio of local budget expenditure to GDP; dDF^{I}/Y or LG^{I} is the local investment expenditure to GDP; dDF^{C}/Y or LG^{C} is the ratio of local recurrent expenditure to GDP; *dxnk/Y* or *TOP* is the ratio of total export and import turnover to GDP which is used to measure the economic openness.

With:

$\partial Y/\partial K = \alpha_1$; $\partial Y/\partial TW = \alpha_2$; $\partial Y/\partial DF^{I} = \alpha_3$; $\partial Y/\partial DF^{C} = \alpha_4$; $\partial Y/\partial xnk = \alpha_5$; $\partial Y/\partial L = \alpha_6$; $\partial Y/\partial lp = \alpha_7$

After adjustment, equation (5) is rewritten as follows:

$$GDP_t = \alpha_o + \alpha_1 PI_t + \alpha_2 CG_t + \alpha_3 LG_t^{I} + \alpha_4 LG_t^{C} + \alpha_5 TOP + \alpha_6 PGR_t + \alpha_7 \inf_t$$

The equation (5) indicates that the economic growth depends on variables *CG, LG^I, LG^C, PI, PGR, inf* and *TOP*.

In order to test the research mode, the statistical equation (6) below is employed.

$$GDP_t = \alpha_o + \alpha_1 PI_t + \alpha_2 CG_t + \alpha_3 LG_t^I + \alpha_4 LG_t^C + \alpha_5 TOP_t + \alpha_6 PGR_t + \alpha_7 \inf_t + \varepsilon_t \quad (6)$$

In the model, the yearly data are mainly secondary numerical data. Specifically, economic growth rates are collated from GSO; local budget expenditure and income from the Ministry of Finance and the official website of Vietnam's government (www.chinhphu.vn); private investments, economic openness and inflation rate from the Ministry of Industry and Commerce and GSO, website of Vietnam's General Department of Customs, Asian Development Bank, and author's computation. Such data are summarized in Table 1.

Table 1: Mean Values Stat.

	N	Mean	Medium	Max	Min	Standard deviation	Skewness	Kurtosis
GDP	22	7.251274	7.210677	9.54048	4.773587	1.402967	-0.135299	1.900928
CHI	22	14.05455	14.425	20.8	10.4	2.910113	0.585084	2.747044
XNK	23	112.6054	111.51	171.05	57.90446	36.17004	0.159929	1.718312
DXNK	21	4.117979	6.21	23.41554	-24.1	11.87252	-0.680727	3.077509
INF	22	13.56088	7.572459	67.5	-1.710337	18.37987	2.344822	7.361105
TXU	22	7.162727	7.415	16.07	1.68	3.843113	0.663807	3.303848
PI	22	18.67773	17.91	29.21	8.92	5.487388	0.284784	2.201123
DPI	21	0.765714	0.54	6.67	-3.04	2.233131	0.570485	3.598534
PGR	22	2.807500	2.700000	4.400000	2.270000	0.489370	1.891747	6.767838
DTU	22	6.891818	7.235	8.72	3.53	1.575187	-0.700082	2.337979

b. Test Results:

- Stationarity testing:

The Augmented Dickey – Fuller (ADF) is employed to test whether or not the time series data set is stationary. Results are in Table 2.

Table 2: Testing Stationarity of Variables

Variable	t-stat	ρ-value*
GDP	(-2.796216)***	0.0766
LG	(-3.736389)**	0.0116
Inf	(-3.732253)**	0.0113
TOP	(-0.395555)***	0.8931
dTOP	(-7.465247)*	0.0000
PI	(-1.893055)***	0.3288
dPI	(-3.146345)**	0.0391
PGR	(-3.808546)*	0.0002
LG^C	(-3.586455)**	0.0160
LG^I	(-2.908097)***	0.0612
CG	(-3.674329)**	0.0152

N.B.: ***, **, * respectively denote the statistical significance level of 10%, 5% and 1%.

As Table 2 indicates, the time series data set of *GDP* is stationary with the significance level of 10%. Due to the fact that the number of observations is too small, the significance level of 10% is deemed as an acceptable standard in the present research. Also, *LG, LG^C*, and *CG* are stationary with the significance level of 5%; while *PGR* at 1% and *LG^I* at 10%. Due to the fact that *TOP* and *PI* are not stationary at the acceptable significance level, the authors find their simple difference (*dTOP* and *dPI*) to test their stationarity; and the results show that *dTOP* and *dPI* are respectively stationary at the significance of 1% and 5%.

- Testing results:

With

$$GDP_t = \alpha_o + \alpha_1 PI_t + \alpha_2 CG_t + \alpha_3 LG_t^I + \alpha_4 LG_t^C + \alpha_5 TOP_t + \alpha_6 PGR_t + \alpha_7 \inf_t + \varepsilon_t$$

The OLS method is employed to evaluate the relationship between annual GDP growth rate and independent variables *LG* and *CG*. Others including *PI, PGR, inf* and *TOP* play as control variables. The evaluation results are presented in Table 3.

Table 3: Estimation Results

Dependent variable: GDP

Variable	Coefficient	Standard error	t-stat	ρ-value
C	6.517989	1.995318	3.266642	0.0061
CG	0.154292	0.068879	2.240054	0.0432
LG	-0.221588	0.073067	-3.032678	0.0096
dPI	1.806852	0.869443	2.078172	0.0581
dTOP	0.038596	0.016573	2.328834	0.0366
PGR	-0.051192	0.367434	-0.139323	0.8913
inf	0.002157	0.012440	0.173380	0.8650
R-squared	0.818911	Mean dependent var		7.426356
Adjusted R-squared	0.735331	S.D. dependent var		1.343045
S.E. of regression	0.690943	Akaike info criterion		2.367697
Sum squared resid.	6.206221	Schwarz criterion		2.716203
Log likelihood	-16.67697	Hannan-Quinn criter.		2.435729
F-stat	9.797969	Durbin-Watson stat		1.635265
ρ-value	0.000340			

As Table 3 indicates, at the significance level of 10%, most variables are statistically significant, excluding the inflation rate and population growth rate; and this is consistent with the theoretical background. The inflation rate has a bidirectional relationship with economic growth rate, that is, it can accompany with a high economic growth rate due to the loose fiscal and monetary policies, and it can also hinder the economic growth rate when the fiscal and monetary policies are tightened. The population growth rate might not influence the economic growth rate of a developing country like Vietnam because the full employment is not secured and that the unemployment rate, both official and quasi-official one, is very high.

The Ramsey test is utilized to test whether or not a variable is not included in the model. The result shows it does not have omitted variable with the probability of 0.4545 (> 0.1); and thus the null hypothesis about the sufficiency of variables is not rejected. Also, after testing the normal distribution of an error by the Jarque–Bera method, the null hypothesis which says errors have normal distribution (p = 0.362119 > 0.1) is not rejected. For a small number of observations, such p-value is not rejected. Besides, the Lagrange multiplier test indicates there is no autocorrelation (p-value = 0.966 > 0.1). The Breusch-Pagan-Godfrey (BPG) test posits that the null hypothesis of homoskedasticity is not rejected (p-value = 0.7476 > 10%).

c. Regression Results:

Regression results indicate that the variables *dTOP* and *dPI* have a positive relationship with the economic growth rate at the significance of 5%. This implies that the economic openness positively affects the economic growth. This finding is factually correct in Vietnam where the private sector is the most dynamic and has contributed tremendously to the economic growth in past years.

Meanwhile, the variable *LG* retains a negative relationship with the economic growth (with α = 1%), or in other words, budget decentralization has a negative relationship with economic growth. The high budget expenditure ratio in localities has hindered the national economic growth as a whole. This finding is corresponding to that of Davoodi and Zou (1998) who pointed out a negative relationship between fiscal decentralization and economic growth in developing countries. The variable *CG*, by contrast, has a positive relationship with economic growth (with α = 1%). This implies that central government expenditure is still a strong backup for economic growth; and in past years, because the central government expenditure has been put in strategic infrastructure projects. Still, it is unquestioned that the economic growth has are heavily dependent on public investments.

The regression analysis keeps being used for two sub-items of local budget expenditure, that is, local investment expenditure (LG^I) and local recurrent expenditure (LG^C).

Table 4: Regression Results after Addition of LG^I and LG^C

Dependent variable: GDP				
Variable	**Coefficients**	**Standard deviation**	**t-stat**	**ρ-value**
C	6.712435	2.191369	3.063124	0.0098
CG	0.117849	0.152338	0.773602	0.4541
LG^I	-0.141659	0.304647	-0.464993	0.6503
LG^C	-0.222255	0.075859	-2.929852	0.0126
dTOP	0.039355	0.017424	2.258662	0.0433
dPI	1.726025	0.950250	1.816391	0.0944
PGR	-0.096166	0.415853	-0.231251	0.8210
Inf	0.003145	0.013414	0.234461	0.8186
R-squared	0.820011	Mean dependent var		7.426356
Adjusted R-squared	0.715018	S.D. dependent var		1.343045
S.E. of regression	0.716967	Akaike info criterion		2.461600
Sum squared resid	6.168500	Schwarz criterion		2.859893
Log likelihood	-16.61600	Hannan-Quinn criter.		2.539351
F-stat	7.810128	Durbin-Watson stat		1.583186
ρ-value	0.001116			

The addition of LG^I and LG^C to the model is to examine impacts of fiscal decentralization on economic growth in the period 1990 – 2011. As the results show, no relationship between local investment expenditure and economic growth is found; yet, the local recurrent expenditure has a positive relationship with the economic growth (with $\alpha = 5\%$). The research also identifies positive impacts of the economic openness and private investments on the economic growth. In the meantime, the inflation rate and labor force fluctuation do not affect the economic growth rate.

The results relating to other explanatory variables are consistent with the author's expectations: Trade openness and private investment affect positively the economic growth while inflation and population growth produce no effect on the economic growth.

As the empirical results indicate, it is possible to identify some basic reasons for negative impacts of fiscal decentralization on Vietnam's economic growth rate as follows:

Firstly, public investments by local authorities are not sufficiently effective due to lack of advance planning or thorough consultancy of practicality. Local budget and available resources have not been assigned in order of importance of strategic projects, which cannot stimulate the socioeconomic development. Moreover, investment decisions are not made in accordance with an appropriate legislation. Many projects whose related matters have not been thoroughly inspected are licensed anyway. When building an investment project, many localities have not paid due attention to thorough evaluation of pros and cons, making ineffective investment projects. Therefore, local public investment cannot play a crucial role in the national economic growth.

Secondly, local recurrent expenditure (such as on administration, culture, sports, etc.) has caused unnecessary waste of budget (Nguyễn Phi Lân, 2009). In addition, most of such expenditures are salary paid to state officials, including ones in VCP offices, which are based on a general salary scale while it is difficult to monitor the effectiveness of budget expenditure in connection with the payee's performance; and thus adversely affecting the economic growth.

Thirdly, the transparency and accountability is not properly attended to. As evaluated by Kaufmann et al. regarding the institutional quality (World Bank, 2002) and the International Transparency Organization (TI), Vietnam as yet has coped with the following barriers: the layperson's voice to the government and the authority's accountability are low; the policy quality and governance of state institutions have not been improved; legislation compliance is not stable; the transparency of policy is poor.

Fourthly, the monitoring and evaluation (M&E) system of Vietnam is not assured. For instance, the current M&E system just concentrates on the compliance with administrative procedures, and control over input and output factors, but not on evaluation of economic impacts of public expenditure on national strategic goals. It focuses on monitoring and evaluating the financial health of investment projects, but

not on the harmony of sustainable targets (i.e. socioeconomic and environmental goals). It focuses on improving the governance without attending to the people's satisfaction and social participation approach (Sử Đình Thành, 2012).

6. RECOMMENDATION

Based on the empirical research and testing results concerning impacts of fiscal decentralization on economic growth, it is recommended that:

- The investment expenditure should be improved as follows: (1) decentralization of investment expenditure must be combined with decentralization of zoning and planning management; (2) assignment of capital sources should not be dependent on group A, B or C, or hierarchical authorization; provincial authorities shall have the rights to decide local budget-sponsored plans and license foreign-invested projects with a close observation of the local socioeconomic development; (3) investment expenditure decentralization must specify the authority of management and utilization of assigned assets and accountability; and (4) it is necessary to improve and undertake the law on public investment, the urban law, the law on protection for national security and interests; clarify the procedure of recruiting state officials and other codes to create a synchronous legal system which can facilitate the decentralization of budget investment and governance.

- Monitor and evaluate public expenditure: The results indicate that local budget expenditure is not effective due to bad monitoring and evaluation of public expenditure. Therefore, it is necessary to regard the M&E system as a tool of public management (IMF, 2009) and treat the renovation of public management as a foundation for renovation of the current M&E system. To do so it is a must to apply the managerial regime and tools of the private sector to the public sector; attend to long-term targets; dispose of weaknesses of the new public management model by harmonizing civil rights and civil society.

- Enhance the transparency and accountability of local authorities: The accountability of local authorities must be specified in laws and by a suitable mechanism. It should be facilitated by more empowerment in the governance hierarchy. Enhancement of accountability must accompany with the transparency of national budget. Approved budget expenditures and related decisions must be publicized so as for people to monitor and evaluate.

As this research shows, no impact of the inflation rate on Vietnam's economic growth is found; yet the import and export and private investments have positive influence on economic growth. Therefore, local authorities should encourage private investments and promote export, as well as manage effectively public expenditure so as to curb inflation rate and enhance economic growth■

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